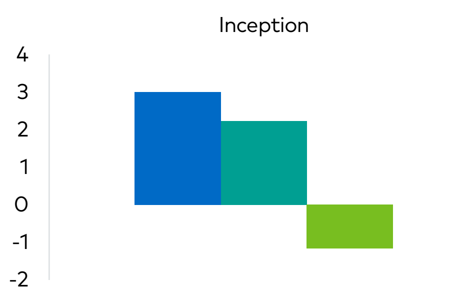
Polen Global Emerging Markets Growth

Portfolio Manager Commentary - September 2020

Summary

- Market momentum continued in the third quarter with emerging markets equity indices building on their strong rebound in the second quarter.
- The Polen Global Emerging Markets Growth Composite Portfolio (the "Portfolio") returned 9.59% gross of fees for the period, broadly in line with the MSCI Emerging Markets Index (the "Index) return of 9.57%. Year to date, the Portfolio has returned 3.00% gross of fees compared to -1.14% for the Index.
- During the quarter, we added to our stakes in Mercado Libre, Raia Drogasil, Alibaba, FEMSA, and President Chain Store. We reduced our weighting in United Spirits and eliminated our position in Emami.
- The Portfolio's performance reflects encouraging results for the third quarter as reported by our holdings, which we believe again demonstrates their resilience in tough economic environments.

Seeks Growth & Capital Preservation (Performance (%) as of 9-30-2020)



	Qtr	YTD	Inception
Polen Global Emerging Markets Growth (Gross)	9.59	3.00	3.00
Polen Global Emerging Markets Growth (Net)	9.33	2.23	2.23
MSCI Emerging Markets	9.57	-1.14	-1.14

The performance data quoted represents past performance and does not guarantee future results. Current performance may be lower or higher. Periods over one-year are annualized.

The commentary is not intended as a guarantee of profitable outcomes. Any forward-looking statements are based on certain expectations and assumptions that are susceptible to changes in circumstances.

Commentary

The Polen Global Emerging Markets Growth Composite Portfolio (the "Portfolio") returned 9.59% gross of fees for the period, broadly in line with the MSCI Emerging Markets Index (the "Index") return of 9.57%. Year to date, the Portfolio has returned 3.00% gross of fees compared to -1.14% for the Index.

As countries emerge from an intense period of lockdown, business activity is beginning to return. In most emerging markets, shops have reopened, and life on the streets is returning to normal. Almost all economic indicators are trending upwards, and the worst of the pandemic looks like it could be behind us. The magnitude of the lockdown-induced downturn, we believe, naturally implies that the pace of the recovery should also be dramatic. Many emerging economies are expected to grow between 5% and 10% in 2021. Sentiment is certainly improving.

Yet, the encouraging reopening trajectories and improved outlooks should not blind us to the severity of this current downturn. As rehearsed in our last letter, we think 2020 is set to be the first year of recession for emerging markets since the asset class gained formal relevance. Despite the rapid growth forecast for next year, as measured by GDP, most emerging economies are expected to go into 2022 smaller than they were in 2019. So, the going is likely to remain tough for some time.

As we look out to the remainder of the year and the early months of 2021, we believe a key indicator will be the extent of damage to financial systems. In most of our investee countries, government-mandated loan moratoriums have prevented bank loans from dropping into non-performing loan buckets.

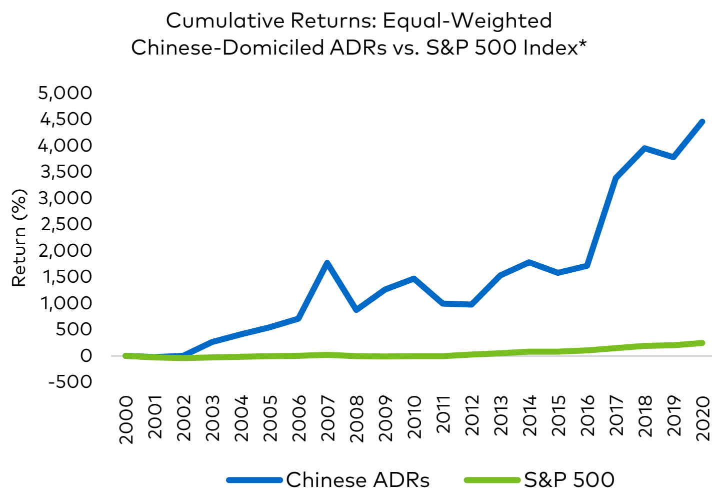
These moratoriums are generally set to roll off as we move into the fourth quarter. Logic suggests that given emerging economies have been unable to provide the sort of fiscal and monetary support we have seen in the west, there will likely be some systemic impairment of credit quality. We think the uncertainty principally surrounds its magnitude.

All this means that emerging markets' experiences of the pandemic are likely to be more severe than in the west, at least in the short term, in our view. On the positive side, there has been little borrowing off the future to pay for it all. Fiscal deficits have generally not ballooned as they have in the more developed countries, meaning that in most cases, government debt has increased only marginally. And monetary policy has, largely, remained orthodox. Economic adjustments have been allowed to happen, and though painful, we believe developing economies (particularly those in Asia) should emerge from this crisis with a strong foundation for the decade ahead.

Chinese ADRs

As the anti-China rhetoric has ramped up in the U.S., the SEC has been pushed to mandate higher standards of reporting for Chinese businesses listed in the U.S. Claims of fraudulent activity, like at Luckin Coffee and other companies, have prompted calls for the delisting of certain Chinese ADRs from U.S. markets. In a possible attempt to front-run these calls, a wave of Chinese businesses have recently sought secondary listing in Hong Kong, amongst them Alibaba, Netease (both current holdings in the Portfolio), JD.com, Yum China, and Huazhu Group.

Chinese businesses have been tapping U.S. capital markets for approximately 20 years, and at current count, nearly 300 Chinese companies are currently listed in America. As an exercise, we ran an internal index to track the performance of these companies. In the twenty years since September 2000, an equal-weighted basket of these companies would have returned an annualised figure of 21% in USD terms, assuming annual rebalancing. That works out as 45x your money over 20 years. That figure includes the companies that have gone to zero. We do not think this is too bad, given the sentiment surrounding these companies.



Until now at least, the average Chinese investor has been unable to participate in this wealth creation. Chinese capital controls ensure that domestic investment capital remains onshore, out of reach of U.S. markets. On the contrary, investors in the rest of the world, and in particular the U.S., have benefited most from the phenomenal progress of businesses like Alibaba. With the retreat of these companies back to their home market, we think this balance is likely to shift.

* Data from 9-30-2000 to 9-30-2020. Based on Chines ADRs being rebalanced annually.

Portfolio Activity

We made a number of adjustments to the Portfolio in the quarter, primarily shifting money towards existing holdings that we felt had either made a material step forward in their outlook as a result of the pandemic or whose share prices had significantly sold off on short-term concerns rather than long-term prospects. The aggregate magnitude of the transactions in the quarter represented 4.5% of the Portfolio, an implied run rate of 18% annualised turnover.

We added to Latin American e-commerce and fintech giant **Mercado Libre** despite a significant increase in share price year to date. In this case, we believe that Mercado Libre's stock price move genuinely reflects a dramatic increase in the fundamental value of its businesses. The pandemic has accelerated the shift to online commerce and digital payments in Brazil and the wider Latin America region. This degree of acceleration has likely leapfrogged forward two or three years of development for the business. Through the crisis, and despite the macroeconomic headwinds the region is facing, Mercado Libre has been able to grow many of its key KPIs at a rate of 100% or above. The company is likely to report a net loss this year, but we believe that the cost of heavy investments the business is making today is hiding its inherent underlying profitability. These investments, we believe, will further cement its market leadership and pave the way for many more years of rapid growth and, ultimately, substantial profits.

Valuation is typically the issue with Mercado Libre. Given the structural step forward it has made this year, however, we believe that an investment at this level will yield attractive long-term returns. In the short term, there is scope for volatility in the share price, but we have high conviction that in three to five years' time, the business will be worth considerably more than the current $60B USD market cap.

> **Rather than concerning ourselves with market timing, we're happy to add to our position and keep our eyes on the horizon.**

Also in Brazil, we added to Brazilian pharmaceutical chain **Raia Drogasil**. Raia is Brazil's largest drugstore operation. It has a 13% market share, and we think a highly predictable long-term runway for growth driven by ongoing industry consolidation and formalisation of the Brazilian economy.

The immediate operations of this brick-and-mortar business have been among the most disrupted of the Portfolio's holdings. The company has suffered store closures, reduced footfall, and the associated negative operating leverage. We expect the business to bounce back strongly in the second half as COVID-19 related restrictions have eased—in July the business was already back to mid-teens year-on-year growth rates.

Given the challenges that Raia's competitors will be facing, we expect it will emerge from this crisis with a significantly stronger hold on the Brazilian market and an accelerated growth potential. Looking out five years, we think that the business will be able to compound annualised sales and earnings at a rate of 20% and above.

We also increased our ownership in Chinese consumer internet giant **Alibaba**. Alibaba is the dominant e-commerce business in the largest e-commerce market in the world. It is, by far, the most profitable online retail company globally. We estimate that if you summed the profits of all other e-commerce businesses on earth, they still would fall short of Alibaba's.

It stands to reason that Alibaba's e-commerce operation should be one of the lasting beneficiaries of the post-COVID future. In addition, we think the tailwinds behind its dominant and rapidly growing cloud business should only accelerate, as should the digital finance business of its soon to list affiliate Ant Group. All in all, we view Alibaba to be one of the most cash generative (it made circa $20B USD of free cash flow in calendar 2019) and structurally advantaged businesses anywhere in the world, and we believe its prospects are only improving.

We also added to our position in **FEMSA**, Latin America's largest convenience retail empire. FEMSA's business can be broken down into three units: (1) retail where it operates a dominant convenience store network in the region, with over 19,000 stores and a burgeoning pharmacy and fuel retail businesses; (2) a 47% stake in Coca-Cola FEMSA, Mexico's leading Coke bottler; and (3) a 15% stake in Heineken.

FEMSA's shares have been the worst-performing in the Portfolio, falling over 40% in USD terms year to date. The market is very much focusing on the now, where same store sales have been under pressure, and operating deleverage has pressured quarterly profits. Whilst it probably will not be until 2021 that the business returns to full health, we do not believe the pandemic will result in any structural challenges to FEMSA's long-term business. Its convenience and specialty focused retail formats are unlikely to be threatened by e-commerce players in our view. As the economy kicks back into life, the business should be well placed to continue its growth trajectory. FEMSA opens a new Oxxo convenience store every six hours on average. As we roll into 2021, we think it should be larger and more dominant than ever before.

If one assumes that the listed Heineken and Coke FEMSA stakes are fairly valued by the market, the implied current valuation of FEMSA's core retail business is approximately 7x cash flows, which we view as reasonable given it should be able to compound at mid-teens growth rates over the next five years. Given the share price dislocation this year, we expect our returns from investing today should considerably exceed our forecast of when we first made the investment at the start of 2020.

Lastly, we added to our position in the Taiwanese convenience retailer **President Chain Store**. We think Taiwan has navigated the pandemic as well as any country. The company's core business operation is the leading national convenience store chain, but it also runs other affiliate fast-growing businesses, including the domestic Starbucks franchise, a leading Taiwanese drug store chain, Shanghai 7-Eleven, and a 52% stake in the 7-Eleven business in the Philippines, which is perhaps the crown jewel. Over the medium term, we think President Chain Store is unlikely to deliver exceptional topline growth but believe it will comfortably grow its profits at a high single-digit to low double-digit rate thanks to new openings, same store sales growth, and margin improvement. A healthy 90% payout ratio could nicely supplement these returns through dividend payments.

To finance these additions, we reduced our stake in Diageo's listed Indian subsidiary **United Spirits** and completely sold our shares in **Emami**. Emami is a leading consumer packaged goods producer in India. We believe its portfolio of brands are well-placed to capture the rising demand of the increasingly health and beauty conscious Indian consumer. The business generates attractive margins and has compounded cash flows rapidly over the last decade. An aggressive amortisation policy means that its tax rates are optimised and actual cash profits are well in excess of reported earnings. However, we think the very real challenges facing the Indian economy are likely to weigh heavily on future growth rates. We do not believe that the company will be able to return to the double-digit growth numbers that it historically recorded for many years. The shares rallied aggressively in the third quarter. With valuations looking stretched and the business outlook seeming subdued, Emami was a natural source of cash for the previously mentioned additions, all of which we believe are now significantly more compelling.

Team Update

We are pleased to announce that Jack Wakefield has joined the Polen Global Emerging Markets Growth team as an analyst. Jack joins us from Arisaig Partners and brings considerable experience in Latin American markets where he spent four years based out of Rio de Janeiro. Jack becomes the 8th member of our burgeoning London office.

Thank you for your interest in Polen Capital and the Polen Global Emerging Markets Growth strategy. Please feel free to contact us with any questions or comments.

Best,
Damian Bird

Experience in High Quality Growth Investing

Damian Bird, CFA
Head of Team, Portfolio Manager & Analyst
11 years of experience

Historical Performance

	Polen (Gross) (%)	Polen (Net) (%)	MSCI Emerging Markets Index (%)
3 Months	9.59	9.33	9.57
YTD	3.00	2.23	-1.14
Since Inception (01-01-2020)	3.00	2.23	-1.14

Returns are trailing through 9-30-2020. Annualized returns are presented for periods greater than one-year.
Source: Archer.

Past performance is not indicative of future results. Returns are presented gross and net of management fees and include the reinvestment of all income.

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The MSCI Emerging Markets Index captures large- and mid-cap representation across 26 emerging markets countries. The MSCI Emerging Markets Index is maintained by Morgan Stanley Capital International. It is impossible to invest directly in an index. The performance of an index does not reflect any transaction costs, management fees, or taxes.