SGA
Sustainable Growth Advisers

Q3 2019 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned -2.3% (gross) and -2.6% (net) in Q3 2019 compared to -4.2% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned -2.0%*

- *Stock selection detracted from relative returns for the full period, but added value during the market weakness in July/August. Selection in the Consumer Discretionary and Financials sectors detracted most, mitigated to some degree by strong selection effects in the Health Care sector. Sector allocations, a byproduct of our bottom-up stock selection process added value over the period*

- *A new position in Unicharm was initiated. Positions in New Oriental Education, Raia Drogasil, and Nestle were trimmed on strength, and Shoprite was trimmed to a below-average weight. Positions in HDFC Bank, Sanlam, Infosys, and MercadoLibre were added to on weakness.*

Performance

SGA's Emerging Market portfolio returned -2.3% (gross) and -2.6% (net) in the third quarter of 2019 while its benchmark, the MSCI Emerging Markets Index, returned -4.2%, and the MSCI Emerging Markets Growth Index returned -2.0%.

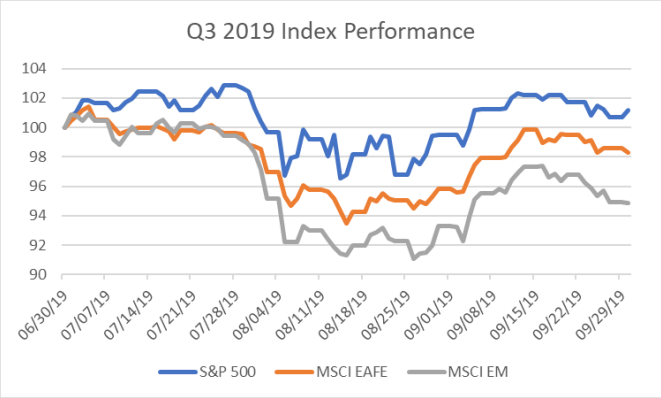
Global Economic Slowing versus Increased Stimulus

Slowing growth and uncertainty plagued many of the emerging markets during the quarter. Chinese Q2 GDP growth was officially reported at 6.2%, the slowest rate in three decades, with independent analyses indicating an even slower growth rate. Manufacturing in the country has been particularly hard hit by higher tariffs, on the back of already slowing global demand for Chinese products. In response to the ongoing weakness, and the additional strains resulting from the U.S.-China trade dispute, the Chinese government continued to apply significant monetary and fiscal stimulus to temper the slide in economic growth. Unrest in Hong Kong escalated with protests over a proposed extradition bill turning increasingly violent. The impact on Hong Kong's economy is yet to be seen, however investors worried about the potential impact on Hong Kong's financial system and stability in the region.

The Indian economy grew 5% on a year-over year basis in Q2, its slowest in the last six years, as unemployment hit its highest level in decades. In response to the disappointing economic data, the Indian government announced planned cuts to the corporate tax rate from 30% to 22%. The effective tax rate in India is among the highest in the world at 48.3% according to the OECD and the move was well-received by investors. Indian markets rallied, led by sectors benefiting most from the proposed tax cuts, such as raw materials, financials, and industrials.

Concerns over global economic growth and escalating trade tension between the U.S. and China, Japan and South Korea, and expectations for slowing global economic growth weighed heavily on markets in late July and August with emerging markets trailing developed markets and more resilient growth companies performing best. In contrast, speculation around renewed trade discussions between the U.S. and China lifted market sentiment in September. Increased optimism over a possible truce in the trade dispute accompanied by more accommodative monetary policies from central banks around the world led to a swift rotation out of more defensive growth stocks into more cyclically-sensitive value stocks.

An attack on Saudi Arabia's oil infrastructure, which led to a reduction of 5.7 million barrels per day in output and a spike in Brent crude prices, weighed on markets later in the quarter. While the production outage was expected to be temporary in nature, it further inflamed geopolitical risks in the region and strained oil dependent economies globally.



Source: FactSet, MSCI.

Key Performance Drivers

Stock selection detracted from relative returns during the quarter, although it added value during the market weakness in July/August. Selection in the Consumer Discretionary and Financials sectors detracted most, driven by weakness in Ctrip.com, MercadoLibre, HDFC Bank, and AIA Group. In contrast, selection in the Health Care sector contributed most positively, driven by strength in Shandong Weigao. Sector

allocations, which are purely a byproduct of our bottom-up stock selection process, contributed positively during the quarter given the portfolio's overweight in the Consumer Staples sector, lack of exposure to Materials, and underweight in the Financials sector.

Largest Contributors

Raia Drogasil, the largest drug store chain in Brazil, was the largest contributor over the period. The company benefited from a strong Q2 report which highlighted an improving competitive backdrop, and reported mature store same-store-sales (SSS) growth ahead of inflation, as it is gaining market share. Raia Drogasil's strategy of lowering prices for generic drugs resonated with customers and put pressure on smaller scale competitors. Overall revenues grew 17% compared to the same period last year, while SSS growth accelerated to 8%, and SSS growth for its mature stores grew 4%, well ahead of last quarter's 1.9%. While the recent results were strong and encouraging we are cognizant that margin pressures may continue to exist in the second half of 2019 as they absorb some of the newly acquired stores from CVS. Over the long term, we see an attractive growth opportunity for Raia Drogasil as it continues to take market share in the highly fragmented pharmaceutical market in Brazil given its superior store productivity, scale, and profitability. We trimmed the position on strength during the quarter, but maintained an above average weight position in the company.

New Oriental Education (EDU) was the second largest contributor to portfolio performance in Q3 as it reported its FY Q4 results which benefited from classroom expansion and strong increases in student enrollment. The company's revenues increased about 28% in RMB (20% in USD) with both its K-12 and Overseas Testing segments posting strong growth. In the case of Testing, growth was above expectations due to reforms management made in their offering to cater more to younger students. Margins improved due to lower sales & marketing outlays, as well as improved classroom utilization. Management guided to 20% capacity expansion moving forward, as well as 30% top line revenue growth (in RMB) and continued margin expansion, which was at the high end of expectations. The stock recovered quickly from weakness later in the quarter due to rumors about possible changes in government policies with regard to permitted business structures for private K-12 schools, which would not apply to EDU. We trimmed our position in the stock as its valuation increased, but maintained an average weight target given our positive 3-5-year outlook.

Wal-Mart de Mexico, the largest retailer in Mexico and Central America, was the third largest contributor over the period. Walmex reported strong Q2 results which beat consensus expectations but were in line with our estimates. The company continues to execute very well and strike an impressive balance between value offerings, business investments and operating leverage. While the business faces headwinds from a weaker Mexican macro environment, it is well-positioned to weather any further weakness, and stands to thrive in the current environment or if things improve. The company's recent report showed same-store-sales growth of 5.4% in Mexico and 1.7% in Central America, while e-commerce sales grew 50%, although e-commerce represents only 1.5% of total sales at this time. We continue to view the growth opportunity favorably despite a more difficult macro environment in Mexico.

Shandong Weigao and **Infosys** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

South African retailer **Shoprite** was the largest detractor from portfolio performance for the period. Their most recent report highlighted improvement in South African (RSA) operations, but showed weaker results in the non-RSA businesses which are critical to our growth thesis for the company. We are concerned that the non-RSA operations continue to remain a contagion to the more favorable parts of the business, thereby possibly pushing out our growth thesis for the business further. With the complexity of the non-RSA business rising as the number of moving parts keep increasing, lower cash productivity and higher debt, our expectation for growth in the future has declined. Based on our analysis, much of this is reflected in the stock's current valuation and we have maintained a below average weight position in the company as we continue to evaluate Shoprite's growth opportunity relative to other businesses on our Qualified Company List

Ctrip.com, China's leading online travel agency was the second largest detractor from portfolio performance for the period. Continued concerns over the U.S.-China trade dispute, a slowing Chinese economy, RMB depreciation, and unrest in Hong Kong has weighed on the near-term outlook for Ctrip.com and its stock price. Despite the recent weakness, Chinese travelers are becoming increasingly frequent leisure travelers, with higher incomes combined with major national week-long holidays resulting in significant opportunities for extended travel. Ctrip has seen an increasing proportion of repeat travelers every year, indicating high levels of customer loyalty, however we are closely monitoring the company's ability to navigate the current environment and generate the predictable

and sustainable revenue streams we expect. Given the greater near-term risks, yet attractive cash-flow based valuation, we have maintained a below-average weight positon in the company.

Indian financial services company **HDFC Bank** was the third largest detractor from performance during the quarter reporting earnings growth generally in line with expectations after raising provisions for non-performing loans, but otherwise controlling other expenses well. Given the weakness in the Indian economy, the size of their provisioning is consistent with their conservative nature. We continue to see HDFC as an attractive beneficiary of ongoing growth in the Indian middle class and their demands for more efficient services than the country's national banks are able to provide. The conservative nature of the bank's loan portfolio and its low cost of capital put it in an attractive position to capitalize on this long-term trend. We continued to maintain an above-average weight position in the company during the quarter and added to the position on weakness.

AIA Group and **Sanlam** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover was below-average during the quarter with the only change to the portfolio being the addition of Unicharm. Positions in New Oriental Education, Raia Drogasil, and Nestle were trimmed on strength, and Shoprite was trimmed to a below-average weight given our rising concerns over the company's non-RSA business and its future growth. Positions in HDFC Bank, Sanlam, Infosys, and MercadoLibre were added to on weakness.

Purchases

A new position in **Unicharm**, a leading Japanese provider of nonwoven fabric and absorbent materials, baby care, feminine care, adult incontinent care, and pet care products, was established during the quarter. Unicharm has a leading market share in key regions for most of its product lines and is benefiting from exposure to emerging markets (>50%) where growth in GDP per capita and consumption upgrades provide long runways of growth for the company. Unicharm has the leading technology, product quality, and manufacturing know-how, which separate it from its competition. Additionally, Unicharm's strong brand awareness and relationships with local wholesalers has enabled the company to gain market share across regions. Its products are used and replenished frequently and highly resilient to fluctuations in economic conditions, and we see an attractive growth opportunity for the business over our 3-5 year investment horizon.

Risks we are monitoring in regards to Unicharm include key man risk given the importance of current President Takahara, and competition risk particularly in growth markets such as India and Indonesia. The company generates 60% of sales outside of Japan, so currency risk is also a factor to keep in mind, as is the risk to gross margins as 80% of the raw materials used in production have prices correlated to crude oil. Balancing these risks with our positive outlook on Unicharm's growth opportunity, we initiated an average weight position in the company.

Outlook

There were numerous signs of slowing global economic growth that heightened uncertainty and raised investor fears during the quarter. At the same time, significant steps by central banks around the world to reduce interest rates spiked investor risk appetites and supported the prices of risk assets, contributing to volatility with the rebound of value and cyclical stock prices in September. As we have noted in prior quarters, we continue to see many key economic issues which we expect to contribute to rising volatility in global equity markets. As such, we expect the more predictable, sustainable growth provided by our portfolio companies to resonate with investors. During this time, there will inevitably be brief periods of renewed optimism benefiting lesser quality and more cyclical businesses which may pose a headwind, but we continue to expect slow to moderate growth moving forward marked by greater market volatility which has historically tended to benefit our approach. In the meantime, with an attractive cash flow based enterprise yield valuation of 3.0%, higher margins, less debt, greater cash generation with more stable double-digit growth, we are excited by the prospects for the portfolio in coming years.

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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clients, 1.1%, employing the Emerging Markets 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 Emerging Markets portfolio for the past year. Past performance is not indicative of future results.