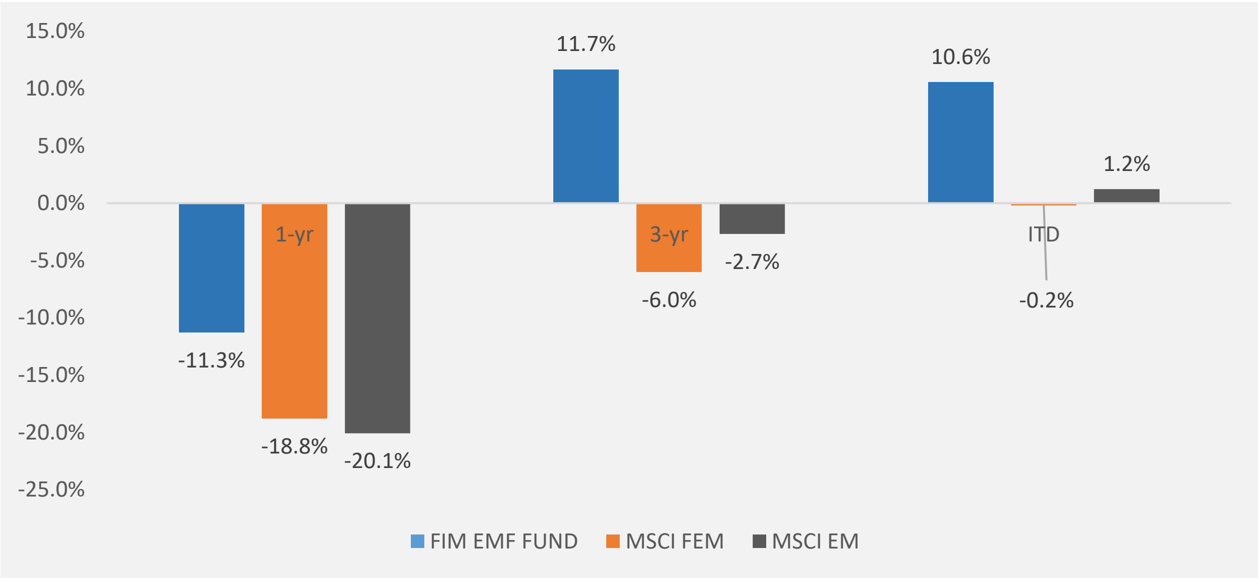
FIM Partners

EM Frontier Equities - Year in Review (2022)

By Mohammed Ali Hussain, Head of Research at FIM Partners

2022 was as close to the perfect storm for global equities given it had all the key ingredients i.e., rising inflation, aggressive rates tightening, and global geo-political turmoil. The Fund was not immune to these pressures as we delivered a gross return of -11.3%[1] vs. -18.2% for the MSCI FEM Index. This takes our inception to date performance to a +10.6% annualized return, outperforming both the MSCI FEM Index (-0.2%) and the MSCI EM Index (+1.2%).

Figure 1: FIM EM Frontier Fund vs. Indices [2]



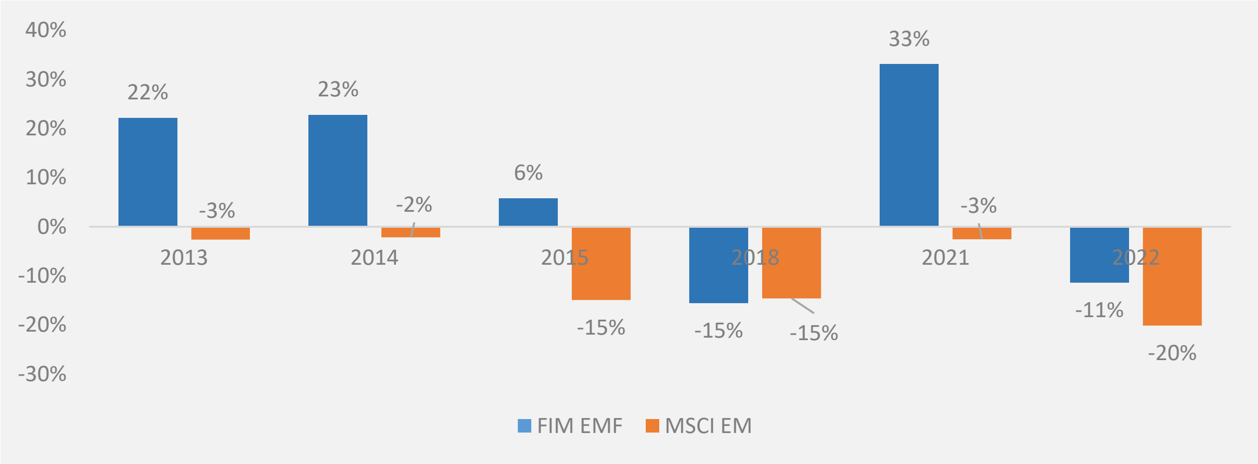
Source: FIM Partners, Bloomberg

Our 2022 performance can be evaluated from two perspectives. On one hand, we continued to generate significant alpha to the respective equity indices but are cognizant that alpha alone is not a reason to give ourselves a pat on the back. On the other hand, we acknowledge that our bias toward quality businesses positioned in powerful domestic secular themes would be out of favor in a year where market short termism is rampant and global commodity driven sectors benefitted from the surge in hydrocarbon and agricultural commodity prices. Disciplined investing mandates not dancing to every new tune markets throw at you but rather have faith in your philosophy and process to outperform in the long term. Case in point, in addition to our inception to date outperformance, if we compare the Fund's performance to years where the MSCI EM index delivered negative returns, the Fund has not only outperformed but has delivered positive returns in the majority of those years. (Figure 2).

[1] All returns are in US$ terms

[2] Fund returns are on a gross basis and indices returns on a total return basis. All returns are annualized except for 1-yr

Figure 2: FIM EM Frontier Fund vs. MSCI EM (Index Negative Return Years)



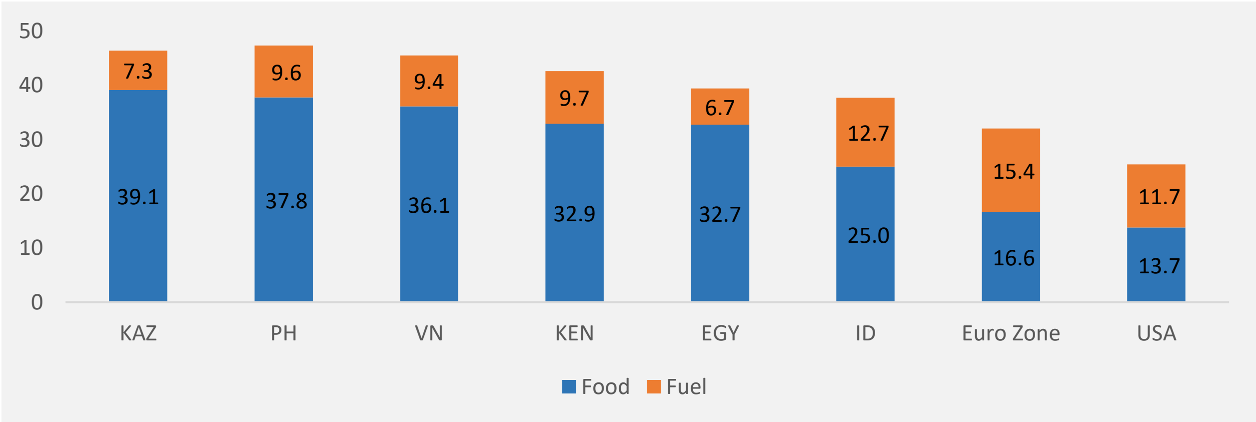
Source: FIM Partners, Bloomberg

As highlighted in our 2021 Investor Letter, banking on the artificially induced low-rate environment of the last two years to prevail was unrealistic:

"It is the basis of monetary tightening i.e., rising global inflation that requires closer attention. We could spend a lot of time debating whether this inflation trend is transitory vs. long term but that would be futile… This is not the first time we have seen an elevated inflationary environment and likely will not be the last." – FIM Partners EM Frontier Investor Letter (2021)

Our base case scenario assumed inflation to sharply increase initially at the behest of pent-up demand with supply chains simultaneously facing pressure from the demand surge, but that these pressures would gradually recede leading inflation and interest rates reverting to pre-pandemic levels. Given FEM countries did not have the luxury of handing out hefty stimulus support, the inflation drivers were distinct from what we were seeing in developed markets. However, it was specific inflation drivers for FEM and unique geo-political circumstances that transpired which could not be reasonably anticipated. The rapid escalation of the Russia-Ukraine crisis to a full-blown military conflict which led to spiraling agricultural and hydro-carbon commodity prices created an additional inflationary headwind to compound those already stemming from economic reopening.

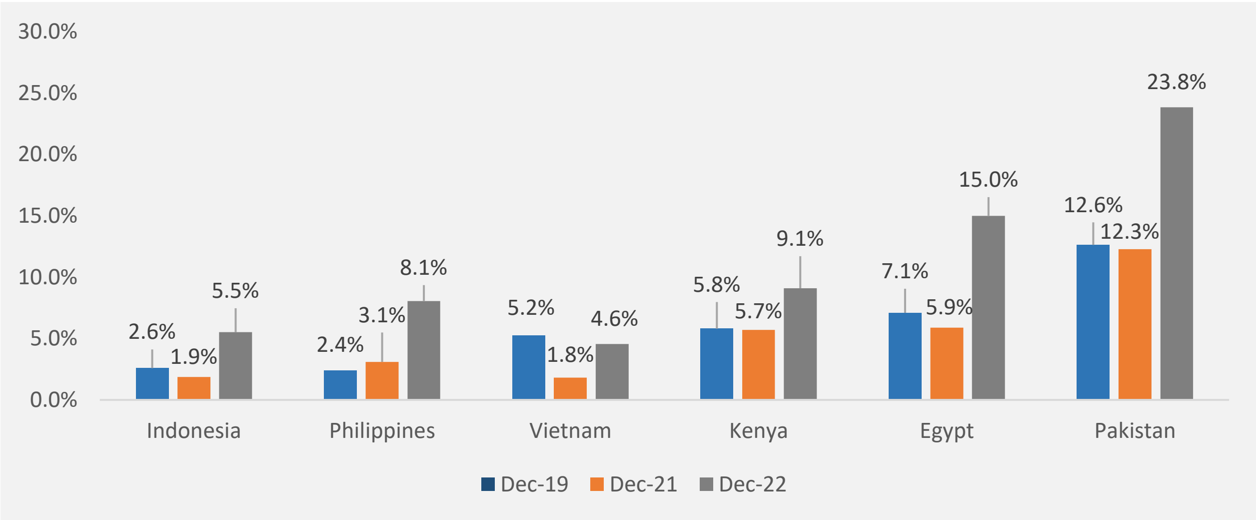
Figure 3: CPI Basket Weight Comparison



Source: World Bank, Bureau of Labor Statistics, Euro Statistics

While the global inflationary impact from the Russia-Ukraine conflict has been widely discussed, the specific impact on FEM is perhaps not as widely understood. Unlike developed markets, FEM inflation baskets are heavily skewed towards food consumption (Figure 3) and thus faced higher pressure versus developed markets, considering the dominant role of Russia and Ukraine in global cereal crops supply. Conflict induced food protectionist policies being imposed by countries like India did not help matters either. And if these factors alone were not a challenge, the spike in global shipping rates further aggravated the situation given the food import dependencies of some of our key markets. For instance, Indonesia is the world's largest wheat importer accounting for 6.1% of global imports and completely reliant on imports for its needs, whilst the Philippines has a food import dependency ratio of 25%. Even domestic agricultural production wasn't spared as fertilizer prices rose exponentially in lieu of Russia's position as the world's top fertilizer exporter. The result was that inflation significantly overshot pre pandemic levels (except in Vietnam due to domestic subsidies cushioning the impact) leading central banks to aggressively hike interest rates.

Figure 4: Inflation Comparison (pre pandemic vs. present)



Source: Bloomberg

These extra-ordinary circumstances translated to some critical portfolio decisions. In addition to exiting businesses which we felt would not be able to pass on this heightened inflation impact, we also took the decision to quickly exit holdings in Eastern Europe that could have potentially gotten embroiled in the conflict by virtue of geographic proximity. Unfortunately, this meant beating a hasty exit and, in the process, bearing the downturn that was engulfing these markets. However, we were able to recuperate some of those losses by taking advantage of the fundamental-valuation mismatch prevailing during 1H 2022 to invest in businesses like Network International, which is discussed in further detail below.

The Bright Spots

Amidst the gloomy environment facing equity markets, there were a few bright spots. One was our Indonesian multi-format retailer investment Mitra Adiperkasa TbK (MAPI) which operates department stores, specialty apparel, and F&B outlets with exclusive rights for 150 brands such as Inditex and Starbucks. The company operates 2,500+ stores with a GLA of 0.9mn sqm primarily across Indonesia along with presence in the Philippines, Thailand, and Vietnam. In addition, MAPI has built a formidable online presence with online retail sales accounting for 9% of sales. Our investment thesis is premised on: (i) broad exposure to growing

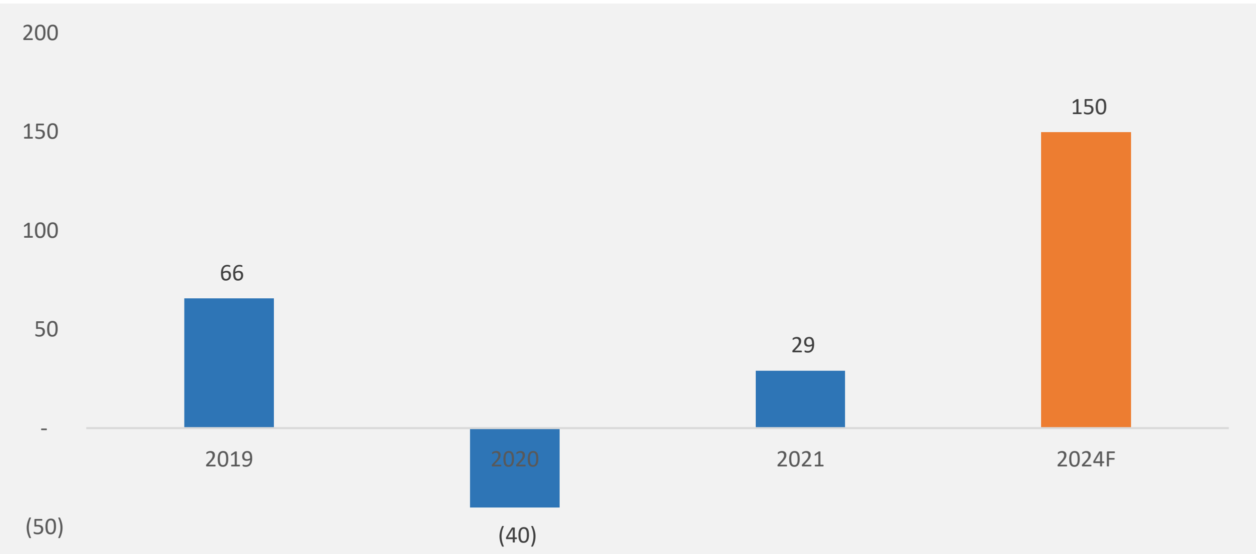
Indonesian middle-class consumption, (ii) strong rental bargaining power with mall operators given their brands tend to occupy 1/3 of the typical mall space, and (iii) fruits of a 2018-19 restructuring plan that led to shutting down non profitable brands and improving inventory management policies that would significantly improve working capital management and overall profitability.

Figure 5: MAPI Store Formats & Brands Portfolio

Source: MAPI Investor Presentation 3Q 2022

We saw MAPI as a strong proxy to the Indonesian re-opening theme given its exposure to the middle-income class through a number of distinct high quality global brands, with our country visit earlier in the year affirming our thesis as we witnessed first-hand vibrant mall traffic reminiscent of pre-pandemic levels. Our thesis panned out as the company has delivered 47% earnings growth over the same period in 2019, whilst the stock delivered a +87% return.

Figure 6: MAPI Earnings (US$ mn)

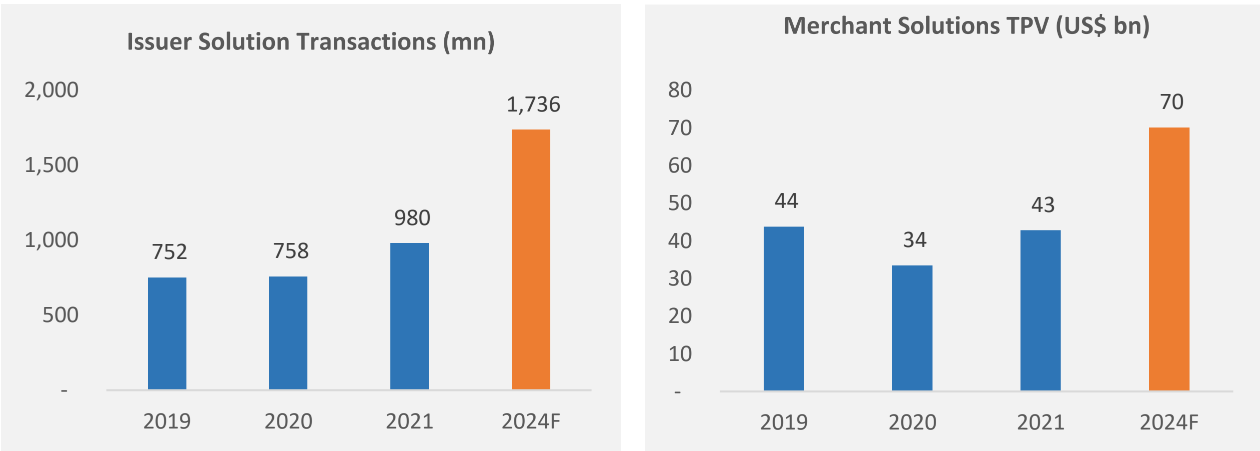


Source: Company Financial Reports, FIM Partners

In a year where "tech" went from buzzword to buzzkill, the Fund's U.A.E payment processor was another bright spot as it delivered +150bps positive contribution for the Fund. Network International (NI) is the largest payment processor in the UAE that processes almost USD42bn of TPV, 16mn payment credentials, services over 150k merchants and 200 financial institutions – positioning NI as the market leader (almost 50% merchant service market share in the UAE). At its core, the business model is simple - NI earns a commission for facilitating secured payments. NI operates a more reliable payment processing platform resulting in better customer loyalty, which leads to higher market share and wider network shaping a comprehensive ecosystem, further attracting more financial institutions / merchants to sign-on. In addition to doing the basics right, the company offers industry's leading value-added services such as providing data analytics, integrated inventory management, and 3D secure authentication to name a few.

We are also impressed by the management's strategic growth objectives that have led to NI securing new licenses across its footprint in 2022. This includes the category-1 license in the UAE, and PSP license in Egypt enabling the company to start merchant acquiring business. The company also secured a payment Institution category license from the Saudi Central Bank that will enable it to provide direct-to-merchant services in Saudi Arabia. We expect this business to deliver 20% earnings CAGR from 2022-25 while maintaining around 4-5% ROA / 13-15% ROE.

Figure 7: Network International - Key Metrics



Source: Company Presentations, FIM Partners

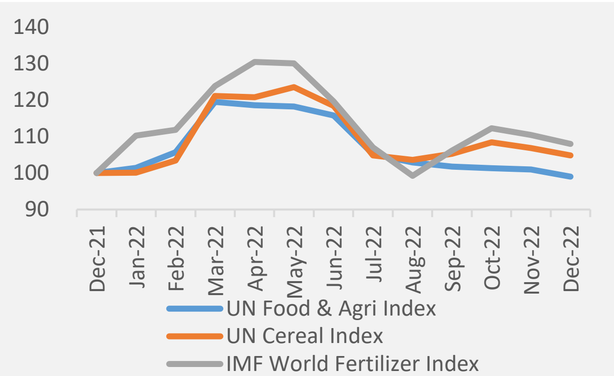
With equity markets battling the perfect storm, fundamentals may not always being rewarded. For instance, our investment in a Pilipino multi-format retailer with similar attributes to MAPI delivered negative returns despite benefitting from a similar re-opening theme. In this case, our company is one of the largest supermarket and drug store operators which also has discretionary spending outlets catering to DIY, Department stores and Specialty Stores. The company operates 2,111 stores with a GLA of 1.46 million sqm. Despite delivering 50% earnings growth over the same period in 2019, the stock trades at a 40% discount to its 10-year median P/E multiple as the market chose to ignore the company's astounding recovery and inflation resilient business model. This highlights an important aspect of our investment philosophy i.e. returns may not always materialize in a single given year thereby patience is mandated as long our thesis remains intact. Hence, even though our investment did not translate to positive returns this year, we view this investment as a bright spot as the market short termism has allowed us to buy into a quality business with strong long term growth prospects at an attractive valuation.

Outlook

Interest rates, geopolitics, and China's COVID policy will remain key swing factors for investors in 2023. Inflation, albeit lower than 2022 peaks, will remain elevated requiring Central Banks to maintain a hawkish stance, at least in the first half of the year.

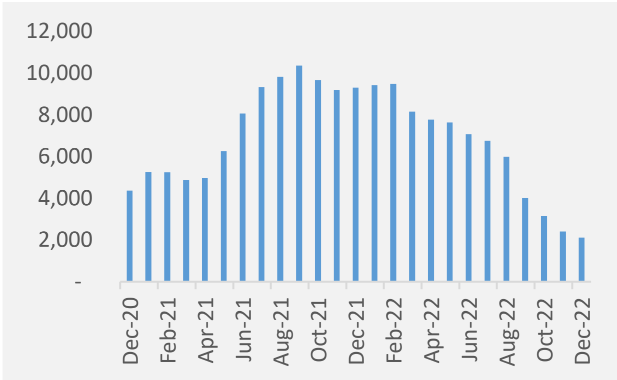
While the global debate rages on the direction of Fed rates and U.S. inflation, it is not something we are losing much sleep on. Specifically, as it pertains to this inflation cycle, when/where U.S. inflation peaks and when/if the Fed pivots are not as material given the distinct inflation drivers of our markets and the fact that most of our markets have been seeing foreign outflows long before the Fed tightening cycle commenced and remain at decade low foreign ownership levels. We see positive signs for inflation reversing in some of our key markets as agricultural commodity prices, inputs, and global freight rates have significantly come off from recent highs. We are already beginning to see the initial rounds of inflation downgrades which means the chances of central banks pausing/reversing course is higher than current consensus estimates.

Figure 8: Agri Indices (normalized to 100)



Sources: Bloomberg

Figure 9. World Container Freight (US$/40ft Box)



With the prospect of the first full year of uninterrupted tourism, the key beneficiaries in our investable markets are Philippines (with tourism c.12.8% of GDP), Vietnam (c.9.2%), and Dubai (c.12.1%). While many of our markets began allowing tourists in 2022, in-bound quarantine requirements coupled with restrictions on returning passengers in their home countries restricted tourist flows. The absence of Chinese tourists was also detrimental for tourism recovery considering Chinese tourists alone accounted for 20% of global tourism spending in 2019 and are typically the largest source of tourists in our markets. Aside from the impact of FX receipts, tourism is a major source of domestic employment accounting for 13.6% and 5% of total domestic employment in Philippines and Vietnam respectively. While we do not expect tourism numbers to immediately revert back to pre-pandemic levels due to the projected global economic slowdown, the return of Chinese tourists after a two-year hiatus and rising overall tourist arrivals will be a positive catalyst for domestic consumption.

Figure 10: Philippines Tourism GDP Contribution

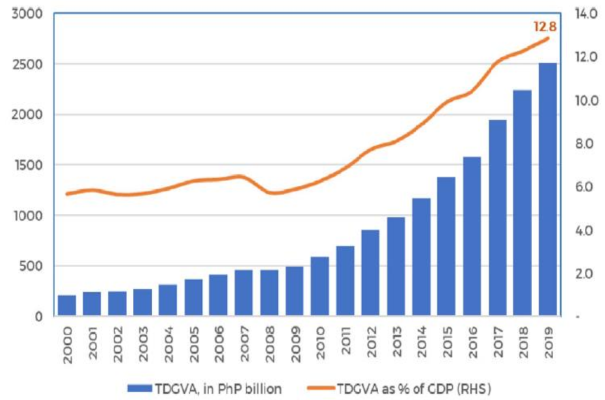
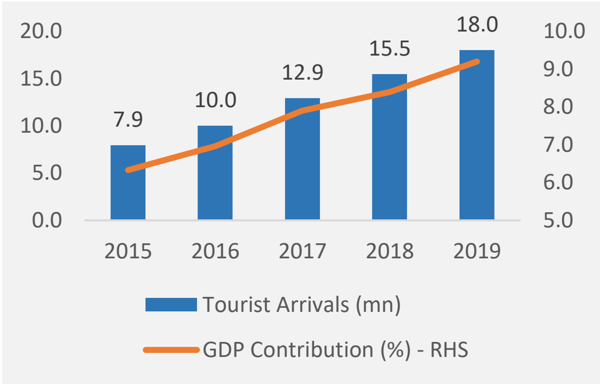


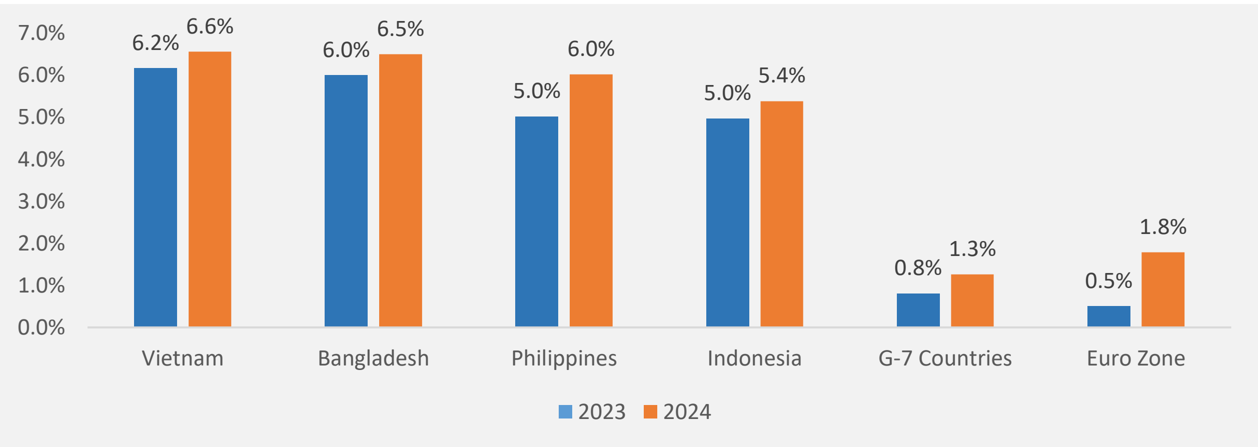
Figure 11: Vietnam Tourist Arrivals & GDP Contribution



Sources: BSP, Vietnam Ministry of Culture, Sports & Tourism

Amidst a projected global slowdown, the FEM economic outlook in 2023 is among the brightest. Indonesia, the Philippines, and Vietnam should see domestic demand driving headline GDP growth to 5-6.2%, outperforming the likes of China which is expected deliver 4.5% growth. Headline GDP growth in the GCC should be at 3.8%, with non-oil private sector GDP growth expected to be in excess of 6% (notable as this is most pertinent to our opportunity set). This outlook is in stark contrast to weak growth in other mainstream EM countries (Brazil, Mexico, Turkey) and the G-7 countries.

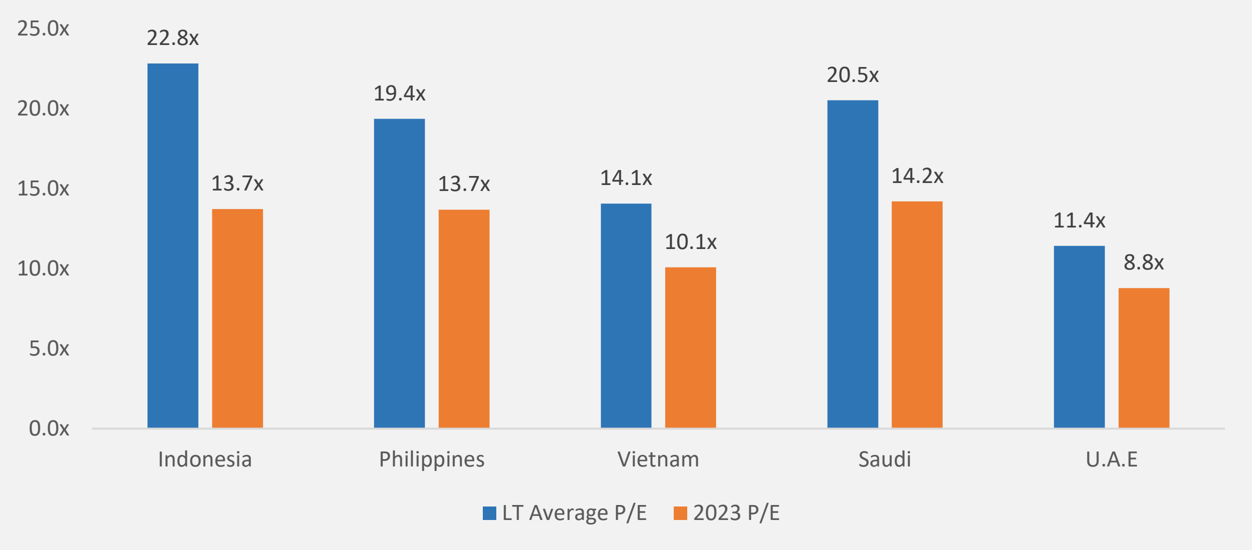
Figure 12: GDP Growth Outlook – FEM vs. DM



Source: IMF World Economic Outlook, October 2022

When it comes to valuations, despite relatively stronger growth expectations, P/E multiples are at a 20-40% discount to their long-term average. Philippines and Vietnam, accounting around 40% of our portfolio, are trading at a 30% discount respectively to the historical average.

Figure 13. Select FEM - 2023 P/E vs. LT Average

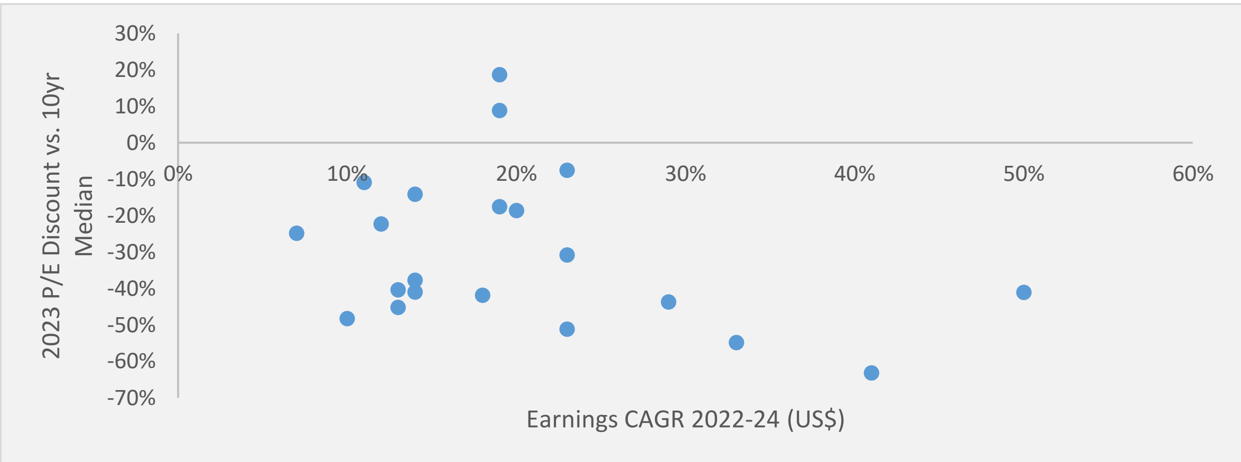


Source: Bloomberg

Key risk factors for the frontier markets would be resurgent food and energy price inflation especially in markets with dovish central banks. A global recession would pose challenges to some of the more export-oriented economies such as the GCC and Vietnam, but the former has substantial domestic stimulus room (including onshore spending of sovereign wealth funds), and Vietnam's room for fiscal easing via public investment spending can offset external pressures. We are generally avoiding markets that have high debt burdens and vulnerabilities to global liquidity, but these markets are few and not systemic to the investment universe.

The portfolio looks attractively valued at a 31% discount to the long term weighted average P/E and projected to deliver a US$ 20% earnings CAGR from 2022-24. At the same time, our portfolio companies have adequate internally generated cash flows and reserves to execute their growth plans, with portfolio Net Debt/EBITDA at 0.2x. Hence, the interest rate path that Central Banks take is not important to our earnings expectation considering the balance sheet strength of our holdings. But as we say every year, sentiment is not something we can account for, and we keep our fingers crossed that fundamentals are rewarded.

Figure 14: Portfolio Holdings -Valuation Discount vs. 2022-24 Earnings CAGR



Source: FIM Partners, Bloomberg

We continue to view the portfolio as a conglomerate of businesses with sustainable strengths and are confident in the portfolio's composition going into this year. The fund's high-conviction concentrated strategy has worked well across market cycles in the past and we will therefore continue to focus on underwriting high-quality businesses with excellent capital management.

We would like to thank all our partners for your support and trust in us. We look forward to our continued partnership and wish you a healthy and happy new year.