SGA
Sustainable Growth Advisers

Q2 2019 International Growth Commentary

Highlights

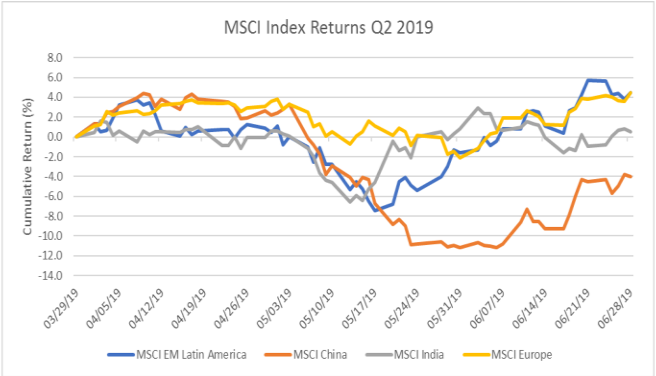
- *The portfolio generated attractive absolute and relative returns in the Q2 as volatility in the markets increased*
- *Stock selection was the key driver of excess returns and was additive across most sectors; sector allocations also contributed positively*
- *Selection in the Information Technology and Consumer Staples sectors was strongest while selection in the Consumer Discretionary sector detracted most*
- *New positions in adidas and Alcon were initiated while the portfolio's positions in Ambev, Sinopharm and Wirecard were liquidated*
- *Positions in Alibaba, Asian Paints, Heineken and Tencent among others were added to on weakness, while positions in MercadoLibre and HDFC Bank were trimmed on strength*

Performance

SGA's International Growth portfolio returned 7.3% (gross) and 7.0% (net) in the second quarter of 2019, while its benchmark, the MSCI All Country World Index ex-U.S.A (ACWI ex-U.S.A), returned 3.0%.

Rising Global Growth Concerns

Increasing signs of slowing global economic growth compounded by rising trade tensions between the U.S. and China negatively impacted expectations for corporate earnings growth in Q2. The World Bank reduced its forecast for global economic growth in 2019 from 2.9% in January to 2.6% due to rising trade tensions, declining business confidence and more signs of slowing global growth. Developed Markets outperformed Emerging Markets. Russia, Greece and Thailand were the best performing markets for the period while China and South Korea were among the weakest. Cyclical stocks performed best in April as hopes for a settlement to the U.S. – China trade war rose, but then gave gains back in May as differences thought to have been settled reemerged and negotiations ended, sending stocks lower. June saw new gains as hopes that a trade deal could be worked out at a meeting between Presidents Trump and Xi at the G-20 summit at the end of the month. This together with indications that the European Central Bank (ECB) and other monetary authorities around the world were contemplating interest rate cuts if economic data weakened further pushed the ACWI Index up for the month.



Source: FactSet

European GDP grew at a 1.5% rate in Q1, better than feared, while Indian Q1 GDP growth slowed to 5.8% year-over-year, the slowest pace since Prime Minster Modi took office in 2014. South Korea's economy contracted by 0.3% in Q1 as Korean exports fell sharply. In contrast, China's economy grew at a 6.4% rate according to government supplied figures, indicating that its recent massive stimulus efforts may be helping the economy navigate the current slowdown. Manufacturing continued its weakening trend globally, with activity in the U.S., Europe and Japan contracting further resulting in the weakest quarter for production for the European and Japanese economies in several years. Europe faced headwinds tied to Brexit uncertainties as well as weakening in China, one of its largest trade partners. While manufacturing weakness for key global economies raised concerns for central banks, the service side of the economies generally showed better resilience.

Source: FactSet

Rising Expectations for New Monetary Accommodation

At the same time that global growth concerns became more pronounced, more dovish comments from the U.S. Federal Reserve, indications of more accommodative monetary policy by the ECB and the Bank of Japan, and multiple interest rate cuts by central banks in India, China and elsewhere benefited equities as investors reacted to the potential for new stimulus to counter further economic slowing. Indeed, U.S. 10-year Treasury yields briefly sank below 2% while yields on German 10-year Bunds declined to negative levels reaching all-time lows. Despite growing signs of weakening global growth, some markets hit new highs as volatility rose, particularly in May. Market leadership varied significantly over the course of the quarter, reflecting an increase in expectations for interest rates to decline. Industrials performed best followed by Financials and Information Technology and Consumer Discretionary stocks. In contrast, Real Estate and Energy stocks generated the weakest returns for the period, with Energy weak due to declining oil prices for much of the quarter.

Portfolio Attribution

The portfolio performed well in very different market environments over the course of the quarter consistent with the return pattern we would expect given SGA's quality growth approach. The portfolio outperformed its benchmark in April as markets reacted positively to economic news out of the U.S., Europe and China. In May, it protected capital and outperformed as global markets declined due to resurfacing trade tensions, weaker economic data in China and rising geopolitical tensions. In June, the portfolio rebounded strongly, as global markets rallied on more dovish comments from world monetary authorities. The reward to higher business quality characteristics during the quarter was mixed with companies that had higher levels of debt, higher returns on equity, earnings and lower betas performing best.

The portfolio's performance benefited from strong stock selection. Selection in Information Technology, Consumer Staples and Financials contributed most due to positions including SAP, Wirecard, Danone, Aon and HDFC Bank. In contrast, selection in the Consumer Discretionary sector detracted most due primarily to positions in Chinese stocks Alibaba and Ctrip which were negatively impacted by the relative weakness in Chinese stocks during the period. Sector allocations also contributed positively primarily due to the portfolio's lack of exposure to the underperforming Energy and Real Estate sectors. This benefit was mitigated to an extent by the portfolio's underweight in the strongly performing Industrials sector and overweight in the weakly performing Consumer Staples sector.

Largest Contributors

SAP was the largest contributor to portfolio performance. The company reported sales and profit growth that exceeded consensus and our expectations, with attractive software license growth and strong results in its cloud division including a 26% rise in new bookings. With added pressure from activist investors, management raised its 2019 operating profit target and focus on long-term margin improvement. Our research continues to point to an attractive growth runway for SAP's business, as it continues to transition its business from the traditional software licensing model to higher margin cloud based offerings. We maintained an above average weight position in the company during the quarter.

IHS Markit, a global information services business, was the second largest contributor. IHS provides critical information and analytical insights to the energy, automotive, aerospace & defense, chemicals, and technology industries, and generates the vast majority of its revenues from subscriptions related to its proprietary information and analysis of data collected in its databases. With renewal rates of about 90%, the company generates a high level of recurring revenues from its subscriptions. As a leading provider of critical data and insights that are deeply embedded into client workflows, IHS Markit is able to increase its organic subscription revenues on a consistent basis while leveraging its resources to develop new products and insights. In its most recent earnings report, the company delivered 5% organic topline growth, in-line with consensus expectations, while adjusted earnings growth of 16% was better than expectations. IHS also continued to show attractive margin expansion across the board, driven by strong volume flow and operational efficiencies. Our research indicates the company has an attractive opportunity to cross-sell their products across their respective client bases while increasing their penetration of global clients outside the U.S. We maintained an above-average weight position in the company during the quarter.

Leading professional services firm **Aon** was the third largest contributor to performance for the period. Aon reported solid quarterly results with overall organic growth of 6% and four of its five segments generating organic growth above 5%. The company's growth rate has improved from the Aon United initiative, an effort to enable the firm to gain scale advantages from acting as one integrated firm as opposed to operating disparate companies that have been acquired over the years. We expect the company to continue to focus on cash flow generation and profitable growth, using its scale advantages and investments in data and analytics. Accordingly, we maintained an above-average weight in the company.

HDFC Bank and **Linde** were the fourth and fifth largest contributors to performance during the quarter.

Largest Detractors

Given weakness in the Chinese equity market during the quarter, **Ctrip** was the largest detractor from portfolio performance despite delivering solid Q1 results. The company's revenues grew 21%, while operating profit grew by 42% year over-year driven by significant improvement in operating margins. Ctrip's weakness reflects broader softness in China ADRs as a result of escalating trade tensions and the challenging macroeconomic outlook of China. However, despite the short-term overhang from trade and macro economic factors, the longer-term outlook for China travel growth remains intact, underpinned by China's rising middle class, and the country's shift to a more consumption driven economy. In addition, the fundamental picture of the company is improving: margin improvement was well ahead of expectations as a result of stabilizing competition; and the company is gaining market share at an accelerated pace with solid execution. We maintained a below-average weight in the company given its improving business fundamentals but greater sensitivity to China's domestic economic slowdown.

Chinese e-commerce company **Alibaba** was the second largest detractor from performance over the period, suffering from the same market-wide pressure on Chinese stocks as Ctrip. Fundamentally the company remains strong and its most recent earnings display resilience in the face of uncertainty. While there's no question growth in China is slowing from its torrid pace of the past decade, over our 3-5 year time horizon, we continue to see attractive growth for Alibaba. As consumption continues to grow as a percentage of GDP and as online commerce penetration increases 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". In addition, Alibaba is the largest cloud computing provider in China, with an approximated 50% market share, and a business that is growing rapidly. We maintained an above-average weight position in the company during the quarter, adding on recent weakness.

Chr. Hansen, one of the world's leading companies in bacteria cultivation with businesses in Food Cultures and Enzymes, Health and Nutrition, and Natural Colors was the third largest detractor for the period. Chr. Hansen's shares declined following its report of fiscal Q3 results where both sales and earnings fell short of expectations. This was due primarily to weakening in its Food Cultures and Enzymes and Natural Colors segments. Food Cultures and Enzymes' results were attributed to macro related weakening in China, where year-over-year growth deteriorated. Importantly, China only represents approximately 8% of the Chr. Hansen's revenues. Additionally, management lowered full-year guidance while maintaining its long-term financial outlook for 8-10% organic top-line growth and 10% adjusted free cash flow growth. Future growth will be driven by a combination of continued growth in global dairy consumption—as emerging market consumers upgrade their diets to include more protein—and new product releases, including culture solutions for dairy alternatives and bio-protective cultures for non-fermented products like vegetables, salads, fish and meat (among other new products). We continue to see Chr. Hansen's growth opportunity over our 3-5 year time horizon as providing an attractive investment opportunity given Chr. Hansen's strong pricing power derived from its innovative platform of unique solutions, scalable production and strong client relationships. We maintained an average weight position in the company during the quarter.

Shandong Weigao and **Novo Nordisk** were the fourth and fifth largest detractors from performance during the quarter.

Portfolio Changes

Portfolio turnover was about average for the period, with positions in Alcon and adidas initiated and positions in Ambev, Sinopharm and Wirecard being liquidated to free capital for other opportunities. Positions in Alibaba, Asian Paints, Heineken and Tencent, among others, were added to on weakness, and positions in MercadoLibre and HDFC Bank were trimmed on strength.

Purchases

adidas is the second largest active footwear and apparel company in the world with approximately 11% global market share relative to 15% for Nike. It operates in over 100 countries and sells more than 900 million sports and sports lifestyle products annually. Following years of underperformance, management orchestrated a turnaround in the business in the mid-2010s under its "Creating the New" strategy which included a corporate restructuring into vertical business units by category, the hiring of top designer talent from Nike, as well as a focus on speed to market, key cities and an "open source" strategy emphasizing enhanced customer feedback loops and collaborations with key influencers in pop culture. Pricing power is supported by strong brand equity as well as product innovation. In addition, its increasing mix of direct-to-consumer sales is margin accretive, while an increasing utilization of data and investment in order to create a faster supply chain leads to faster feedback loops and production cycles and improved price yields. Its revenues are highly recurring given the broad nature of its sales geographically and across products, with over 400 million pairs of shoes and 400 million pieces of apparel being sold each year, and no region comprising more than 30% of sales. The company benefits from a growing active footwear and apparel market which is driven by secular trends including increased consumer focus on health and wellness, under-penetration in markets outside North America, the ongoing trend toward casualization in the workplace, and growth in aging populations that favor athletic footwear over more traditional shoes.

Among the key risks we are monitoring are the fact that 60-80% of footwear sales are for non-athletic purposes and therefore more subject to fashion and influencer risk, the fact that active footwear is a discretionary purchase and therefore more vulnerable to consumer cyclicality (although our research does indicate that shoe sales tend to be more sticky with consumers staying with brands that they find to fit well and are comfortable). Strong competition from Nike in areas such as endorsement deals also is an ongoing point we must keep an eye on. We initiated a below-average weight position in the stock and expect to build the position opportunistically moving forward.

Alcon is a medical devices company with a leadership position in ophthalmology. The company serves eye surgeons in its surgical division which comprises about $4 billion of its $7 billion in revenues, and optometrists/consumers in its vision care division which contributes the balance. Equipment and consumables used in surgeries comprise about 40% of sales, implantable intraocular lenses used in cataract surgery contribute 16% of sales, contact lenses comprise 27% of sales and contact lens solutions contribute about 17% of sales. With the exception of the contact lens solution business, there are high barriers to entry in its businesses including technology, capital requirements, and regulation. This has resulted in an oligopolistic global market where Alcon benefits from highly recurring revenues (90% of the company's revenues outside of equipment are recurring), and attractive pricing power. The company's runways of growth are driven by increasing secular demand for eye surgeries and contact lenses, which are driven by aging and myopia, the continued penetration of healthcare services in emerging markets, and the shift towards higher technology products. With the company's spin off from Novartis, we expect better execution from a more motivated team, a more engaged sales effort, and improving margins and free cash flow due to new product launches beginning with the introduction of new intraocular lenses and new contact lenses later this year.

Among the key risks we are focused on, should there be new technological developments which replace or significantly change current methods of treating eye diseases such as cataracts or retinal disease, this could negatively impact Alcon's base business. New product launches will be important and must be executed well and be accepted by doctors and consumers. Finally, competition in monofocal lenses, and pricing pressure from reimbursement policy will continue to pose a risk, but less than in the case of pharmaceuticals. We initiated an average weight position in the company over the course of the quarter.

Sales

Ambev, the largest brewer in Brazil and the largest Pepsi bottler outside the U.S., was sold during the quarter to fund other more attractive opportunities. The company already enjoys a high share in its key market of Brazil, making it among the slower growth businesses in the portfolio. Additionally, competitive pressure is intensifying in Brazil from a stronger Heineken following the company's acquisition of Kirin's beer operations in the country, doubling its market presence and significantly improving its distribution capabilities. Accordingly, while we think highly of the company, given the rise in market volatility and the evolving opportunities being created, we saw the chance to upgrade growth and valuation.

We previously noted in our Commentary last quarter, Chinese pharmaceutical distributor "**Sinopharm** continues to perform better than its competition, and we continue to see an attractive growth opportunity in China's evolving health care system. However, the company's collections and cash productivity have been disappointing and we are maintaining a below-average weight in the stock". Given the continued issues with regard to collections and cash productivity, together with other more attractive growth opportunities on our Qualified Company List, we liquidated our position in the stock.

Credit card and online electronic payments company **Wirecard** was sold during the quarter in order to reallocate capital to other higher confidence business opportunities. We became increasingly uncomfortable with the company's accounting including ballooning accounts receivables, and considering the publicized allegations of improper business practices in one of its Asian units, combined with other attractive opportunities on our Qualified Company List, we sold the stock.

Outlook

Rising volatility has traditionally been positive for SGA's portfolios, and Q2 2019 continued the historical trend, as the portfolio generated strong absolute returns in months when investors were more optimistic and less focused on risks, and protected capital in periods when greater uncertainty reigned and investors refocused on higher quality and sustainable growth. We continue to see ample reason for volatility in the markets to remain high given that, even after recent increases, rolling 3-year trends show volatility below long-term averages. The current opportunity to buy unique high-quality businesses that reliably generate above average levels of revenue and earnings growth, and significant free cash flow, at attractive valuations excites us. Periods like May of this year give us the opportunity to take advantage of weakness in shares of high-quality businesses, while periods like April and June allow us to actively reallocate capital away from great businesses that are valued a little less attractively. We continue to have a deep list of attractive high quality growth businesses on our Qualified Company List to select from, and strongly believe that the more predictable and sustainable growth that these businesses offer will continue to be rewarded in an environment where earnings growth is scarce.

We thank you for you continued confidence in our team and process and look forward to speaking with you about the portfolio in more detail.

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SGA earnings growth forecasts are based upon portfolio companies' non-GAAP operating earnings. Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 1.0%, employing the International Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's International portfolio for the past twelve months. Past performance is not indicative of future results.