SOMERSET CAPITAL MANAGEMENT LLP

MI Somerset Global Emerging Markets Fund OEIC

31 August 2019

Investment Adviser's Monthly Report

Assets Under Management	
Somerset Capital Management LLP:	$6,491 million
Global Emerging Markets Strategy:	$3,390 million
Global Emerging Markets Fund OEIC:	£297.5 million

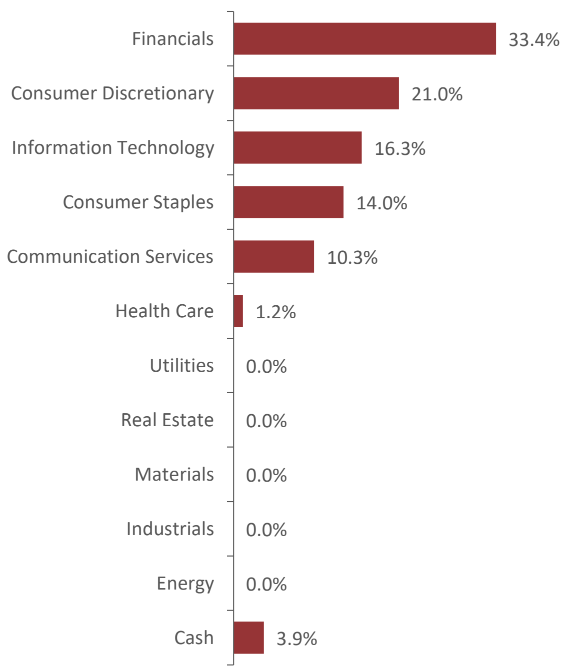
Acc Performance in GBP (net)*

	Fund	*MSCI EM*	*+ / -*
This Month	-4.94%	-4.36%	-0.58%
Last 6 Months	9.07%	4.11%	+4.96%
YTD	12.10%	8.67%	+3.43%
1Yr Annualised	8.60%	2.07%	+6.53%
3Yr Annualised	8.24%	8.35%	-0.11%
5Yr Annualised	6.88%	6.81%	+0.07%
10Yr Annualised	7.69%	7.15%	+0.54%
2018	-10.98%	-9.27%	-1.71%
2017	22.49%	25.40%	-2.91%
2016	33.82%	32.63%	+1.19%
2015	-10.00%	-9.99%	-0.01%
2014	2.53%	3.90%	-1.37%
2013	-2.93%	-4.41%	+1.48%
2012	13.23%	13.03%	+0.20%
2011	-14.60%	-17.82%	+3.22%
2010	29.04%	22.61%	+6.43%

Fund Principles

Lead Manager, Edward Robertson, runs a c. 40-45 stock conviction-driven portfolio, following a bottom up, research-intensive process where long term quality and value are paramount. He is backed up by a team of thirteen managers and analysts, based in London and Singapore.

Sector Breakdown



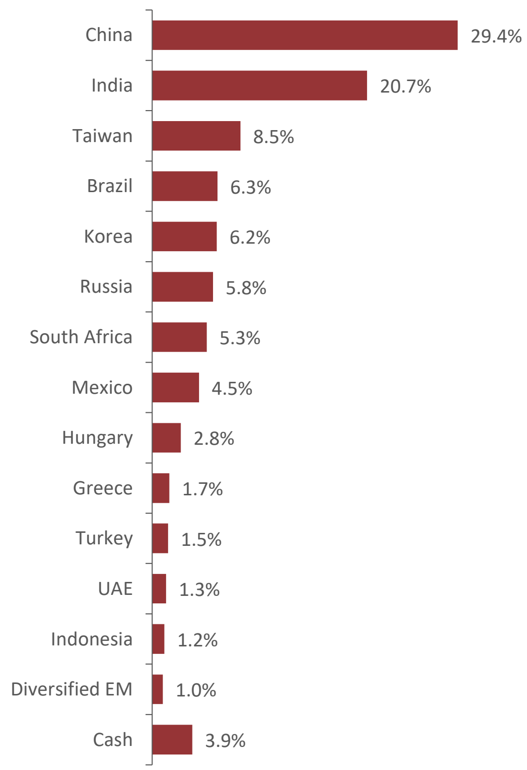
Portfolio Data

	Fund	*MSCI EM*
Dividend Yield	2.1%	2.9%
P/E (hist)	21.9x	13.2x
Wgt Ave Mkt Cap ($mn)	59,816	77,209
Number of Stocks	41	
Price (Accumulation)	275.3	
Price (Income)	243.2	

Top Ten Holdings

	Country	*% NAV*
ICICI Bank LTD	India	5.2%
Tencent Holdings Ltd	China	5.1%
China Mengniu Dairy Co Ltd	China	4.4%
Midea Group Co-A	China	4.3%
Taiwan Semiconductor Manufacturing	Taiwan	4.1%
Samsung Electronics Co.	Korea	4.0%
Itau Uniban-PREF	Brazil	3.6%
AIA Group LTD	China	3.6%
Sands China Ltd	China	3.3%
LIC Housing Finance	India	3.2%

Fund Country Weightings



* Source: Maitland Institutional Services Limited & MSCI. The Fund inception date is 17th November 2008. Characteristics and market cap ranges are for the model portfolio. The Index is the MSCI Emerging Markets Index with net dividends reinvested. Index data is sourced directly from MSCI.

Trade tensions have boiled over dragging down EM markets and currencies; China-US tensions will remain elevated through the rest of the year, with security issues like 5G networks again coming to the fore. Slower global growth and poor business sentiment will put downward pressure on US interest rates – where a slowdown of sorts is inevitable – and spur the Chinese government into an economic stimulus, something they have resisted up to now.

Currency weakness accounted for nearly 50% of the negative index return this month (in USD), with Brazil and China two of the worst performing markets. The portfolio's Indian financials were weak on the back of poor economic growth numbers, indicating a cyclical downturn. However, government stimulus and reform, including the recently announced consolidation amongst public sector banks, will help enable the recovery.

Dollar strength in times of panic is not unusual, but any downward pressure from lower interest rates is positive for EM liquidity. Relatively depressed EM equities should not fear an over-valued US equity market sell-off, a scenario in which the former often outperforms, nor should EMs fear a US economic slowdown, again an environment that sees the former outperform. Of course, there remains the possibility of exogenous shocks from a bad trade war outcome to confrontation in the Middle-East and an oil price spike.

Our investment process is founded upon a long-term investment horizon and owning – at reasonable valuations – a portfolio of good companies with the ability to grow through the economic cycle. We have been buying shares in three companies recently which fit that criteria: Autohome, Mr Price and more recently Heineken. It is worth explaining in detail – as a way of highlighting our investment preferences – the fund's most recent acquisition of Heineken.

The core investment thesis for Heineken is based, first, on favourable structural trends in demand for beer in emerging markets, and second, on the company's ability to grow profitably on the back of those trends, thanks to its strong competitive positioning and brand portfolio. In many emerging markets per capita consumption of beer remains well below developed-market levels, but is rising steadily as consumers' disposable incomes increase. This is particularly true in South East Asia, Africa and India, where consumption is a fraction of what it is in the West. Heineken is especially well placed to benefit from this trend. It is the dominant player in India; in South East Asia the company is number one in Indonesia, Malaysia and Singapore, and a strong number two in Vietnam (four of the region's six largest economies); and in Africa it is number one in the four most populous countries (Nigeria, Egypt, Ethiopia and the Democratic Republic of Congo). In the first half of 2019, Heineken's consolidated volumes grew by a healthy +3.1% organically. The key contributors to this growth were the company's Asia Pacific (+10.4%) and Africa, Middle East and Eastern Europe (+7.1%) divisions.

As well as consuming more beer, as their affluence increases, emerging market consumers increasingly aspire to drink premium international beer brands in preference to local brands. This shift in preferences is also happening in developed markets, though more slowly, as the starting share of premium is higher. Premium as a category is growing more quickly – in many cases materially so – than mainstream in almost all markets globally. Heineken has arguably the leading portfolio of international premium brands of any beer company and is therefore set to be a major beneficiary of this trend. This is exemplified by the company's success in Vietnam, where it is number two behind Thai Beverage in overall volume share, but dominates the more profitable premium segment, which has doubled in size in volume terms over the last five years. Heineken's volumes in Vietnam are growing at double-digit rates as a result. The Heineken brand, which is the company's flagship premium brand, achieved volume growth of +6.9% in 1H19, well ahead of the company as a whole (+3.1%). The increasing contribution of Heineken's higher-priced premium brands to group volumes is driving rising revenue per hectolitre, which increased +3.0% in 1H19; this in turn should be beneficial for margins.

Growth is not necessarily valuable. To create value, it must be profitable enough to provide a good return on the investment required to fund it. This requires a sustainable competitive advantage to protect that return from erosion by competition over time. Heineken benefits from two such advantages. One is the leading premium brand portfolio mentioned above. This supports superior pricing. The Heineken brand, for example, sells at a premium to the mainstream average of around 20% in the UK, 75% in Vietnam and 200% in China. The second major competitive advantage that Heineken enjoys is economies of scale. Selling beer involves large fixed marketing and distribution costs. The ability to dilute these costs with higher volumes in a given market results in superior profitability.

Profitability is therefore highly correlated to market share in the beer industry. For this reason, Heineken's stated aim is to be the number one or two player in all its markets. In addition to its leading market shares in Africa, India and South East Asia, the company is number one or two in most major markets in Europe and a strong number two in the two principal Latin American markets, Brazil and Mexico. The extent of Heineken's market power across such a diverse portfolio is unique in the industry.

There are other brewers listed in emerging markets that, unlike Heineken, provide undiluted exposure to emerging market consumers. None of these, however, benefit from the combination of advantages enjoyed by Heineken. The domestic Chinese brewers such as Tsingtao lack credible premium brands with which to tap into the fast-growing Chinese premium market, which constitutes the main profit pool. Thai Beverage, the only large listed brewer in South East Asia, is hampered by its declining domestic spirits business, which accounts for the majority of its profits. In Africa there are no listed beer businesses liquid enough to be investable. In Brazil, Heineken's main competitor is Ambev, a listed subsidiary of Anheuser-Busch InBev ('ABI'). While Ambev dominates the Brazilian market and enjoys high margins, its brand have suffered in recent years from a reputation for indifferent quality, in part because of its use of corn as an 'adjunct' ingredient in its beers, which weakens the taste. This has worked to the advantage of Heineken, which only uses only the traditional ingredients of barley, hops and water, and has been able to capitalise on increasing demand for 'pure malt' beers to take market share.

Heineken's main international competitor is ABI. Heineken and ABI compete in numerous markets around the world and have a track record coexisting profitably, notably in Brazil and Mexico, where they are the two dominant players. A wave of consolidation has taken place in the global beer industry over the last twenty years: the top ten beer companies account for around two thirds of global volumes, up from a third in 1998. A handful of large multinationals now dominate the industry: ABI, Heineken, Carlsberg and, to a lesser extent, Molson Coors, Asahi and Kirin. Competition in the beer industry is local rather than global, but this concentration has been helpful for competitive dynamics, as the large brewers have not typically attempted to undercut one another on price. In a number of emerging markets, in particular, the industry is highly consolidated, including Mexico, Brazil, India, South Africa and Vietnam, which are among Heineken's key growth markets.

Although listed in the US, ABI, like Heineken, derives the majority of its revenues from emerging markets. The company is highly profitable and like Heineken enjoys leading positions in many of its markets. The cultures of the two companies, however, are entirely distinct. The creators of ABI in its current form were 3G Capital ('3G'), the Brazilian private equity firm; Jorge Paulo Lemann, one of 3G's founding partners, remains the company's largest shareholder. Fundamental to 3G's management philosophy is a relentless focus on cost efficiency and pricing in order to drive financial returns. While ABI has achieved operating margins that are amongst the highest of any large FMCG company as a result, the perceived quality of its beers has deteriorated in the eyes of consumers, notably in the US and Brazil (see above), its largest markets. Partly as a consequence, the company has struggled to deliver consistent volume growth. Heineken, by contrast, is still controlled by the family that founded it. The family's objective is to create shareholder value over the long term, rather than to meet profitability or margin targets within a particular time-frame. As a result, the company has never skimped on marketing or product investment and its brands enjoy a global reputation for good quality. We would not like to predict which company might outperform the other in the short run… in the long run however, we think Heineken's approach is likely to prove more sustainable.

Edward Robertson, Lead Manager

Contact Information and Disclaimer

The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested.

Fees
0.75% AMC
0.3% Dilution Levy Applicable (paid to the Fund)

Share Class Information (Institutional B Class)

	Accumulation	*Income*
GBP SEDOLs	B3KL3W6	B4XX519
GBP ISINs	GB00B3KL3W60	GB00B4XX5197
USD SEDOLs	B3Z0942	B3VTJX2
USD ISINs	GB00B3Z09429	GB00B3VTJX23
EUR SEDOLs	B9XQL37	
EUR ISINs	GB00B9XQL371	

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