SGA
Sustainable Growth Advisers

Q4 2019 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned 9.0% (gross) and 8.8% (net) in Q4 2019 compared to 11.8% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 13.7%.*

- *A trade truce between the U.S. and China, continued stimulus efforts from global central banks and expectations for improving global economic growth drove a strong market rally in Q4. The portfolio delivered strong absolute returns, but trailed the broad market.*

- *An overweight to the Consumer Staples sector, the worst performing sector, detracted most from relative returns. Selection in, and an underweight to, Information Technology, which was the strongest performing sector, also detracted from relative returns.*

- *New positions in Heineken and WuXi Biologics were initiated and the portfolio's position in Nestle was liquidated. Positions in Infosys and MercadoLibre were added to on weakness and positions in Ambev, FEMSA, Huazhu Group, Raia Drogasil, Shandong Weigao, and Sinopharm were trimmed.*

Performance

SGA's Emerging Market portfolio returned 9.0% (gross) and 8.8% (net) in Q4 while its benchmark, the MSCI Emerging Markets Index, returned 11.8%, and the MSCI Emerging Markets Growth Index returned 13.7%. For 2019, the portfolio returned 31.0% (gross) and 29.6% (net), compared to 18.4% for the MSCI Emerging Markets Index and 25.1% for the MSCI Emerging Markets Growth Index.

Emerging markets rebounded sharply in Q4 as uncertainties that had weighed on global equities in Q3 receded with a trade truce between the U.S. and China looking more probable (and a phase one deal ultimately being agreed upon), uncertainty over Brexit disappearing with Boris Johnson's landslide victory in British Parliamentary elections, stabilizing economic data in key global economies, and continued accommodative monetary policies from global central banks. With the uncertainty over issues that could heavily influence future economic growth receding (at least temporarily), investors were willing to take on additional risk, leading to a strong narrowly driven upward movement in the market. Interestingly, gold, which usually increases in price as investor confidence in global growth weakens, was on track to post its best annual performance since immediately after the financial crisis in 2010. While growth scares related to ongoing weakness in China, the potential impact of the trade war between the U.S. and China and weakness in Europe and Japan negatively impacted global stocks prices at times through the first nine months of 2019, markets climbed a wall of worry and recovered the losses experienced in 2018's weak market environment. Given our long-term focused approach of investing in businesses with high degrees of predictability and long durations of sustainable growth which are attractively valued based on cash flow, the strong momentum upwards in Q4 presented a headwind for our approach but the portfolio performed as we would have expected for the quarter and exceptionally well for the year.

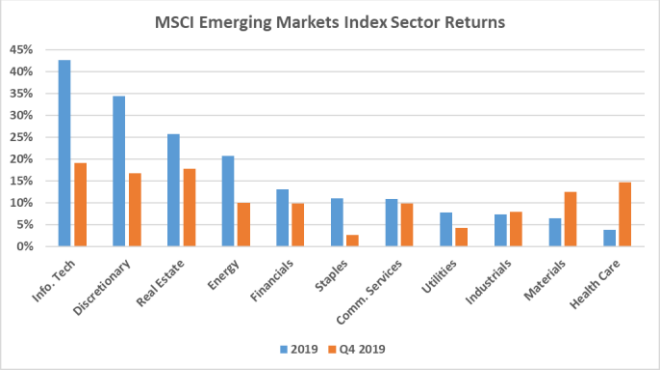
While Q4 saw a respite from the deep concerns investors had over weakening global growth and profits, great uncertainty remains over the impact of the phase one U.S.-China trade deal and subsequent negotiations for a phase two deal, rising Middle East tensions and their impact on oil prices, secular slowing of China's economy and near-term impacts from the Coronavirus outbreak, sluggish growth in key Latin American economies, and political unrest in Hong Kong. Additionally, the outcome of the 2020 U.S. Presidential election is likely to have major ramifications for U.S. fiscal, trade and regulatory policies over the coming years, which will inevitably affect markets and risk tolerance levels around the world in the coming years. With these and myriad other macroeconomic and geopolitical uncertainties, we continue to believe there is ample reason to expect continued higher levels of volatility in the markets. If history is any precedent, the greater differentiation between businesses which often takes place during such periods should be positive for the portfolio's focus on more predictable, above-average growth businesses with attractive cash flow based valuations.

Portfolio Attribution

Investors' willingness to accept more risk given greater optimism led to a market environment that was less favorable for our approach to quality growth investing. The Information Technology, Real Estate, and Consumer Discretionary sectors performed best over the quarter. In contrast, more defensive sectors including the Consumer Staples and Utilities sectors performed worst as investors preferred areas with higher expected growth and more economic sensitivity given their more upbeat economic outlook.

For the year, the Information Technology sector outperformed by a wide margin returning 42.6%, with the Consumer Discretionary, Real Estate, and Energy sectors also outperforming the Index. The Health Care sector generated the

weakest returns for the year followed by the Materials, Industrials, and Utilities sectors.



Source: FactSet, MSCI.

For the quarter, stock selection detracted from performance driven by the strong broad-based rally in Technology stocks and weakness in the portfolio's position in Infosys. Positions in Abbott and WuXi Biologics detracted in the Health Care sector, while selection was strong in Communication Services due to strength in Tencent. For the year, stock selection accounted for a majority of the outperformance. Selection in the Consumer Discretionary sector was strongest driven by strength in MercadoLibre and New Oriental Education. Selection was positive across all sectors except in the Information Technology and Materials sectors. An overweight to the Consumer Staples sector detracted from relative returns for Q4 and for the year given the market's preference for less defensive businesses.

Largest Contributors

Chinese e-commerce and cloud computing leader **Alibaba** was the largest contributor to performance for the quarter. Alibaba's shares continued to rise following better-than-expected fiscal Q2 results released in November. Revenue growth was solid while profits and cash generation exceeded our expectations. The company's cloud segment posted 64% revenue gains, only slightly under the 66% growth reported last quarter, while Core Commerce, Digital Media and other initiatives also posted attractive results. After delivering 40% revenue growth and 35% profit growth during the first half of FY 2020, the company aggressively reinvested back into their business in the second half of the year in order to continue to widen the moat relative to their competitors. We welcome the company's long-term focus, although some shorter-term investors were put off by management's plan for another round of investments. As consumption continues to grow as a percentage of GDP and online commerce penetration continues to increase in China, Alibaba remains exceptionally well-positioned to benefit from this growth given the dominant size of its e-commerce platforms and the resulting network effect. Meanwhile, Alibaba continues to expand its global e-commerce and logistics footprint and invest in regions where e-commerce penetration is still low, such as South East Asia, Russia and Europe, which can augment its long-term growth opportunities. In addition, we expect Alibaba, the largest cloud computing provider in China, to capitalize on its scale advantage given its 50% market share, and expand its markets to outside China, further boosting future growth. We maintained an above-average weight position.

Leading K-12 after-school tutoring services provider in China **TAL Education (TAL)** was the second largest contributor to performance for the period, given a favorable market backdrop and solid operational results. TAL's fiscal Q2 revenues increased 39% while operating margins declined less-than-expected, helped by improving efficiency in its offline business offsetting continued aggressive investments in online promotion. Looking forward, the company is set to benefit from its significant online expansion efforts while enjoying higher retention rates in its online business given improving product quality in addition to providing a better balance between customer acquisition and efficiency. We continue to view TAL's growth opportunity as attractive, as secular tailwinds provide long runways of growth including the rising affluence of the Chinese population driving increasing demand for K-12 tutoring services, continued industry consolidation as larger players dominate in technology and teaching resources, and tightened education regulations increasing the barriers to entry.

Chinese hotel chain **Huazhu Group** was the third largest contributor to performance for the period. Huazhu's shares largely benefited from the same favorable market backdrop as Alibaba and TAL Education, as well as continuously improving competitive dynamics and impressive growth in both Huazhu's hotel count and new hotel pipeline (which are partly driven by defections from competitors). Huazhu announced during the quarter that it is acquiring German hotel chain Deutsche Hospitality (DT) for roughly $800 million as part of its international expansion plans. The deal does not signal a substantial shift away from Huazhu's long-term ambition focused on the Chinese middle-class leisure and business markets. DT has a portfolio of strong brands such as Steigenberger and InterCity, which Huazhu will bring to China to fill out its wide-ranging portfolio of brands with some strong concepts in the mid-upscale segment. DT's hotel portfolio will make up about 2% of Huazhu's total hotel count by the end of this year. Huazhu's recent results continued to be impacted by a weaker macroeconomic environment as same-hotel RevPAR (revenue per available room) growth declined 3.8%, although

overall revenues grew 10% driven by robust hotel count growth. The position was trimmed on strength during the quarter, but we maintained an above-average weight given an attractive longer-term growth opportunity.

Raia Drogasil and **JD.com** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

Thai convenience and wholesale store operator **CP All** was the largest detractor from performance on macroeconomic related weakness as well as concerns that Tesco Lotus is looking for an acquirer and speculation that CP All could be a buyer. Should they be the acquirer, there could be an initial impact to EPS due to the cost of additional debt that could be incurred, but our analysis indicates that this is likely already reflected in the stock's price. CP All's recent results showed solid same-store-sales growth of 2% in its convenience store format and 5.5% in its wholesale format, with higher spend-per-ticket and more favorable mix shift leading to solid margin expansion. Store openings remain on track and the company aims to reach 13,000 7-Eleven stores by 2021 from 11,640 stores currently, although new license agreements in other markets is likely, which would further increase the growth opportunity. While we recognize that CP All's international expansion of its Makro business is likely to weigh on earnings in the near-term, management has proven an ability to prudently suspend growth plans in places like India until they get the current stores working, while also experiencing faster-than-expected breakeven in places like Cambodia and China. Despite the near-term weakness we continue to have a high degree of conviction in the company's longer-term growth opportunity. We maintained an above-average weight in the company.

Indian information technology vendor **Infosys** was the second largest detractor from portfolio performance. While the company posted a solid report on most key metrics and increased their annual guidance marginally, it was not sufficient for some investors with more aggressive expectations who had pushed the stock's price up earlier in the period. Revenue growth on a constant currency basis was strong, rising by 11.4%, while Digital revenues continued to grow at a 30%+ rate. Margins continued to expand with improving team utilization, lower employee turnover and strong new business signings. With some concern over the weakness of a competitor, billings that weren't as strong as the consensus may have expected, but reasonable in our view, and conservative guidance, the stock failed to keep up with the upward momentum of the markets.

Additionally, there was an allegation from a whistleblower during the quarter that was blown out of proportion in our view due to mismanagement of information flow with the media. We have known Infosys for many years and whistleblower issues are neither new to it or to other companies in our coverage. In fact, they highlight the strength of the corporate governance that exists which ensures that such issues are brought up to the board as well as investors.

We analyzed the specific issues cited in the current whistleblower case, and it was not obvious if the management was at fault. Topics related to the recognition of costs and taxes often lead to back and forth exchange between companies and their auditors. Furthermore, investors already know that some of their large deals don't have significant profitability upfront. The manner in which investors learned about the issues from the media, rather than the company itself, caused surprise and lowered the confidence of investors in management. While we understood that increased volatility due to news flow could divert attention away from the underlying strong fundamentals of the company's growth, the investment opportunity which existed after the stock's weakness caused us to increase our weighting. Subsequent to the end of the quarter, the company announced that its board and the investigation committee established did not find any wrongdoing, and the company will continue to work with the SEC and SEBI regarding their questions until the issue is resolved completely.

Philippine food and beverage company **Universal Robina (URC)** was the third largest detractor during the period. With market leadership shifting away from more defensive, predictable growth companies such as URC given greater optimism around global economic growth and lessening trade concerns, URC's shares declined slightly despite reporting solid Q3 results. URC delivered solid results with its Philippine Branded Consumer Foods (BCF) division, which accounts for more than half of total sales, growing sales 7% year-over-year, supported by solid growth across major categories such as Snacks and Coffee. Its international BCF sales were flat, however growth accelerated in Vietnam and declines in Thailand decelerated compared to the previous quarter. We continue to view URC's longer-term growth prospects favorably given its regional dominance, strong brand power, world class manufacturing and supply chain management, along with a long runway of growth driven by favorable demographics and a rising ASEAN region middle class. We maintained a below average weight position in the company.

Nestle and **Wal-Mart de Mexico** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover was roughly average during the quarter with positions in Heineken and WuXi Biologics added and the portfolio's position in Nestle liquidated. We took advantage of weakness in the shares of Infosys and MercadoLibre, adding to those positions during the quarter, while trimming positions in Ambev, FEMSA, Huazhu Group, Raia Drogasil, Shandong Weigao, and Sinopharm.

Purchases

Heineken, the second largest global beer brewer by revenue, with the number one international premium beer brand, was added to the portfolio during the quarter. The company operates more than 160 breweries across 70 countries, with Heineken being its primary brand in addition to 250+ other brands including Amstel, Sol, Dos Equis and others. Heineken's strong pricing power is supported by the company's premium beer line up which is ranked #1 or #2 in 5 of the top 10 premium beer markets. The beer industry benefits from relatively stable, recurring consumption patterns across the world, and Heineken's business is geographically diversified with no region accounting for more than one-quarter of its profits and no country accounting for more than 15% of sales. This geographic diversity and consumption pattern have enabled the company to generate strong recurring revenues, and we see no reason for this to change based on our research. Heineken also benefits from long runways of growth driven by two key secular trends – the increasing demand for premium brands and the ongoing development of middle class consumers in emerging markets. With about 40% of its profits derived from the premium segment of the market and profits from developing markets making up about 60% of the firm's total profits, we see plenty of room to grow from current levels. Additionally, plans to capitalize on the growing cider, craft beer and non-alcoholic markets offer further opportunities.

Key risks we see for Heineken include increased competition from AB InBev (ABI), the loss of exclusivity at a key retail partner in Mexico, and the eventual transition of the company's distribution system in Brazil. Regarding ABI, now that their period of growth via transformational M&A (e.g, acquisitions of SAB Miller and Grupo Modelo) has passed, there is a risk that ABI will become more aggressive in their commercial tactics to sustain business momentum. However, we believe ABI will remain disciplined in the marketplace because its top priority is cash flow to pay down its considerable debt from these acquisitions. Regarding Mexico, Heineken's loss of exclusivity with convenience store operator OXXO is noteworthy considering the retailer represents 25% of the volume in Heineken's most important market, but the risk is mitigated by a number of factors including OXXO's intention to expand total beer shelf space in its stores to accommodate new brands while preserving Heineken sales, as well as Heineken's increased freedom to pursue other more profitable commercial opportunities with new retailers. An additional risk to the company's emerging markets growth is increased government regulation as seen recently in Vietnam where harsher drunk driving laws were instituted. The development of these laws in other emerging markets could have an adverse impact on growth.

Leading global biologics technology platform, **WuXi Biologics**, was also added to the portfolio during the quarter. The company offers end-to-end solutions empowering pharmaceutical and biotechnology companies to discover, develop, and manufacture biologics drugs from concept to commercial manufacturing. WuXi is well-positioned to benefit from a growing biologics end-market as well as the rising demand for outsourcing the discovery, development, and commercialization of such drugs given the capital requirements and complexity involved. The company's unique business model, which is focused on becoming a one-stop-shop in biologics outsourcing, as well as their edge in drug development and ability to aggressively take on new projects due to its unparalleled team of scientists, cost competitiveness, and technological capabilities has led to a dominant position in China with a 75%+ market share as well as the fourth largest company globally. Limited competition, superior technology and scale, and high switching costs allow for strong pricing power and high client retention rates. We see a strong growth opportunity for WuXi moving forward given that it is the only company to provide the full spectrum of biologics outsourcing services. While a majority of their revenues are currently generated in the Discovery and Preclinical Development segments, the company's backlog and project pipeline create visibility into future revenue streams. The company's revenue stream will become more recurring over time as late phase and commercial manufacturing services increase as a percentage of total revenues.

Among the risks we are monitoring are the impact on cash flows and profitability as the company aggressively expands its manufacturing capacity over the coming years, the R&D funding cycle and its impact on the company's pipeline, changes in industry dynamics, the regulatory environment in China, and execution quality given its importance to reputation.

Sales

Global food and nutrition company **Nestle** was liquidated from the portfolio during the quarter given recent strength and a more attractive growth opportunity in Heineken. We continue to view Nestle as a high quality global growth business with its new management demonstrating solid progress in improving existing operations and optimizing the portfolio of businesses, but felt the capital was better deployed elsewhere.

Outlook

Rising optimism among investors generated strong equity market returns in Q4 as the concerns of Q3 seemed less troubling given the recent phase one trade agreement between the U.S. and China, greater certainty regarding Brexit and signs of stabilizing economic data in key global economies. This optimism fed a willingness to own companies more sensitive to fluctuations in the macro-economic backdrop and created a headwind for our focus on companies that tend to generate more predictable and sustainable growth regardless of the macro-economic backdrop. Over the next three years, the portfolio is expected to generate 22.4% EPS growth while the MSCI EM Index is expected to generate 16.8% EPS growth. In a world experiencing the 12th year of a global expansion, with muted economic growth across key economies despite unprecedented and massive monetary and fiscal stimulus, we are confident in the ability of our portfolio companies to continue generating superior revenue and earnings growth compared to broad Indexes with less variability. Quarter-to-quarter and even year-to-year returns can be affected by changes in investor emotions similar to those seen in Q4. Given such variability, we remain focused on implementing a disciplined investment process aimed at reducing the variability of the portfolio's earnings growth over time and generating strong absolute and relative returns that will protect capital in periods of weakness and participate strongly in periods of optimism. Whether or not in favor from quarter-to-quarter, the approach has served our clients well over time and our team remains excited by the opportunities we see over the coming years.

We thank you for your continued confidence in our firm and look forward to answering any questions you may have on the portfolio.
