MARKET COMMENTARY

How the Value Team Finds "Gems" in Emerging Markets


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Have you ever encountered an investment manager that seeks low-quality companies? All investment managers take pride in finding "quality" stocks and take pains to demonstrate that their process yields superior results. Rather than jump on the same bandwagon with some differentiated verbiage and leave it at that, I want to explain the "why" of the Seafarer Value team's stock selection process. In doing so, I hope to explain the nuance that defines our research process.

The white paper *On Value in the Emerging Markets* quantified the value opportunity in the emerging markets universe and explained a pragmatic approach to finding value through financial statement analysis.[1] However, over the past year Seafarer's Value team invested in several new companies that it specifically targeted for research after their share prices declined drastically. Our team did not begin researching these stocks because they came through one of the screens described in the white paper, or after the stock price met a specific valuation parameter. Consequently, I found myself in the position of having to explain where the ideas came from.

Such questions made me realize that one of the deficiencies of the white paper is that it is perhaps overly technical, at the expense of what actually "motivates" Seafarer's Value team. If the white paper devoted many pages to screening out potential value traps (a negative definition of value), this commentary will define what the Value team actively searches for (a positive definition of value).

> The Value team's search for "Gems" identifies companies with the following attributes:
>
> - **ROE-COE Spread**: a return on equity significantly higher than the cost of equity throughout most of the economic cycle.
> - **Resilience**: the ability to prolong the growth and income stage of the company's life cycle across a long period of time.
> - **Global Validation**: proof of the company's ability to sustain and defend its source of value.
> - **Valuation**: a valuation consistent with the targeted minimum long-term rate of return.

Conscious that probably only the hardcore investor had the interest to read an admittedly dry and technical white paper, this commentary will instead opt for a short, concept-based explanation.

How the Value Team Finds "Gems" in Emerging Markets

To state it as directly and simply as possible: Seafarer's Value team searches for "Gems." Other managers use the term as well, but the Value team uses the concept not as a metaphor for something of value, but rather as a symbol for the process of extracting investment returns. A gem is a mineral crystal whose constituents are arranged in a highly ordered microscopic structure. Crystals are formed by a process of cooling, or energy release. According to the second law of thermodynamics, this process is irreversible and chaotic, a phenomenon referred to as entropy.

What is fascinating about entropy is that the chaotic release of energy leaves behind a highly ordered structure, the gem, as a natural process. Equity investors also seek a pre-designed outcome of highly ordered positive future investment returns, ideally delivered in a consistent manner that minimizes volatility, and with a balanced structure of income and capital appreciation. Investment managers are tasked with delivering this orderly structure of returns from the chaos of real life, and an unpredictable future.

ROE-COE Spread

The first trait of a Gem stock that the Value team looks for is profit understood not as the difference between revenue and cost, but as the spread between the return on equity (ROE) and the cost of equity (COE). While there certainly are other managers that focus on this parameter as well, it is less common in the emerging market context where most investors make decisions based on growth-related considerations. The Value team chooses to focus on this parameter first, before growth, because it forces the team to understand the actual operations of the business, as opposed to simply the growth it delivers. Time and again, we have found a thorough examination of the "mechanics" of a business to yield better investment results by identifying where the company generates value – and, equally important, the cost of growth, which in my personal experience tends to be underestimated by growth-focused investors, ironically.

The Seafarer Overseas Value Fund's purchase of Ambev, a Brazil-based brewer in the Americas, over the past year represents a practical application of this idea. The stock price delivered a negative total return over the past decade as the market correctly identified a slow process of profit deceleration and market share loss. While some growth-focused managers may have exited the stock, macro-focused investors also had a reason to sell Ambev as Brazil struggled with recession, political chaos, and the pandemic.

With the foregoing true, and the market correct in its assessment, why did the Value team purchase Ambev stock in the Fund? Because Ambev is equipped to survive all of that, something that in my opinion only operationally-focused investors would identify. The analyst jargon for that quality is "ROE-COE spread." In the case of Ambev, it means that even when Brazil goes through a recession and the Brazilian real devalues (i.e. the COE rises and the ROE spread shrinks), Ambev's ROE and spread are high enough that the company enjoys a significant buffer to continue being profitable under such conditions.

When the market obsessed about Brazil macro risk, as evidenced by the spike in Brazilian bond yields seen in Figure 2 below, the Value team saw Ambev competitors' operations performing significantly worse than Ambev's in an environment of impaired demand, and we noted this would likely result in market share gains for Ambev. Instead of focusing on raw material inflation eating into margins, the Value team saw a company with the capacity to raise prices ahead of cost inflation.[2] When sell-side commentary limited itself to discussion of earnings pressure over the twelve months following the global onset of the pandemic, the Value team focused on the cumulative ROE-COE spread this company earns through an economic cycle, including during recessions.[3]

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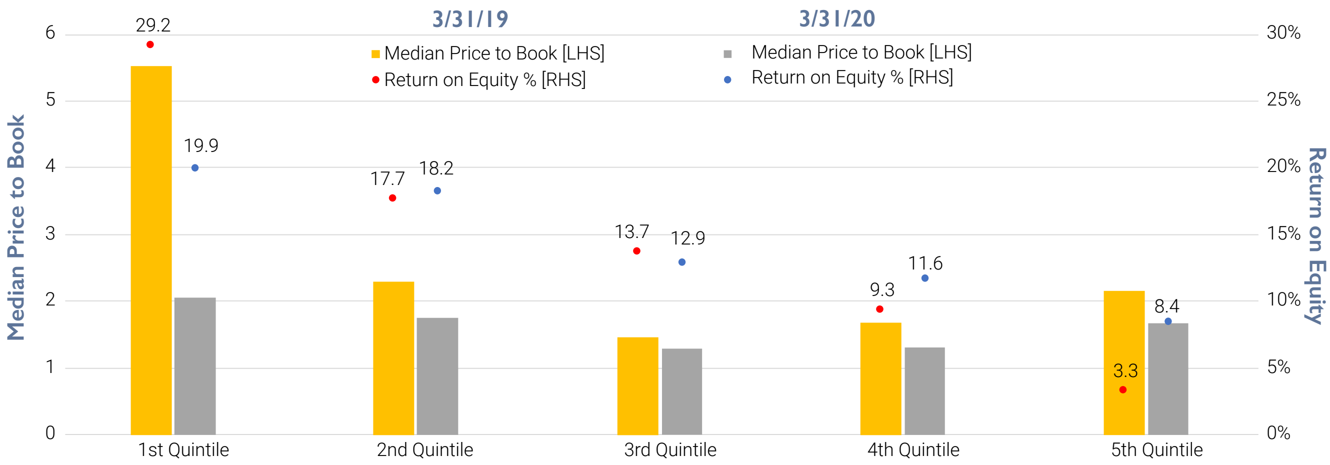
The charts below illustrate the point for Brazil's capital markets in the aggregate. Figure 1 compares the price to book value ratio (P/BV) for Brazilian equities by ROE quintile nearly a year before the pandemic (March 2019) and at the height of the pandemic-induced market volatility (March 2020). Figure 2 illustrates the rapid rise of Brazil's COE as represented by the yield to maturity of a Brazilian government international bond maturing in 2028. First, note that while extraordinary ROEs, ranking in the first quintile, declined the most as the pandemic gathered momentum, their absolute level was high enough to earn a positive spread versus a rising COE. Second, note that the median P/BV of the first quintile ROE company category also declined the most, to the point that it did not differentiate itself much from the rest of the market, even if the financial performance maintained a significant difference. The opportunity lies in the possibility of purchasing companies that generally trade at a premium, for good reason, at a valuation inconsistent with the value these companies generate over a full economic cycle.

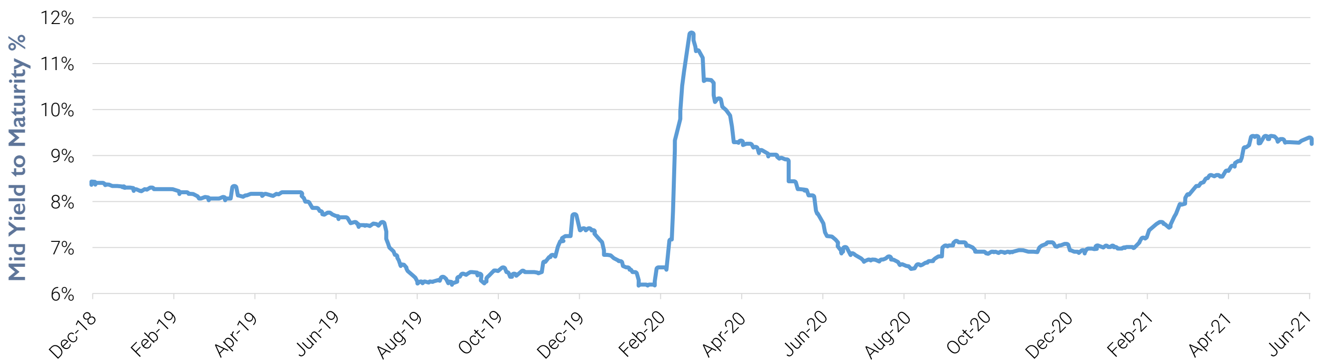
Figure 3 illustrates the same idea as Figure 2, but expands it globally by illustrating the rise in the historical emerging market sovereign bond spread on U.S. dollar-denominated debt compared to U.S. Treasuries.

Figure 1. Median Price to Book of Morningstar Brazil Index PR BRL by Return on Equity Quintile (3/31/19 vs. 3/31/20)



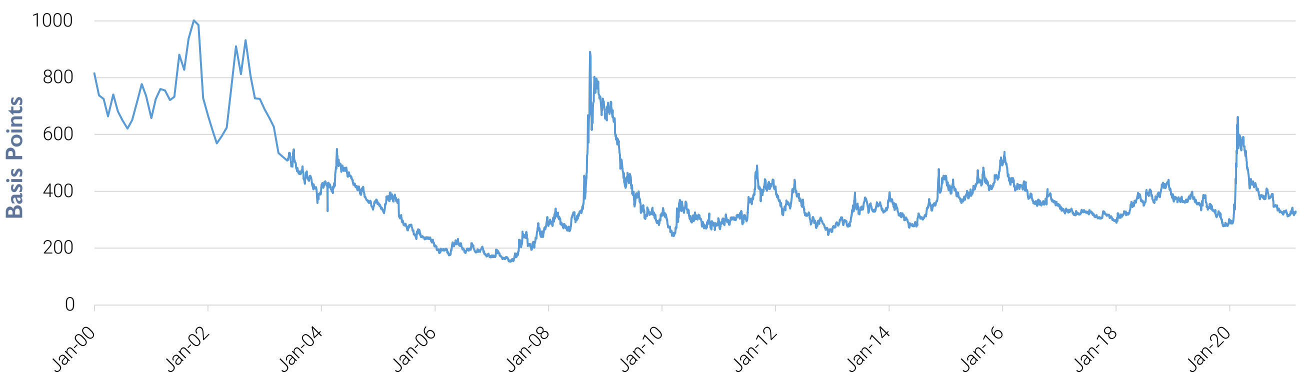
Past performance does not guarantee future results. It is not possible to invest directly in an index.
Note: Quintiles calculated for the 104 constituents of the Morningstar Brazil Index PR BRL with Price to Book and ROE data available from Bloomberg for the periods ending 3/31/2019 and 3/31/2020. For comparability, the quintile groupings for the period ending 3/31/2019 were held constant for the period ending 3/31/2020.
Sources: Morningstar, Seafarer.

Figure 2. Brazilian Government International Bond Maturing 1/10/28, Local Currency, Mid Yield to Maturity (12/31/18 – 6/30/21)



Note: Brazilian Government International Bond BB-Number: EG1787746.
Source: Bloomberg.

Figure 3. J.P. Morgan Emerging Markets Bond Index Global Spread (1/31/00 – 3/30/21)



Past performance does not guarantee future results.
The J.P. Morgan Emerging Markets Bond Index (USD) is an index of dollar-denominated sovereign bonds issued by a selection of emerging market countries. Index code: EMBI. It is not possible to invest directly in an index.
Sources: J.P. Morgan, Bloomberg.

Resilience

The second trait we look for in a Gem stock is resilience. This idea does not mean resilience to a recession as the section above might suggest. Rather, we are referring to resilience across the life cycle of a company, instead of the economic cycle. Analogous to living organisms, companies follow a development curve. In the context of Seafarer, the growth and income stage of a company's life cycle may be described as that which follows the early, high growth phase, and that which precedes the growth deceleration, capital return stage.

One characteristic of a truly great company is the capability to prolong its growth and income stage across vast periods of time.

While Seafarer's Value team may invest in any of these three stages (a topic for another commentary), generally speaking, investor rotation will take place as a company moves through its three life stages depending on investor relative preference for growth or income. One characteristic of a truly great company is the capability to prolong its growth and income stage across vast periods of time.

A case in point of this life cycle resilience is Value Fund portfolio holding Jardine Matheson. This fifth-generation, family-owned enterprise has prospered for over a century through vision and regeneration. Historically, Jardine Matheson had the vision to enter the real estate market prior to Britain's 99-year lease of the New Territories, and to purchase Astra International after the devaluation of the Indonesian rupiah in 1998. More recently, despite owning large scale subsidiaries elsewhere, the company has had the vision to start new businesses in frontier markets within Southeast Asia. Thus, while any given subsidiary's growth rate may decelerate as it gains scale, the overall group acts as a fiduciary of the value already created and continues to grow in new business activities or geographies.

The Value team also predicated its Ambev investment on the idea of resiliency. One could have argued that the stock had crossed from the growth and income stage to the decline phase of its life cycle. We took the opposite view on the basis of our operational understanding of Ambev, as explained above.

The best metaphor for the idea of resiliency is a snake shedding its skin to prolong its lifespan. The Value team partially predicated the Value Fund's investment in Itaú Unibanco, Brazil's largest private bank, over the past year on this idea. The bank is taking impressive steps to evolve from a staid, current account-focused bank to a hybrid one, incorporating valuable elements of the fintech companies that are encroaching on traditional banking through payments. Itaú's ability to adapt – as well as its excellent management of its ROE-COE spread – distinguish the bank and make it a Gem for the Value team.

Global Validation

The third attribute that confirms and reinforces the previous two qualities of a Gem stock may be conceptualized as "global validation." This idea is the Value team's way of ensuring that a company earns a sustainable ROE-COE spread for the right reasons. In other words, many corporates earn high ROEs that I find are not worth investing in if they depend on conditions specific to a locality, such as political connections or uncommon concession terms.

In our view, the most valuable moat is that which is earned through competition.

A company that successfully takes its know-how abroad not only prolongs the life of its growth and income stage of development, but perhaps more importantly, validates that the source of its ROE-COE spread resides in the company itself. Value investors are familiar with the use of the term: moat. This concept refers to a company's ability to defend and sustain its source of value. Most investors view a moat as external to the company.

In our view, the most valuable moat is that which is earned through competition. In other words, it is endogenous to the company and not something easily identifiable – other than through the external validation of successful international competition. Two Seafarer Overseas Growth and Income Fund holdings that demonstrate this Gem quality include Samsung Electronics and Hyundai Mobis. These two South Korean giants are now well-known global manufacturers of semiconductors and autos, respectively. They began, however, as humble, domestically-oriented companies in the 1970s. The reader need only calculate the compounded total return of these public companies since their earliest history to understand the importance and value of the "global validation" idea in defining a Gem.

Valuation

The fourth layer that characterizes a Gem is, inevitably, valuation. An investment return, as opposed to the return a company earns, hinges on purchasing a security at a valuation consistent with the targeted minimum long-term rate of return. Assembling a portfolio of companies with the foregoing attributes is insufficient to deliver attractive future investment returns – that is, if the valuation itself does not mathematically correspond to the targeted future investment return.

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When the Value Fund began to purchase Ambev stock, it traded at a premium valuation with a price to earnings (P/E) ratio above 20x, and a P/BV ratio exceeding 3x, hardly value territory.[4] Yet, these multiples are a very crude method for assessing valuation. Ambev's long history of paying out the great majority of its earnings as dividends distorts the nominal P/BV multiple, as Brazil's recession and the Brazilian real's devaluation distort the company's P/E. Given the nature of the business, cash flow measures that reflect the normalized pricing power we see in the company are the more accurate way of identifying value in Ambev stock.

Itaú's P/E and P/BV multiples did not look cheap either. When the Value Fund purchased Itaú, its P/E in the low teens was high relative to its own history, while its P/BV of 1.6x was low relative to history, but not in absolute terms or relative to global peers.[5] The Value team made adjustments in this case – given the earlier discussion about ROE-COE spreads, it should be clear that comparing a P/BV in Brazil against global banking peers is far from a straightforward exercise.

It should also be clear that comparing multiples to history is meaningless as stock prices discount future earnings, not historical ones, and the pandemic distorts the earnings base to begin with. In this instance, the Value team invested much time identifying the critical sources of value for the bank and assessing where these parameters would likely normalize, given the operating conditions impinging on the bank: extreme interest rate policy, unprecedented non-performing loans, and the true value of other investments that are booked at historical cost in its balance sheet.

Conclusion

In summary, Seafarer's Value team does not simply pursue low valuations, but Gems at low valuations. One may think of the foregoing Gem attributes as a non-exhaustive definition of the Value team's ideal stock, and each company may express these attributes differently. Assembling a portfolio of Gems with valuations consistent with an acceptable minimum long-term rate of return – not a premium valuation – requires much manual ploughing through the rough and patience. Once found, however, the investments are indeed Gems.

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[1] www.seafarerfunds.com/commentary/on-value-in-the-emerging-markets

[2] Source: J.P. Morgan, "Update Post 1Q20: We Are Still Waiting for a Catalyst. Valuations Remain Rich," 19 May 2020.

[3] Source: J.P. Morgan, "2Q21 – Weak as COGS and SG&A offset Solid Top Line. Strong Volumes Not Translating Into Higher Profitability," 29 July 2021. Note: COGS is an acronym for Cost of Goods Sold, SG&A refers to Selling, General & Administrative Costs.

[4] Source: Bloomberg. Data as of 6 July 2020

[5] Source: Bloomberg. Data as of 7 July 2020.

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Glossary

Brazilian Real (BRL): the official currency of Brazil.

Cost of Equity (COE): the return a company requires for an investment or project, or the return an individual requires for an equity investment.

Current Account: the difference between a nation's savings and its investment. The current account is an important indicator of an economy's health. It is defined as the sum of the balance of trade (goods and services exports less imports), net income from abroad, and net current transfers. A positive current account balance indicates that the nation is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower from the rest of the world. A current account surplus increases a nation's net foreign assets by the amount of the surplus, and a current account deficit decreases it by that amount.

Frontier Markets: countries with investable stock markets that are less established than those in the emerging markets. Frontier markets generally have lower market capitalizations and liquidity than the more developed emerging markets.

Morningstar Brazil Index PR BRL: an index that measures the performance of listed equities in Brazil. Index code: MSBRBRLP. It is not possible to invest directly in an index.

New Territories: one of the three main regions of Hong Kong. The New Territories were leased from China's Qing Dynasty by the United Kingdom in 1898 for 99 years.

Non-performing Loan (NPL): a loan in which the borrower is in default due to the fact that they have not made the scheduled payments for a specified period.

Price to Book Value (P/BV) Ratio: the market price of a company's common shares divided by the company's book value per share.

Price to Earnings (P/E) Ratio: the market price of a company's common shares divided by the earnings per common share. The Price to Earnings ratio may use the earnings per common share reported for the prior year or forecast for this year or next year (based on consensus earnings estimates). (Source: Barron's Dictionary of Finance and Investment Terms, 1995)

Return on Equity (ROE): the amount of net income returned as a percentage of shareholders equity. Return on equity measures a company's profitability by revealing how much profit the company generates with the money shareholders have invested.

Sell Side Coverage: analysts from the research arms of investment banks who produce proprietary research, including financial estimates, on a company's securities.

Yield to Maturity (YTM): a concept used to determine the rate of return an investor will receive if a long-term, interest-bearing investment, such as a bond, is held to its maturity date. It takes into account purchase price, redemption value, time to maturity, coupon yield, and the time between interest payments. Recognizing time value of money, it is the discount rate at which the present value to all future payments would equal the present price of the bond, also known as internal rate of return. (Source: Barron's Dictionary of Finance and Investment Terms, 1995)

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As of June 30, 2021, Ambev SA comprised 2.9% of the Seafarer Overseas Growth and Income Fund, Jardine Matheson Holdings, Ltd. comprised 2.0% of the Fund, Itaú Unibanco Holding SA comprised 3.0% of the Fund, Samsung Electronics Co., Ltd. comprised 4.3% of the Fund, and Hyundai Mobis Co., Ltd. comprised 5.0% of the Fund. View the Top 10 Holdings of the Seafarer Overseas Growth and Income Fund at www.seafarerfunds.com/funds/ogi/composition. As of June 30, 2021, Ambev SA comprised 4.0% of the Seafarer Overseas Value Fund, Jardine Matheson Holdings, Ltd. comprised 2.1% of the Fund, and Itaú Unibanco Holding SA comprised 4.0% of the Fund. View the Top 10 Holdings of the Seafarer Overseas Value Fund at www.seafarerfunds.com/funds/ovl/composition. As of June 30, 2021, the Seafarer Funds did not own shares in the other securities referenced in this commentary. Holdings are subject to change.