SOMERSET CAPITAL MANAGEMENT LLP

28 February 2023

MI Somerset Global Emerging Markets Fund OEIC

Investment Adviser's Monthly Report

Edward Robertson
Founding Partner & Lead Manager

Acc GBP Performance Net (%)*	Fund	Index⁺	+/-
1 Month	-5.79%	-4.90%	**-0.89%**
3 Months	-0.06%	-2.14%	**+2.08%**
YTD	-0.37%	0.25%	**-0.62%**
2022	-15.62%	-10.02%	**-5.59%**
2021	-10.10%	-1.64%	**-8.46%**
2020	12.69%	14.65%	**-1.97%**
2019	17.37%	13.86%	**+3.51%**
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 Objectives

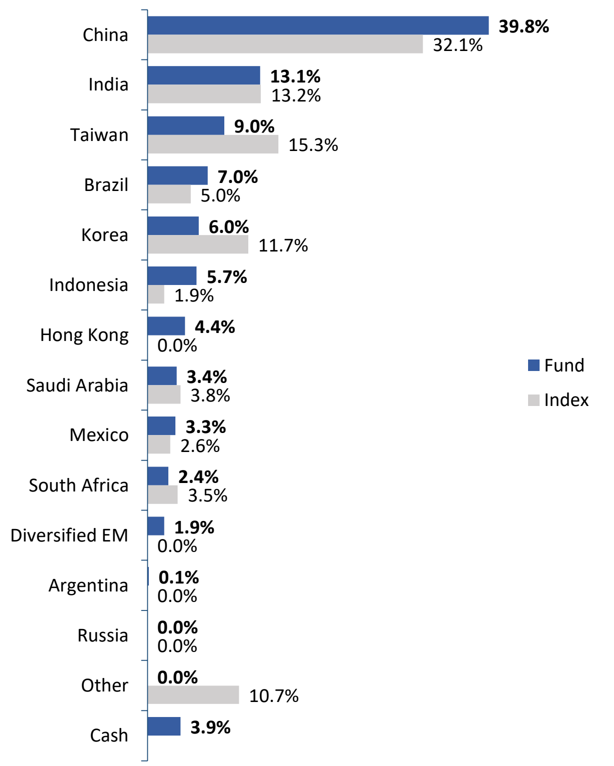
The Somerset Global EM Fund seeks to achieve capital appreciation by investing in a concentrated portfolio of <50 companies in emerging market countries. Lead Manager, Edward Robertson targets companies that can generate sustainable returns over multiple market cycles and are trading at a reasonable price. All companies must adhere to Somerset's independent criteria around environmental, social and governance risk and we actively engage with companies on material issues. Edward is supported by Somerset's team of fund managers and analysts based in London, Singapore and Shanghai.

Assets Under Management	
Somerset Capital Management LLP	$4,079 m
Global Emerging Markets Strategy	$3,848 m
Global Emerging Markets Fund OEIC	£225 m

Model Portfolio Data	Portfolio
P/E (Historical)	25.8x
Dividend Yield (%)	1.4%
Wgt Ave Mkt Cap ($m)	107,068
No. of Stocks	45
Price (Accumulation)	245.5
Price (Income)	211.9

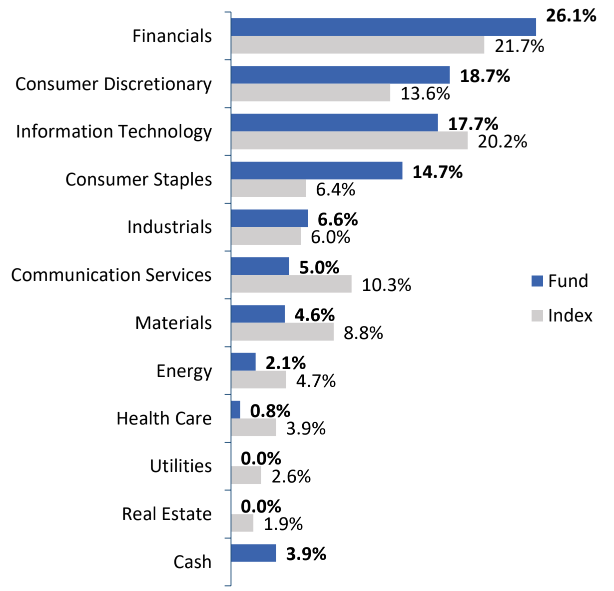
Top 10 Holdings	Country	NAV %
Taiwan Semiconductor Manufacturing Company	Taiwan	6.9%
ICICI Bank LTD	India	5.2%
Yum China Holdings Inc	China	4.6%
Budweiser Brewing Co APAC Ltd	China	4.2%
AIA Group LTD	China	3.8%
Tencent Holdings Ltd	China	3.7%
Wuliangye Yibin Co Ltd	China	3.5%
Samsung Electronics Co.	Korea	3.4%
Al Rajhi Bank	Saudi Arabia	3.4%
Grupo Financiero Banorte	Mexico	3.3%

Country Breakdown



Model Portfolio Market Cap Breakdown	Fund
< $10bn	9.9%
$10-$20bn	11.5%
$20-$50bn	14.5%
> $50bn	63.2%

Sector Breakdown



* 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.

February was a weak month for emerging markets. We underperformed due to company specific issues at JD.com and Meituan, which we explore in detail below.

We also analyse a short-seller report questioning Techtronics Industries' gross margin sustainability, which negatively impacted the share price over the month. We believe the report fails to recognise the incredible success this company has legitimately achieved over the last decade at the expense of rivals, pioneering the push into cordless power tools (they own the Milwaukee and Ryobi brands). We have taken the opportunity to top up our position (see detailed comments below).

More broadly, we have seen EM sentiment reverse of late, alongside global sentiment, as rates remain 'higher for longer' with commodities, growth companies and China all giving up much of their year-to-date gains. The beginning of the year was always going to be opaque for the Chinese economy. However, the manufacturing sector recorded the strongest rebound for a decade in February, which, alongside other data points, suggests the recovery is well underway. The stock market is taking a 'show me' approach. A good example is Bud Apac, which sold off as weak 4Q numbers (average selling price and volume declines) were confirmed and are now in the past, whilst at the same time, management guided volumes had increased by 20% in February with 98% of dining and entertainment venues open again.

Having waited patiently through Covid and lockdowns, building up our company exposures in China on the prospect of a strong recovery and re-opening, a new economic cycle is now beginning after three years of low growth (by Chinese standards). This coincides with a new political team. We believe there is a strong top-down investment thesis for the next two years. Our stock selection is based around our preference for well-managed companies, leading in their field, with the ability to grow their business over the longer term, albeit sometimes in a lumpy manner.

Our portfolio is concentrated by design, backed by high conviction levels. Two of our bigger exposures, JD.com and Meituan, have been volatile recently as sentiment turned negative following the announcement of a subsidy program in the case of JD.com, and Douyin encroaching on Meituan's in-store segment. Importantly though, business fundamentals and our long-term investment theses for these companies remain intact.

JD.com

JD.com, our preferred exposure in the e-commerce sector and a 3.5% position, weighed on the portfolio this month. The company announced an RMB 10bn subsidy program that ignited worries about an industry price war and margin pressure. We believe that the market has overreacted to the announcement, since i) it is not clear how the subsidy will be implemented and how overall earnings would look, given recent cost optimization and restructuring initiatives, and ii) current valuations are already pricing in an overly negative outlook for JD.com's future earnings.

JD.com's management, has in fact stated that retail margins would be "at least flat" despite the company's greater focus on growth, and that group margins should grow. Additionally, sell side channel checks suggest that outside of the top branded merchants (iPhone, Moutai, LVMH etc.), JD.com has been pushing merchants to foot most of this subsidization program. Furthermore, during the recent Alibaba earnings call, management mentioned that these subsidy programs were common for the industry and that they would not be launching similar subsidies, indicating a more rational competitive environment than we have seen in the past.

With the subsidy program partly absorbed by merchants and offset by incremental gross merchandise value (GMV) generated, and with improving margins in JD.com's Logistics and New Businesses, the company can still grow group earnings with a mid-20s CAGR over the medium term. Fundamentally, JD.com's premium reputation, alongside its industry-leading in-house logistics network, are major differentiating factors versus rivals like PDD and Alibaba, and give it an edge within this competitive sector.

Meituan

Meituan has also been under pressure after Douyin stepped up efforts in some of Meituan's business areas. We believe that local services are more vulnerable than food delivery, though the former is still in an early growth stage with <10% of the market penetrated. In other words, we believe that the market can easily sustain more than one player and still offer high growth rates. Meituan has essentially been the only substantial player in this segment. Furthermore, channel feedback suggests that winning in this space is not so straightforward for Douyin, since it is an interest-driven rather than an intention-driven platform, merchants see lower fulfilment rates compared to Meituan. As such, they use it more as a platform for specific-period promotions that require high discounting (50-60% on Douyin vs. 20-30% on Meituan).

The food delivery space is less exposed given Meituan has 70%+ market share and barriers to entry are high due to infrastructure moats and network effects. Meituan delivered 14 billion orders last year, and while that is an incredible achievement in its own right, it represents <2% of total meals consumed by working age people in China. We expect improving unit economics in the food delivery business, and reduced losses from new initiatives, to drive low-20s revenue CAGR and 85% earnings CAGR for Meituan over the medium term.

Additionally, we believe there is a risk Douyin/Tik-Tok may be targeted by regulation in the US on national security grounds, and in China, we have seen comment from the authorities about the addictive qualities to the young from short-form video. Any regulatory-driven slowdown at Douyin/Tik Tok would be positive for the entire industry as competitive intensity would ease.

The market is tentative on the growth rates for electric vehicle sales in China for this year, after a strong 2022. We expect 30% growth. Looking out further, the growth runway for the likes of BYD and CATL is strong as penetration of electric vehicles moves from 30% to 50% in China, and upwards from current 10% levels in Europe and the US.

We sold Hapvida, a smaller position in the portfolio (80bps), on deteriorating conviction in their ability to integrate a similar-sized rival, an acquisition which had the potential to generate significant value. We used the proceeds to build a position in Mercardo Libre (see below), together with proceeds from some other smaller positions which we sold: Unimicron and Globant.

Edward Robertson, Lead Manager

New Position – Mercado Libre (MELI) – Vijai Atal, Global & Consumer Tech

MELI is a leading LATAM e-commerce and fintech company, with an earnings growth profile that we believe is just about to inflect as it starts monetizing two key businesses: credit and advertising. Before purchasing the stock, we waited for 4Q results for an update on the credit book, as trends in the broad banking sector in Brazil have been deteriorating. We also wanted to hear the most recent guidance for growth in the advertising business. Both updates were positive and increased our confidence in the investment case.

The company reported operating margins of 9.8% in 2022. As credit (48% interest margin after losses) and advertising (estimated low 70% operating margins) increasingly contribute to revenue over the next few years, we expect operating margins to reach the mid/high teens and earnings should compound ~50%+ in the medium term. With e-commerce representing just ~10% of overall retail in LATAM, the long-term potential in this business remains significant.

Ads reached 1.4% of GMV in 2022 and management is confident in growing this business in the next few quarters/years given launches of upgraded advertising offerings (new targeted capabilities, automated ad dashboards, and real time display reporting). Management has informal targets of advertising revenue reaching mid-single digit percentage of GMV, in-line with Amazon (estimates of 5-6% GMV advertising revenue contribution). For comparison, today MELI accounts for <2% of digital ad spends in LATAM versus 11% for Amazon in the US.

MELI's credit opportunity is also vast with <1% market share currently and with the business remaining well positioned; solid competitive advantages stem from low customer acquisition costs, platform ecosystem lock-in, and data-driven credit underwriting. Given the current credit environment in Brazil, we believe management's decision to slow down loan growth and focus on profitability is the right one. Recently released 4Q results demonstrate that this strategy of decelerating credit growth has been yielding results; credit quality has improved and profitability in this business remains robust. Our investment thesis is on track as the drivers of long-term outperformance seem to be lining up nicely for MELI.

Techtronic Industries Update – Shashank Savla, Asia

Techtronic Industries fell 19% on 23rd February after a report by short seller Jehoshaphat Research questioned the company's margins and accounting policies. The main allegations related to the continuous increase in gross margins over the years, improper capitalisation of R&D expenses, inadequate depreciation on certain fixed assets and inadequate provisioning for bad debts.

Techtronic's management has vigorously denied the claims and published a detailed clarification statement. According to Techtronic, the increase in gross margins is predominantly related to improving mix with a growing share of higher margin professional products and aftermarket batteries. New products are also accretive to margins. Milwaukee is the number one professional cordless tool brand in the world, and has been consistently gaining market share from its peers and displaying strong 20%+ growth for many years. Techtronic's business model is to invest heavily (and much higher than peers) in R&D, product development and sales development to drive faster growth. Capitalisation of some of the product development costs is based on a subjective judgement by management, but it doesn't seem too aggressive to us given the 3-5 year timeframe for amortisation and the number of new products being launched by the company. The losses on disposal of fixed assets, which is charged to the P&L, relate to the scrappage of Tooling and Moulds which are customised for Techtronic. The amounts involved are not too material. The trade receivable days for Techtronic have been trending lower; the absolute amount of receivables is also falling and historically the company has suffered very few impairments. We believe that Techtronic has given a strong rebuttal to the allegations, and while it would be helpful to get some more clarifications, it does not change our long-term fundamental view of the company.

Techtronic is a market leader in the cordless power tool segment and is gaining market share by introducing new and improved versions of cordless power tools ahead of its peers. Cordless tools are replacing corded, gas-based and pneumatic power tools and are expected to show stronger growth for the next several years. The improvement in gross margins is reinvested in the business to drive further growth.

Techtronic also reported its 2022 full year results recently. While revenues and net profit were slightly lower than consensus expectations due to a weaker consumer/DIY segment, it continued to show strong growth in the professional segment, which resulted in a further improvement in gross margins. This is in contrast to its major competitors which have been suffering from a larger decline in sales and margins. Techtronic now trades at an attractive 12m forward P/E of 15x compared to its 5-year average of 21.6x and is expected to deliver earnings growth of more than 15% per annum in the medium term. We took advantage of the fall in the share price to add to our position.

Fees	
0.75% AMC	

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Share Class Information (Institutional B Class)		
	Accumulation	**Income**
GBP Sedol	B3KL3W6	B4XX519
GBP ISIN	GB00B3KL3W60	GB00B4XX5197
USD Sedol	B3Z0942	B3VTJX2
USD ISIN	GB00B3Z09429	GB00B3VTJX23
EUR Sedol	B9XQL37	B9XQL04
EUR ISIN	GB00B9XQL371	GB00B9XQL041

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