SGA
Sustainable Growth Advisers

Q2 2018 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets portfolio returned -2.5% (gross) and -2.8% (net) in Q2 2018 compared to -8.0% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned -7.0% and the MSCI ACWI with EM Exposure Index returned -5.9%*

- *Higher U.S. interest rates and significant repatriation of funds by corporations due to tax law changes pushed the U.S. dollar higher, negatively impacting emerging market currencies*

- *Non-U.S. developed markets outperformed emerging markets which are more levered to currency fluctuations and restrictive trade policies; European economic growth showed signs of decelerating and markets, particularly in Latin America and Europe, faced selling pressure*

- *Larger-cap growth companies with higher levels of business quality were rewarded, but the reward varied significantly over the quarter*

- *Energy performed best followed by Health Care and Information Technology; Financials, Real Estate and Industrials performed the worst*

- *The portfolio benefited from strong stock selection, as well as positive sector allocation effects. Selection was strongest in the Consumer Discretionary, Information Technology, and Financials sectors*

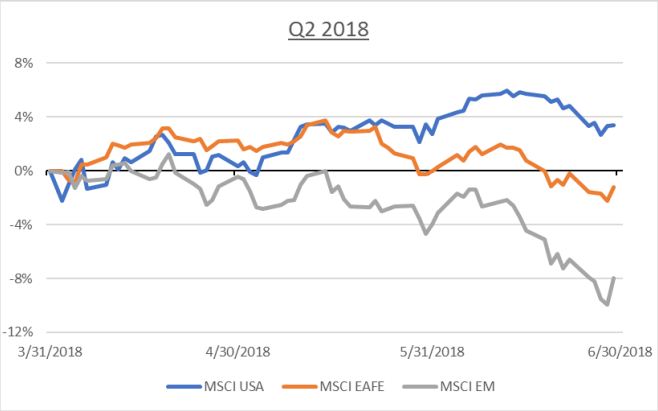
- *New positions in Asian Paints and CP All were initiated, while positions in Universal Robina, SAP, and Core Laboratories were sold*

Performance

SGA's Emerging Market portfolio returned -2.5% (gross) and -2.8% (net) in the second quarter of 2018 while its benchmark, the MSCI Emerging Market Index, returned -8.0%, the MSCI Emerging Market Growth Index returned -7.0% and the MSCI ACWI with EM Exposure Index returned -5.9%. Consistent with the return pattern we would expect, year-to-date the portfolio has returned 0.5% (gross) and 0.0% (net) compared to -6.7% for the MSCI Emerging Markets Index, -5.9% for the MSCI Emerging Markets Growth Index, and -5.4% for the MSCI ACWI with EM Exposure Index. The high-quality business characteristics and strong growth profile of the portfolio has historically resulted in strong downside protection while maintaining participation, although perhaps not fully, in strong up markets.

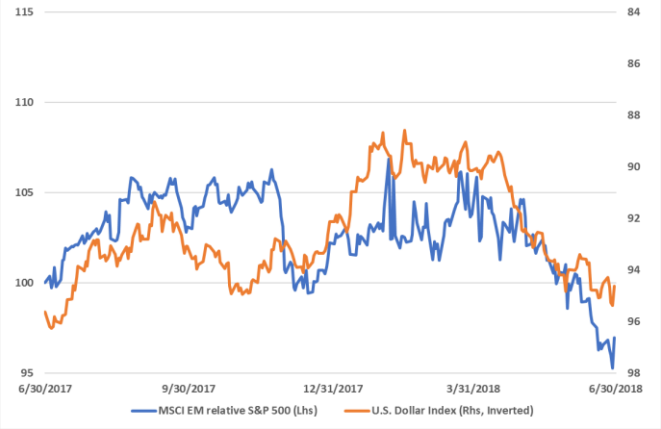
Emerging Markets Wavered on Stronger U.S. Dollar, Trade Tensions and Rising Interest Rates

Emerging markets underperformed developed markets by a wide margin in Q2 as the strong dollar, rising oil prices, global trade tensions, signs of weaker growth in Europe and liquidity issues compounded by currency weakness in emerging markets led investors to redirect funds toward the perceived safety of the U.S. market.



Source: FactSet, MSCI.

The chart below illustrates the close relationship between movements in the dollar and emerging markets relative performance over the past year.



Source: FactSet, MSCI.

China's Shanghai Composite Index fell 14.7% during the quarter on rising concerns over the possibility of a trade war with the U.S. Chinese authorities took steps to loosen monetary policy to stem weakness and the Yuan was allowed to drift lower relative to the U.S. dollar in hopes of mitigating some of the impact from higher tariffs on Chinese products. Weakness in Chinese equity markets, and concerns about the long-term impact of a trade war on China's economic growth, negatively impacted returns in other markets across Asia and the Pacific where any material weakening in China's growth would have a direct effect. Among the most affected were Thailand, Indonesia, Malaysia and Singapore.

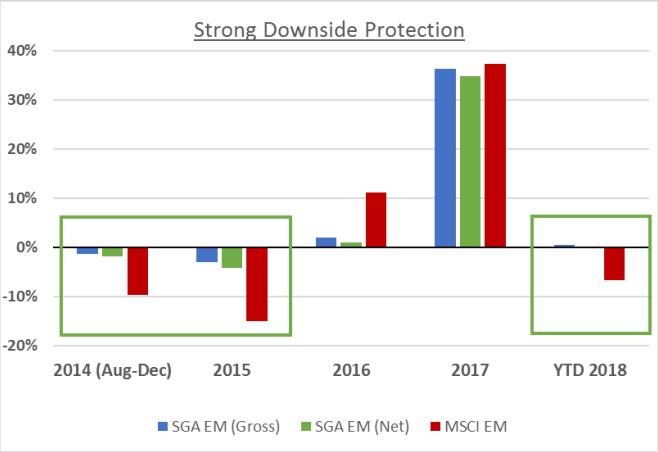
Brazil (-26.4%) was the worst performing emerging market in Q2, driven by slowing economic growth and rising political concerns. An economic recovery that appeared to be occurring in Q4 lost traction as uncertainty over the country's upcoming presidential election in October rose. The economy was also disrupted by a nationwide truckers' strike as industrial production plunged and GDP growth moderated.

Meanwhile, South Africa's economy reported its worst quarterly GDP figures in nearly a decade as the economy shrank by 2.2% in the first quarter, amid broad-based weakness resulting from concern about the African National Congress (ANC) and the potential for redistribution policies. South African equities underperformed materially during the quarter, which detracted from portfolio performance due to holdings in financial services conglomerate Sanlam and retailer Shoprite. The South African Rand depreciated significantly, negatively impacting returns measured in US dollars. In addition, poor sentiment across the emerging markets resulted in weakness across the space. Leading up to this, South African equities had materially outperformed in reaction to the election of the new president in Q4 and hopes for stability and economic reforms. With the weakness in Q2, South African equities retrenched, giving back some of what they had gained earlier in the year.

Key Performance Drivers

Strong stock selection in the Consumer Discretionary, Information Technology, and Financials sectors contributed most positively to returns during the quarter, while selection in the Consumer Staples and Health Care sectors detracted most. Favorable sector allocation effects also contributed positively to relative returns, helped by the portfolio's overweight in the Consumer Discretionary and Consumer Staples sectors as well as its underweight in the Financials and Industrials sectors. While the portfolio also benefited from its allocation to non-EM domiciled businesses (which generate a large portion of their revenues or have significant growth opportunities in emerging markets), stock selection across both emerging and developed market businesses contributed most to the portfolio's outperformance, with approximately two-thirds of the portfolios emerging market holdings outperforming the benchmark.

As we would expect, the portfolio delivered strong downside protection during the quarter. Just as in late 2014 and 2015 when emerging market equities were under stress, the portfolio's higher-quality business characteristics and better growth profile again contributed to strong relative returns in Q2. Since inception (August 1st, 2014) the portfolio has captured only 65% of the downside for the MSCI Emerging Markets Index, while delivering significantly higher returns with a lower level of variability.



Source: SGA, MSCI.

Largest Contributors

Amazon reported an impressive first quarter with AWS revenue growth accelerating to 49% and revenues from advertising growing 75% on a normalized basis. Our research continues to indicate a strong growth opportunity for the company especially in emerging markets, however we remain cognizant of recent stock price appreciation and an above-average cash-flow based valuation. Hence, we trimmed the position during the quarter.

Nike's shares rose to a record high after the company reported sales which exceeded most analysts' estimates and noted a return of growth in the U.S. market. Very strong sales in China carried the quarter for Nike. The company's new strategy of selling more directly to consumers, and thereby improving gross margins, and the use of online wholesale partners such as Zalando, Asos, Tencent and Amazon benefited results as did their greater focus on women's footwear and apparel. We

continue to see attractive opportunities for Nike as it continues to build its direct to consumer sales and capitalize on the trend toward more athletic-leisurewear in the emerging markets. We maintained an average weight position in the company.

Fast Retailing's shares rose following the release of their quarterly earnings report, which showed better-than-expected sales growth for its international Uniqlo stores. International Uniqlo sales grew 58% year-over-year while the company also managed to improve both gross and operating margins. Particularly, the company continues to deliver revenue growth along with increasing operating margins in China and Southeast Asia. Overall, Fast Retailing is executing well on its initiatives, and we remain optimistic about its 3-5 year growth opportunity as they expand into newer geographies such as India, while we are mindful of its above-average cash-flow based valuation.

Oilfield services leader **Core Laboratories** and Indian infrastructure IT company **Infosys** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

Ambev reported results which were slightly below expectations due to weak volumes in Brazil beer (down 8%) and disappointments in Canada which offset solid results in other parts of Central and South America where profits rose 22% and 26% respectively on strong revenue and volume gains. The early timing of Carnival, which traditionally marks the end of summer in Brazil, as well as cold and wet weather, and difficult year-over-year comparisons along with slow improvement in the consumer environment in Brazil combined to hurt volumes. Canadian results reflected difficult year-over-year comparisons. Based on our analysis, we view the issues above as shorter-term in nature and expect improvement in Brazil moving forward albeit it at a gradual pace in the near term because of ongoing political instability in the country. Ambev's premium beer business continued to do well, posting double-digit sales growth, and volumes for its overall business appear to have turned positive thus far in Q2. Also, despite its poor volume growth in Brazil in Q1, profits in the country grew 14% aided by significant margin expansion. Separately, the stock was also impacted by broader issues facing Brazilian equities including the impact of a truckers' strike on Q2 GDP as well as pressures from a strengthening U.S. dollar. With an improving local macroeconomic backdrop and significant margin recovery likely, we remain positive on Ambev's outlook, and added to the position on weakness.

South African retailer **Shoprite** was the second largest detractor from portfolio performance. The company's business in South Africa continues to gain market share and do well operationally but, due to deflation in over 6200 product lines, revenue growth does not have the benefit of inflation it has had previously. The Shoprite story for SGA, however, has always been about its ability to grow outside the mature South African market. While business conditions in many markets outside South Africa remain challenging, they are making progress in Angola, Zambia and Kenya, and they continue to look at other opportunities in Africa to expand. Given the company's strong distribution capabilities and scale, it has been able to maintain attractive operating margins despite the weakness, and its multi-store format which serves customers across all income segments, continues to generate attractive repeat traffic, ensuring strong recurring revenues. We view the current deflationary issue as being short-term in nature and remain positive on Shoprite's growth opportunity in sub-Saharan Africa and expect it to be able to double its revenues in Africa over our 3-5 year time horizon.

Sanlam was the third largest detractor from performance this quarter. Slow economic growth in South Africa and concern on the part of the market over the third and final phase of the company's acquisition of Saham Finances (a Morocco based insurer) negatively affected the stock. We view the acquisition favorably given that Saham provides Sanlam with an attractive footprint in the sub-Saharan Africa market which has attractive long-term growth potential and little penetration at the moment. The equity raise to fund the purchase dilutes the shareholders, but it does meet their hurdle rate requirements. They expect to build a life insurance presence in Saham's markets leveraging Sanlam's expertise in the area while also building Specialist and Reinsurance businesses. We expect gradual improvement in the South African macro-economic situation as reforms are instituted but our thesis is not dependent upon material improvement as Sanlam is well positioned to succeed despite ongoing volatility in the country and region's economic growth. We increased the position to an average weight on recent weakness.

Brazilian drug store chain **Raia Drogasil** and Philippine snack and beverage maker **Universal Robina** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover during the quarter was slightly above average. We initiated a position in India's leading decorative paint brand and manufacturer Asian Paints and a position in Thailand-based convenience store operator CP All during the period. Positions in Universal Robina, SAP, and Core Laboratories were liquidated. Positions in MercadoLibre,

Ambev, FEMSA, Sanlam, and Raia Drogasil were added to on weakness while we trimmed our position in Amazon on strength.

Purchases

India's leading decorative paint brand and manufacturer, **Asian Paints**, was added to the portfolio in the second quarter. The company operates in several segments including Decorative, which accounts for the majority of its business, Industrial and Auto through a joint venture with PPG, Domestic Home Improvement, and International Decorative. Asian Paints derives pricing power from a leading 50% market share in the oligopolistic, four player industry, as well as industry leading distribution and operational capabilities. The four players in the oligopoly make up the organized sector of the market which constitute about 70% of total sales, while the other 30% is unorganized and fragmented, made up of small mom-and-pop shops. We expect Asian Paints to be able to grow their market share further as the unorganized sector cedes share over time. Several structural growth drivers should benefit Asian Paints including Indian middle-class population growth and favorable demographics, urbanization and permanent housing growth, and an increase in the per capita consumption of paint which lags far behind that in other emerging markets. 85% of decorative paint sales, the largest business segment, are consumed in re-painting projects, independent of housing construction cycles, providing a steady stream of recurring revenues.

Potential risks for the company include commodity price volatility, which can cause short-term margin fluctuation and some sensitivity to macroeconomic cycles, however management has proven its ability to navigate these cycles while continuing to grow the company for decades. We initiated a below-average weight position in this high quality, long duration, high growth rate compounder, and expect to build the position opportunistically going forward.

Thai convenience and wholesale store operator **CP All** was also added to the portfolio during the quarter. Established in 1988, CP All is the sole operator of 7-Eleven stores in Thailand and also owns Makro, a wholesale cash and carry store. The company has pricing power due to its huge scale and vertical integration, recurring revenues from the highly repeatable business of convenience goods and cash and carry products, a long runway of international growth and a well tenured and experienced management team.

7-Eleven accounts for 60% of CP All's sales, while Makro accounts for 38% of sales and can be opened in 10 countries including Thailand, Cambodia, India and China, and others without the use of the Makro brand. In Thailand, there are about 15,000 convenience stores and about 10,000 of them are 7-Eleven stores, making CP All the clear leader in this format. Comparing convenience store densities in Japan and Taiwan, Thailand can support many more convenience stores, providing a significant runway for growth for 7-Elevens. CP All is currently opening around 700 stores per year, with half company owned and half franchised, and have set a target of 13,000 stores by 2020. The biggest challenge to more store openings is training the talent pool to run the stores. This is mitigated to some degree by CP All's vertical integration which includes an education business to train staff. CP All also owns a food processing unit of which 90% of sales are via 7-Eleven, a payment service company to pay bills such as electricity, an equipment company which provides all the equipment for the stores along with 24/7 support, and a catalog sales company which could be expanded online. The company's vertical integration and scale has been a major factor in their successful growth in Thailand and has the potential to be replicated in other countries such as Myanmar in the future.

CP All expects around 10% growth for both 7-Eleven and Makro. 7-Eleven has 7-8% growth per year from new stores, with an additional 2-3% same store sales growth. The company has a store traffic target which they seek to maintain through new store openings in order to prevent long checkout lines, as long lines take the "convenience" out of convenience stores. Makro was acquired in 2013 with less than 60 stores and they are now at 70+ and near their goal of one store per province. CP All is also opening a new food service format with 80%+ fresh food which will be attractive to restaurant owners. New store growth is expected at 2-3% with 5-6% same store sales growth for the next 3-5 years. Additionally, CP All has begun its international expansion with Cambodia now open and adding three stores per year, the first store in India expected at the end of the year, and expansion to southern China in 1-2 years.

Some concerns with CP All include the fact that their international expansion will not be profitable for 3-4 years. Additionally, the 7-Eleven format will be limited in its expansion from Thailand pending approval from 7-Eleven for other countries. Taking these issues into consideration along with the strong growth potential for CP All, we initiated an average weight position in the company.

Sales

The portfolio's position in **Universal Robina** was liquidated due to poor execution by the company and increased competition. The company continues to struggle in Vietnam given a recall in

its energy drink and tea products, which received significant social media attention and caused a meaningful drop in sales, as well as the integration of multiple recent acquisitions. In addition, competition continues to grow in their core Philippine business, with local players becoming more aggressive in the coffee segment, and multi-nationals subsidizing products to gain market share. The company faces additional pressure following the Philippine government's recent decision to impose a tax on sugared soft drinks including tea. With these near-term issues in mind, we sold the portfolio's position in the stock. We will continue to monitor Universal Robina's growth opportunity as the company addresses these concerns.

The portfolio's position in **SAP** was liquidated following a solid rebound in its stock price during the quarter. SAP continues to execute well on its transition from the sale of on premise licenses to cloud subscription products with license sales growing in the mid-single digits and cloud sales growing at around 30% per year, however given higher growth opportunities available on our Qualified Company List, we decided to exit the position.

We sold our position in specialty oil field services provider **Core Laboratories** as its shares had rallied significantly recently and its cash-flow based valuation had become less attractive. The company reported strong Q1 results as their business benefited from improved operating leverage, rising margins and attractive gains in free cash flow generation. Strength in their Production Enhancement business boosted results while North American well completions continued to grow quickly as the company helped customers get more from their existing wells. While we continue to expect Core Labs to capitalize on its growing strength in the North American market, we re-allocated the proceeds to more attractively valued growth opportunities.

Outlook

With unprecedented monetary accommodation across the globe receding and the U.S. dollar strong as trillions are repatriated, emerging market economies are facing pressures they haven't experienced since the global financial crisis. We continue to see highly attractive opportunities in the emerging markets, but the changing economic backdrop and likely greater differentiation between higher and lower quality businesses are making selectivity in stock selection ever more important. In an environment where sub-par companies have benefited from cheap borrowing and many investors have become complacent in their benchmark hugging and passive strategies, we are confident that the portfolio is well positioned for a market that is driven by greater differentiation.

We thank you for your interest in our Emerging Markets Growth portfolio and look forward to speaking with you about it in more detail.
