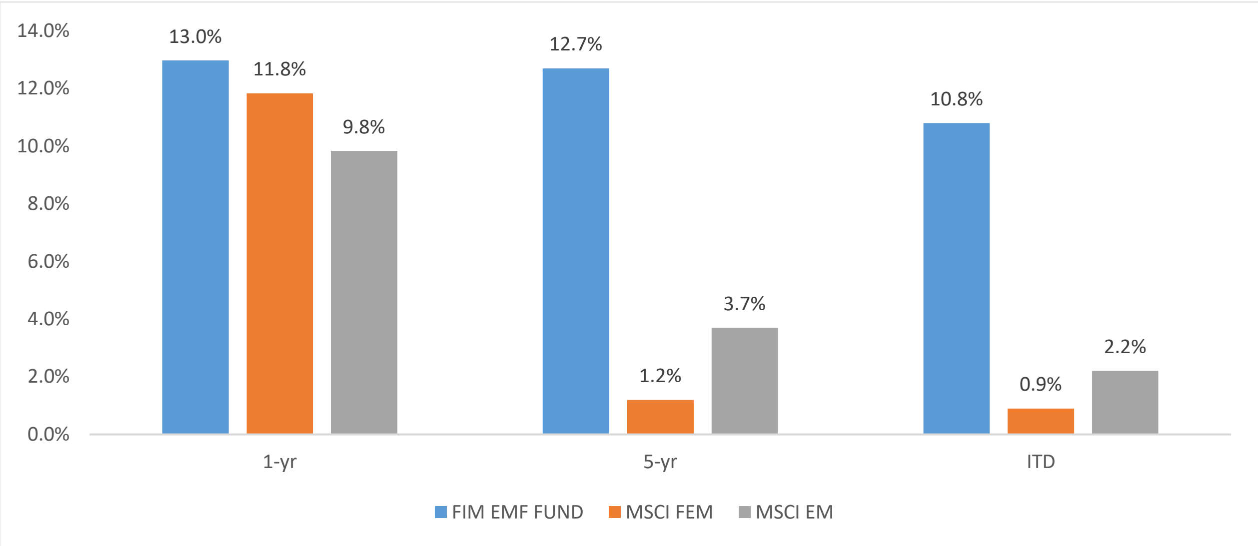
FIM Partners

EM Frontier Equities - Year in Review (2023)

By Mohammed Ali Hussain, Head of Research at FIM Partners

The Fund rebounded in 2023 as it delivered a +13.0% gross return. This takes our inception to date performance to a +10.8% annualized return, outperforming both the MSCI FEM Index (+0.9%) and the MSCI EM Index (+2.2%) whilst delivering double digit returns in 7 out of 11 years.

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



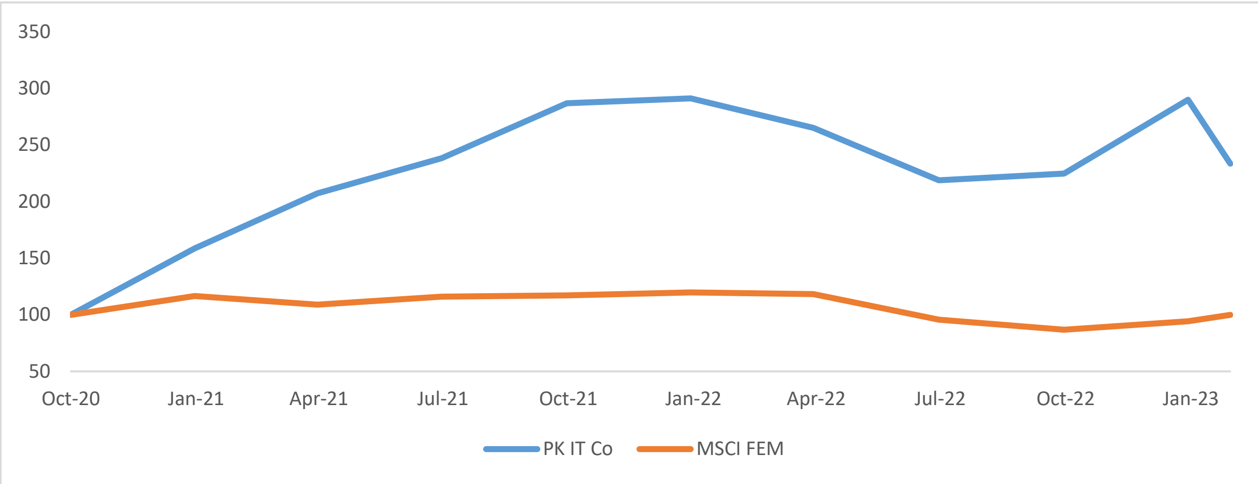
Source: FIM Partners, Bloomberg

Our tech and IT solutions investments contributed approximately 1/3 of our total returns with strong performances from our legacy investments in the Vietnamese IT solutions and Kazakh fintech space, that delivered returns of +43% and +39%, respectively. We were also fortunate with an unforeseen value realization event accelerating our thesis timeline. Recall from our 2022 Investor Letter in which we discussed our investment in Network International (NI); a U.A.E. payment processor that processes almost USD42bn of TPV, 16mn payment credentials, services over 150k merchants, and 200 financial institutions – positioning it as the market leader (almost 50% merchant service market share in the UAE). In April 2023, NI received a non-binding proposal from a consortium led by CVC and Francisco Partners for a possible cash offer representing a 60% premium to the pre-offer price, followed by a competing offer from Brookfield Asset Management at an additional +2.6% premium that valued the business at USD 2.8 billion, which was eventually accepted. At the time of our initial investment, the company was valued at USD 1.4 billion and offered over a 20% USD IRR on our investment. With our IRR target achieved, we exited our holding and collected a handsome contribution towards our annual return.

[1] Fund returns are on a gross basis and indices returns on a total return basis. All returns are in US$ terms and are annualized except for 1-yr. The Fund inception date is January 2013.

However, even the best researched theses are not iron clad. The unexpected 18% devaluation of the Pakistani Rupee in January 2023 sparked sovereign default fears that engulfed the equity market. Our sole Pakistani IT solutions provider exposure was an inherent beneficiary of currency devaluation with almost 80% of revenue derived in US$ and the cost base primarily in local currency, which allowed it to deliver 2.5x US$ earnings growth from 2019-22 despite 46% currency depreciation over the same period. But a potential sovereign default (which eventually did not occur) is an insurmountable hurdle, even for the best of businesses and served a powerful lesson in the rapid snowball effect of macro shocks. Despite the negative contribution this year, this position delivered a +37% annualized US$ return over our two-year holding period.

Figure 2: PK IT Investment vs. MSCI FEM- US$ returns (normalized to 100)



Source: Bloomberg

Travel Diary Snippets

Conducting thorough on-the-ground research becomes paramount in emerging markets given information imbalances reign supreme. A diligent investor must shun the comfort of a desktop approach, for it is on the field where hidden gems often lie concealed. During our excursions, we commit ourselves equally to two tasks: the birth of novel ideas and the vigilant scrutiny of our existing holdings.

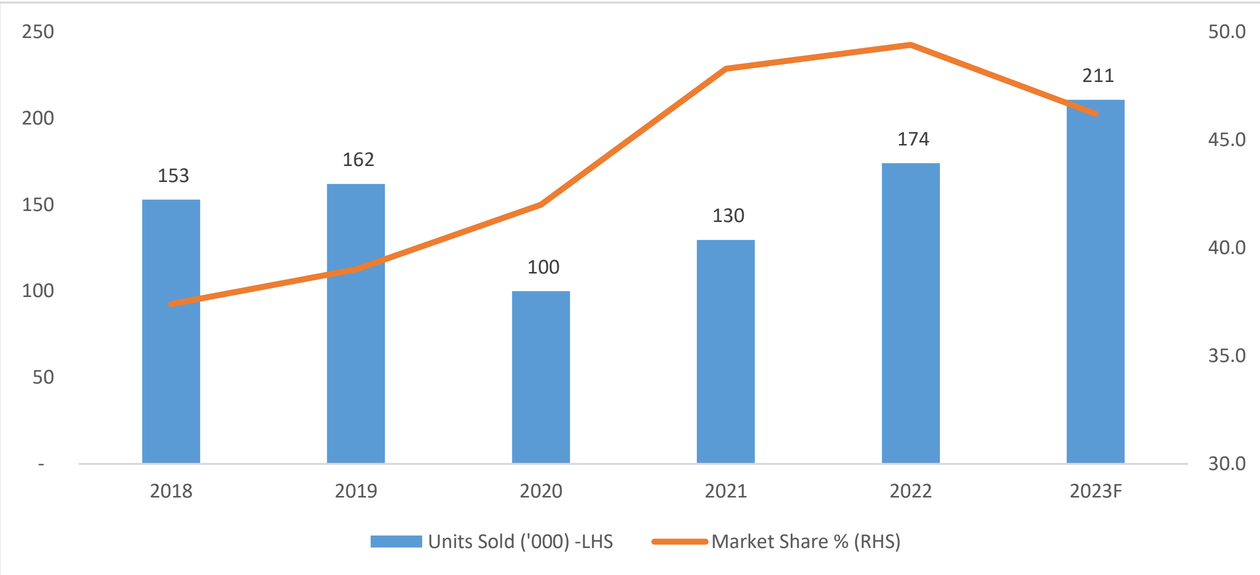
Our preference leans heavily toward rolling up our sleeves, embracing the grit of the field, and witnessing our investee companies' products and services in real-world action. We find solace in the bustling streets and factory floors rather than the opulence of plush C-suite offices. For it is in the trenches, amid the local peculiarities and subtleties, that we discover the secrets that defy conventional wisdom.

Take, for instance, our investment in the Filipino automotive sector. Common sense would suggest that soaring interest rates, particularly when a substantial 80% of auto purchases rely on bank financing, would spell doom for automobile sales. This scenario appeared all too familiar, reminiscent of the interest rate peaks witnessed in July 2007. Yet, our post-pandemic visits to the Philippines unveiled a different narrative. As we traversed the country, we observed a shift in residents' living preferences, away from the crowded metropolitan condos towards suburban spaces, resulting in longer commutes through the notorious Manila traffic. Moreover, new traffic regulations restricted daily access to the city center, necessitating multiple vehicles per household due to the lackluster public transportation system.

Perhaps the most telling sign was our mid-week sojourn to a local car dealership, during one of the year's fiercest rainstorms where surprisingly, a line of eager customers queued for parking spots. Conversations with these customers confirmed that car ownership was evolving into a necessity, propelled by the factors mentioned earlier and an increasing number of employers revoking work-from-home privileges. This feedback validated our hypothesis: a new catalyst for automotive demand was brewing, with car ownership ascending the hierarchy of discretionary spending.

Our conviction bore fruit as our investee company is poised to achieve a remarkable +30% volume growth above 2019 levels (see Figure 3) and yielded a stellar +37% return. Had we adhered to the dogma of interest rate impact on auto demand, this opportunity would have eluded us.

Figure 3: Auto Sales Volumes ('000 units) & Market Share (%)



Source: Company Annual Reports, FIM Partners

Figure 4: Cimory Peer Return Comparison (%)

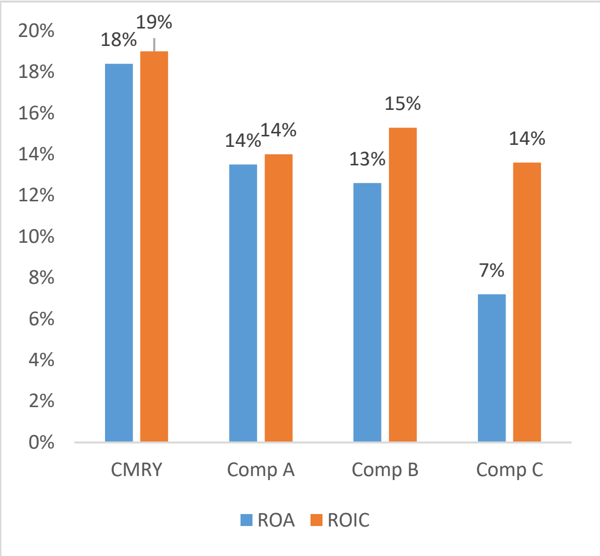
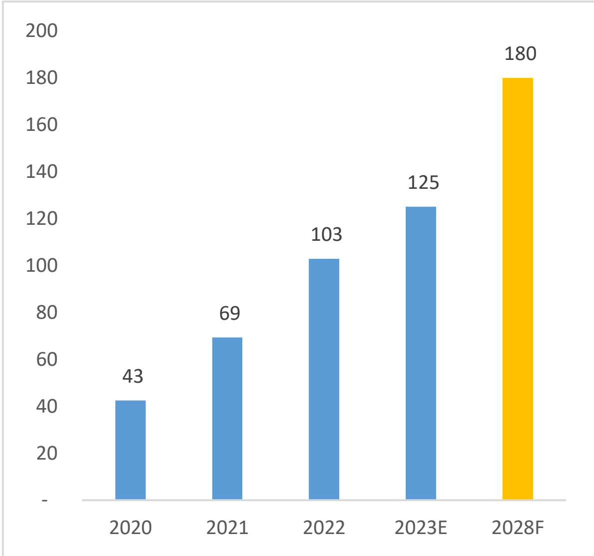


Figure 5: General Trade Footprint ('000)

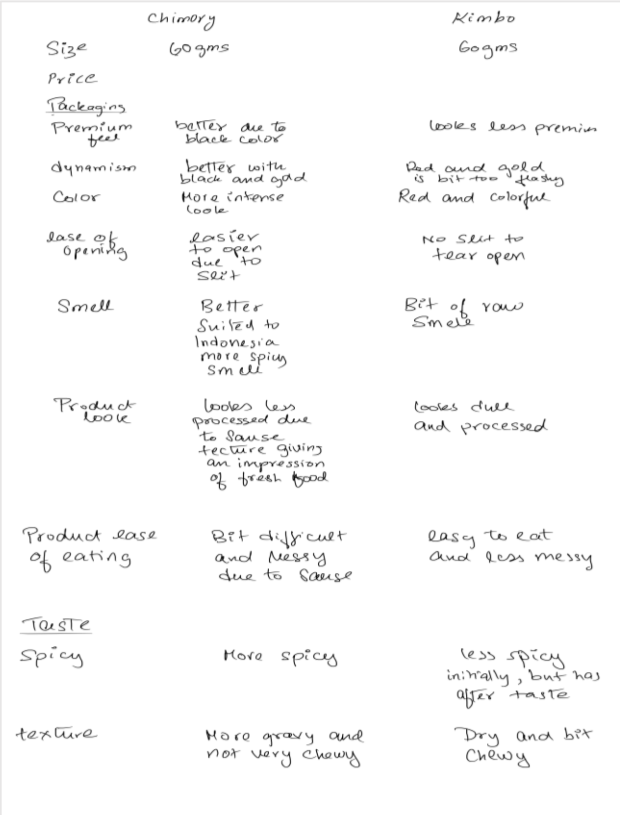


Source: Company Annual Reports & Presentations, FIM Partners

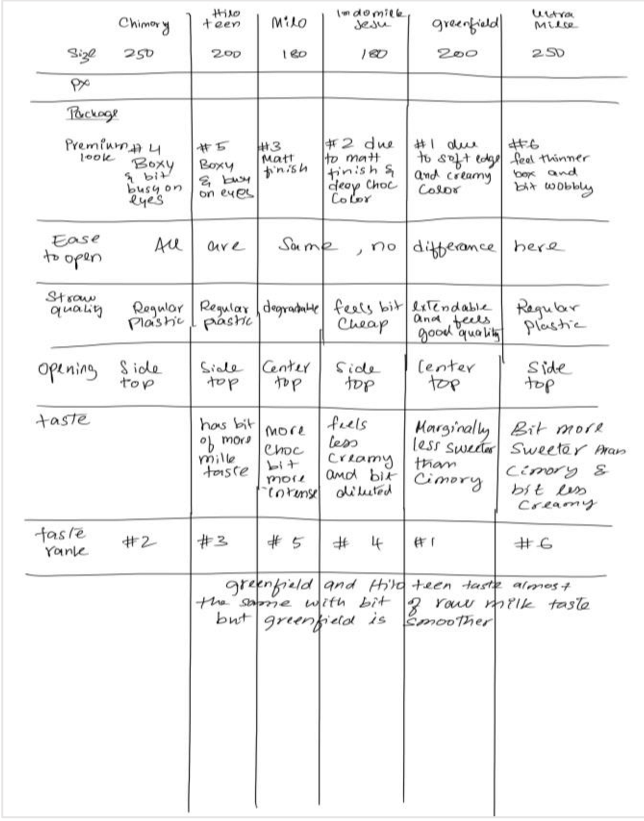
Channel checks are not restricted to our initial due diligence and need to be constantly refreshed to ensure the validity of our thesis. In 2022, we invested in a leading Indonesian packaged foods company that operates in the premium dairy and consumer food segments with our thesis premised on rising demand for premium/healthy products from the burgeoning Indonesian middle class. The company stands out for a number of reasons including: (i) Strong track record as a category creator and/or disrupter as it exploits product niches in established broad categories to find pockets of exponential growth, and (ii) The company's end to end in-house cold chain logistic capabilities coupled with its scale and logistic synergy between dairy and processed meat, enables it to command an operating leverage which competitors struggle to replicate. This feeds into our company commanding an industry leading 18% and 19% Return on Assets and Return on Invested Capital, respectively. We see favorable growth prospects as it plans to enhance its General Trade (GT) footprint by 45% to 180k outlets in the next 4-5 years which factors in our 15% forecast earnings CAGR. To put it in context, Coca Cola has 500k outlets while Unilever has 2 million outlets implying significant growth headroom beyond the company's current GT penetration target.

During our recent trip, we spent significant time revisiting our original channel checks including comparing our company's products against competitors on a variety of metrics from shelf positioning versus prior years down to the nitty gritty of taste, packaging, etc. To enhance the accuracy of these exercises, we had a local resident accompany us as they are the target consumer and whose preferences could differ from ours. We share a snapshot of our findings of their chocolate milk and RTE sausage products versus competitors in Figure 6. The conclusion was that our company continues to retain its competitive edge, giving us higher comfort on its earnings and capital return outlook.

Figure 6: Cimory Products Channel Checks Notes



	Chimory	Kimbo
Size	60gms	60gms
Price		
Packaging		
Premium feel	better due to black color	looks less premium
dynamism	better with black and gold	Red and gold is bit too flashy
Color	More intense look	Red and colorful
ease of opening	easier to open due to slit	No slit to tear open
Smell	Better suited to Indonesia more spicy smell	Bit of raw smell
Product look	looks less processed due to sause tecture giving an impression of fresh food	looks dull and processed
Product ease of eating	Bit difficult and Messy due to sause	easy to eat and less messy
Taste		
Spicy	More spicy	less spicy initially, but has after taste
texture	More gravy and not very chewy	Dry and bit Chewy



	Chimory	Hilo teen	Milo	Indomilk Jesu	greenfield	Ultra Milk
Size	250	200	180	180	200	250
Px						
Package						
Premium look	#4 Boxy & bit busy on eyes	#5 Boxy & busy on eyes	#3 Matt finish	#2 due to matt finish & deep choc color	#1 due to soft edge and creamy color	#6 feel thinner box and bit wobbly
Ease to open	All	are	Same	, no	difference	here
Straw quality	Regular Plastic	Regular pastic	degradable	feels bit Cheap	extendable and feels good quality	Regular plastic
Opening	Side top	Side top	Center top	Side top	Center top	Side top
taste		has bit of more milk taste	more choc bit more intense	feels less creamy and bit diluted	Marginally less sweeter than Cimory	Bit more sweeter than Cimory & bit less creamy
taste rank	#2	#3	#5	#4	#1	#6

greenfield and Hilo teen taste almost the same with bit of raw milk taste but greenfield is smoother

Source: FIM Partners

Being on the ground does not imply coming back with a suitcase of readily investable ideas. Sometimes it's about identifying quality businesses that may not fulfill our underwriting criteria on day one but have the potential to become portfolio candidates.

The diversification of global supply chains away from China is a powerful structural theme benefitting the ASEAN region, particularly as it pertains to the EV supply chain. Indonesia stands as a key beneficiary being Southeast Asia's largest automobile retail market and its second-largest production hub behind Thailand complimented by the manufacturing presence of major Asian OEMs including Toyota, Honda, Hyundai, etc. Indonesia has a strong advantage in capitalizing on EV value chain opportunities considering it is amongst the top 5 countries globally in terms of nickel and cobalt reserves while its legacy automotive infrastructure facilitates a seamless integration for EV manufacturing. There have already been several significant investments in this realm (Table 1) with talks of Tesla and BYD considering establishing EV manufacturing facilities in the country. The Indonesian government is also playing a key role by offering lucrative incentives including removal of import duties to EV manufacturers whilst establishing a domestic production target of 600,000 EVs by 2030. However, to receive the incentives the OEMs need to commit to achieving a 40% localization target by 2026, creating a lucrative opportunity for local automotive parts suppliers.

Table 1: Indonesia EV Value Chain Investments

Country	Company	Segment	Details	Investments (US$ bn)
Indonesia	CATL	EV battery	Battery integration project	6.0
	BASF and Eramet	EV battery material	Production of battery-grade nickel and cobalt	2.6
	Foxconn	EV and battery manufacturing	JV with Indika Energy and Indonesia Battery Corporation (IBC)	1.8
	Hyundai Motor	EV manufacturing	Opened an EV manufacturing plant in Indonesia in 2022	1.5
	Toyota	EV manufacturing	Hybrid and electric cars	1.8
	LG & Hyundai	EV Battery	10 GW EV Battery Cell Manufacturing facility	1.1

Source: HSBC Research, Bloomberg

We sought to gather insights into this powerful structural story and met several automotive supply chain players in the process. Our efforts led us to a relatively under-researched auto parts supplier that popped up on our radar due to its industry leading growth and return profile (+33% earnings CAGR over the last four years with an astonishing 37% ROE). What was supposed to be an hour-long dinner meeting turned into almost three hours followed by an impromptu factory visit the following day, as the CEO's passion and strategic prowess during the initial meeting stoked our intellectual curiosity.

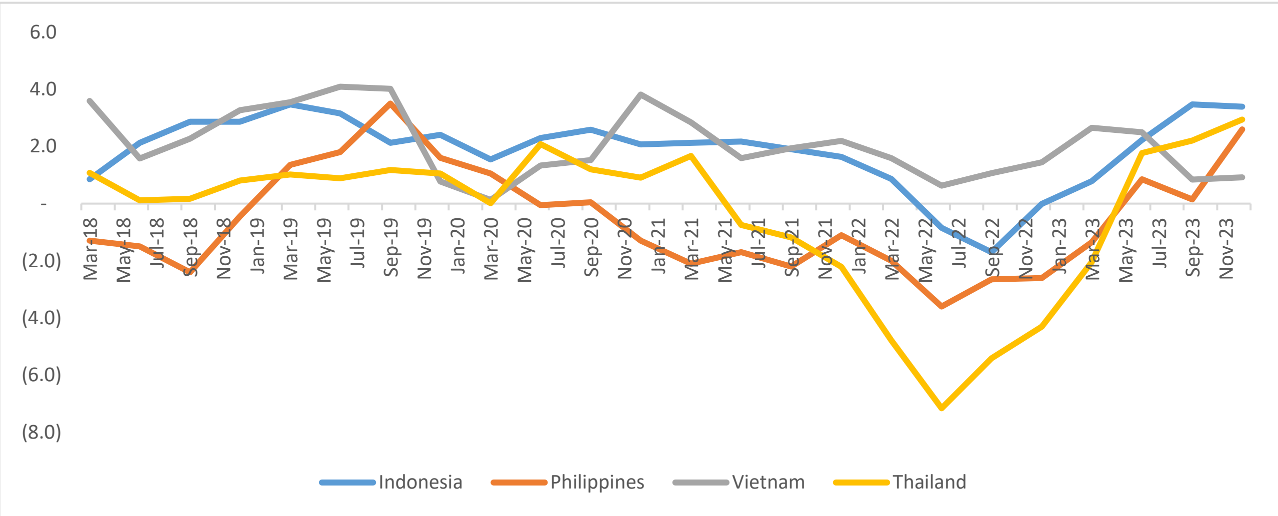
In comparison to local peers, the innovative track record of this company is what sets it apart. For instance, it recently reproduced a key 4-W automotive component, which had been historically produced in Japan and Korea, at a superior quality and competitive price leading to multiple OEMs substituting to their product from imports. Asian OEMs maintain impeccable supplier standards and are reluctant to switch suppliers given the vigorous quality due diligence undertaken during the approval process. Successfully passing this vigorous process for the leading 2-W and 4-W OEMs is a significant MOAT that will likely put the company on the radar of new EV entrants who eventually need to meet the 40% localization requirement. The company is already preparing for the future having recently developed EV battery backs, battery pack lining, ICE to EV conversion kits, and BLDC motors for EV 2-Ws. While the company is on the right path to integrating into the growing Indonesian EV value chain, we remain on the sidelines for now as we await further underwriting milestones to be achieved. But had we not been diligently researching this theme from on the ground, an under researched potential opportunity such as this would have slipped through the cracks.

Parting Thoughts

"I make no attempt to forecast the general market – my efforts are devoted to finding undervalued securities" – Warren Buffett

With the impending Fed pivot and its implications on developing market equities being the focal content of every outlook piece, we prefer to leave the punditry to the experts. Interest rate cycles are always part of the investment equation but not the sole driver. Had we put the brakes on underwriting new investments in 2022 citing interest rate upside risk, we wouldn't have delivered the returns we did this year. The same logic portends with rates heading south i.e. poorly run businesses do not transform into swans by virtue of a favorable rate environment. Assuming the worst of the inflationary cycle is behind us, our key markets are in a comfortable real interest rate position with adequate headroom to withstand any future negative inflationary shocks.

Figure 7: Real Interest Rates History (%)



Source: Bloomberg

But where we sit on the fence is the assumption that EM is on the cusp of a 2003-10 style ("Golden era") rally. Barring the geo-political shift (China-US relations) and bridging of information asymmetries gap to Developed Markets (DM) equities, the economic growth delta of the GEMs[2] vs. DM has compressed too significantly (Figure 8) to justify a blind rush to EM equities, especially if a return to near-zero DM rates is not on the horizon. In that regard, our investment space i.e. the Next GEMs[3], appears more attractive as the favorable demographic dynamics and structural themes provide an adequate GDP growth premium (Figure 9).

Figure 8: GEMs Avg. GDP Growth Rate (%)

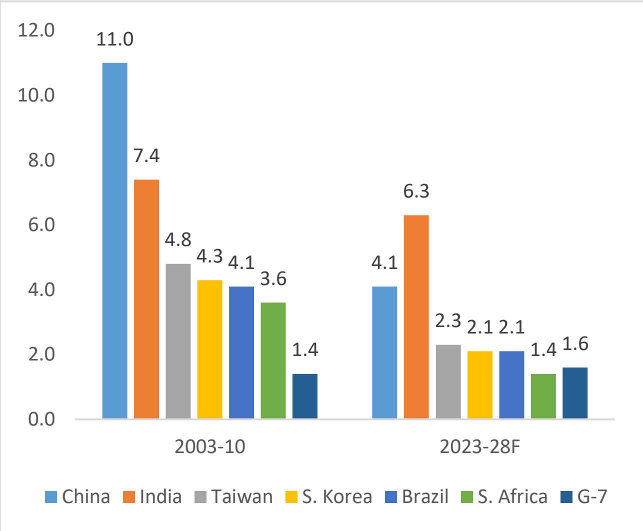
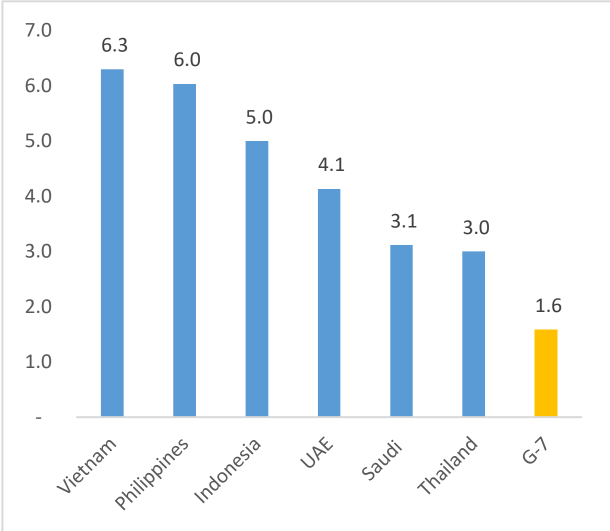


Figure 9: Next GEMs Avg GDP Growth % (2023-28)



Source: IMF World Economic Outlook, October 2023

EM investing remains dominated by GEMs heavy benchmark driven strategies, which as discussed in detail in our recent White Paper (EM Equities – Revisiting the Historical Approach in the New Paradigm) is contradictory to the structural shift of the EM story in favor of the Next GEMs. The purported solution of increased allocation into EM ex-China strategies does not fare any better. Without delving into an extensive discussion on the high economic intra-dependencies between China, Korea, and Taiwan which negates the China diversification argument, the fundamental issue of country concentration (62% weight of the top 3 countries) and benchmark tracking approach of active managers means the Next GEMs will remain under-owned in these portfolios. (Figure 10).

[2] GEMS: Emerging markets which have historically combined for 75-80% of the MSCI EM country weights including Brazil, Russia, India, China, South Africa, S. Korea, and Taiwan

[3] Next GEMs: The remaining 18 countries in the MSCI EM index (excluding the GEMs) and select countries in the MSCI FM index including but not limited to the ASEAN-5 (Philippines, Indonesia, Malaysia, Thailand, and Vietnam) and the GCC bloc (Saudi Arabia, U.A.E., Egypt, Kuwait, and Qatar)

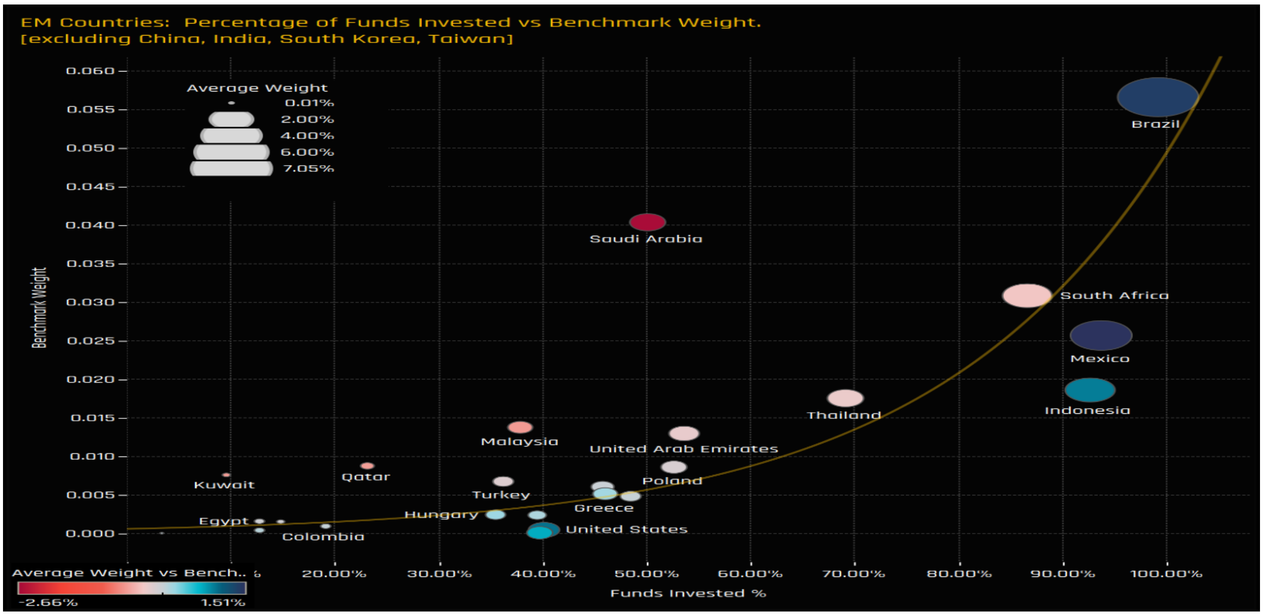
Figure 10: Active EM ex-China Managers Country Allocation

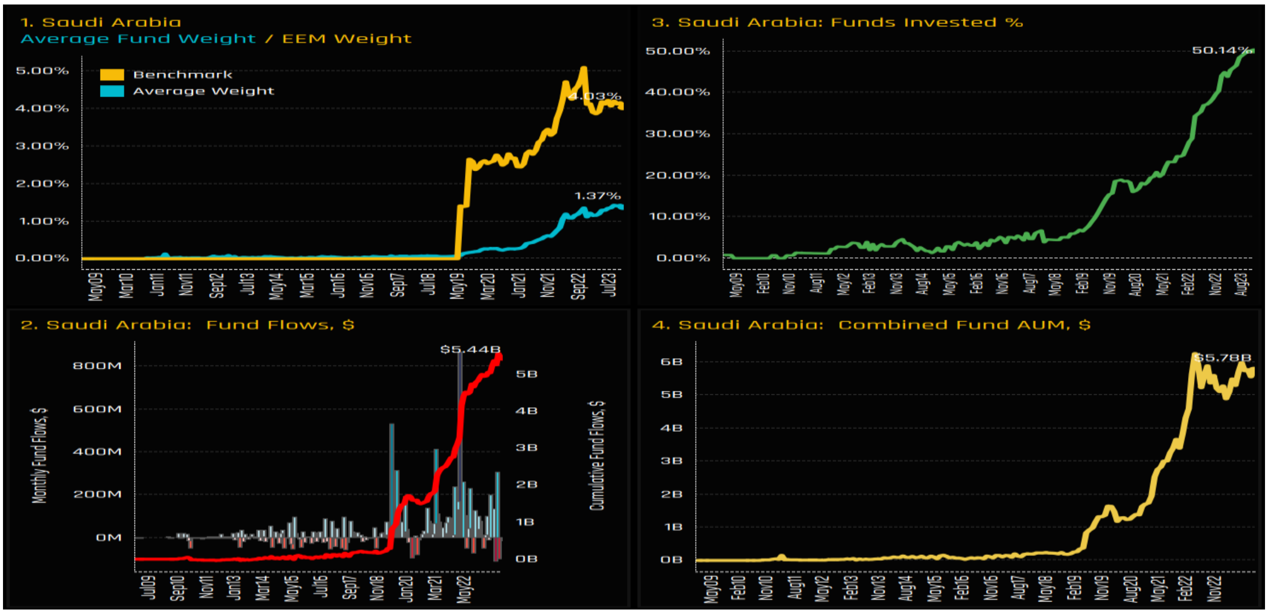
	Taiwan	India	South Korea	Brazil	Saudi Arabia	South Africa	Other EM countries	Developed markets	Frontier markets	Cash
Maximum	32.6%	37.1%	28.4%	21.0%	9.5%	12.3%	56.8%	20.4%	9.1%	9.1%
Highest decile	24.5%	28.0%	21.6%	15.3%	5.1%	5.8%	38.3%	9.2%	2.2%	5.0%
Upper quartile	22.3%	21.4%	19.9%	11.7%	3.8%	4.6%	26.7%	7.6%	0.6%	3.8%
Median	17.8%	17.8%	17.1%	9.8%	1.2%	3.3%	21.2%	1.0%	0.0%	2.2%
Lower quartile	15.3%	14.7%	13.5%	8.1%	0.0%	2.3%	18.1%	0.0%	0.0%	1.3%
Lower decile	12.9%	7.8%	8.4%	6.1%	0.0%	0.8%	15.6%	0.0%	0.0%	0.0%
Minimum	6.1%	1.6%	0.0%	0.0%	0.0%	0.0%	5.3%	0.0%	0.0%	0.0%
Index	21.9%	20.4%	17.2%	7.7%	5.9%	4.5%	22.5%	0.0%	0.0%	0.0%

Source: bfinance, 30 June 2023. Blue indicates overweight vs. index, purple indicates underweight.

On the positive front, Saudi Arabia is finally getting its due attention from active EM investors; a market where we have been investors for over a decade and see its Vision 2030 program at a cataclysmic shift towards decoupling from the legacy dependency on oil. Active EM fund ownership has reached 50% with foreigners invested in 107 Saudi companies despite the MSCI country benchmark having 42 constituents implying investors are dedicating resources beyond benchmark names, which is always a positive sign. Looking at the correlation of percentage of funds invested vs. the benchmark weight of those countries, the relationship is positively skewed towards 100% ownership. Put another way, to align with markets such as Brazil, South Africa, and Mexico, around 90% of funds should have exposure to Saudi Arabia. With the remaining 40% of funds representing USD 127 billion in AUM, there is significant headroom for material foreign inflows.

Figure 11: Active EM Funds – Saudi Positioning & Flows





Source: Copley Research (https://copleyfundresearch.com/saudi-arabia-special-report-a-tipping-point-in-em-equity-allocations/)

We remain focused on constructing a portfolio of high-quality businesses positioned to benefit from powerful secular themes and can deliver compounding returns over the long term. Our benchmark agnostic approach is premised on our core belief that the EM investment opportunity cannot be captured via an indices/benchmark driven approach. Instead, we delve into individual country dynamics and weigh each investment on its individual merits without ownership and sizing constraints imposed by arbitrary benchmark weights.

With that, 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.