Cederberg Capital Frequently Asked Questions
September 2018

1. What motivated you to start a China-focused investment firm?

In 2011, Greater Chinese equities offered a compelling investment opportunity: an out-of-favour asset class, good companies trading at bargain prices, and a large opportunity set with structural inefficiencies that could be exploited by patient investors who do their own research. I wanted to create a vehicle that would allow myself, friends and family to participate in this opportunity, using the extensive experience I had gained investing in China at my previous employer. We've subsequently generated attractive absolute and relative returns, and yet the opportunity remains compelling today.

2. Can you explain the culture of your organisation?

Cederberg's goal is to empower our clients by growing their savings in a trustworthy manner. Put simply, we run our clients' money like we run our own. Over time, we aim to be among the best in the asset class, not among the biggest. Our culture matters, to the extent that it will help us to achieve this purpose. It can be summed up by our core principles:

- *Simplicity*
  We keep things simple: complex investment theses seldom outperform, and complex operations create risk.

- *Accountability*
  We hire bright, ethical and energetic people to do what they do best, emphasizing individual accountability in a collegial environment.

- *Focus*
  In investments, we own a small number of wonderful companies; in operations, we focus on essential, value-adding activities to global best standards.

- *Excellence*
  We aim to do everything we do with excellence, be it investments, operations or client services.

- *Long-term*
  We take a long-term approach to both investing and business management; this will ultimately be in the best interests of our clients, shareholders and staff.

- *Integrity*
  Our clients entrust us with their money; we need to be worthy of their trust at all times.

3. How volatile are Chinese equities, and how do you manage volatility?

Volatility is a defining feature of Chinese equities: over the past decade, A-shares (companies listed in China) were twice as volatile as US and global equities. We expect the asset class to remain volatile, though long-term investors should view this as a *positive*, because companies tend to get mispriced more frequently in this type of environment.

Our goal is not to minimize this volatility, but instead to maximize long term returns. So when it comes to risk management, we aim to avoid a permanent capital loss. Hence even though we run a long-only fund, we very much have an absolute return mindset.

Our main risk control tools are:

- Investing in quality companies: they are less likely to disappoint
- Margin of safety: we only invest if there is 100% or more upside to our intrinsic value estimate
- Diversification: by number of holdings, industries and market cap

The fund has historically shown a degree of defensiveness, with downside capture of 88%, and a relatively low correlation of 0.84 with its index.

4. What does this imply for potential investors?

Given our long-term orientation and the asset class' inherent volatility, the fund is only suitable to investors who can take a five-year or longer view on their investments.

5. What is the make-up of Greater Chinese equity markets?

Greater China is defined as China, Hong Kong and Taiwan. The asset class contains over 5,000 companies with a USD100mn market cap or more listed in Shanghai and Shenzhen ("A-shares"), Hong Kong ("H-shares"), Taipei, and on international stock exchanges such as Singapore and New York.

Like many other emerging markets, Chinese equities are dominated by state-owned entities (SOEs). They represent the bulk of the financials, telecoms, energy, materials and utilities sectors, i.e. over half of most Chinese indices. Most companies in these sectors don't meet our quality criteria, hence we almost never invest in them.

The weighting of the domestically-oriented consumer discretionary, consumer staples, health care and IT sectors has been increasing in recent years. It is in these sectors that we tend to find higher quality businesses, most of which were founded by entrepreneurs.

6. You define the strategy as being Quality Value. Why did you adopt this approach to Chinese equities?

Like Warren Buffett, I started off buying "cheap" and ended up buying "good". I began investing in Asian equities in the early-2000's, a period during which Value strongly outperformed. The margin of safety concept resonated with me and I was hooked. In 2005, I started investing in Chinese equities. I paid my school fees shortly thereafter by getting stuck in a few "value traps" - companies that appear cheap but never realize their potential. At the same time, we made a lot of money for our clients by investing in consumer staples with dominant brands and strong distribution networks. It dawned on me that in China, a Buffett approach was more likely to succeed than a Ben Graham approach, as statistically cheap companies in this part of the world tend to suffer from structural disadvantages or poor governance (or both), oftentimes leading them to stay "cheap". Today, we invest exclusively in quality companies, but only when they offer a meaningful margin of safety.

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7. How do you define Quality Value? Where and how do you find it?

We look for three characteristics in an investment, summed up by what we call the 3M's: a durable **Moat**, excellent **Management**, and a large **Margin of safety.**

Quality consists of the first two M's: a durable **moat** and excellent **management**. These are typically dominant businesses with high or improving ROIC ("Return on Invested Capital"), strong free cash flow, a sound balance sheet, and significant growth potential. When it comes to management, we look for skillful capital allocators with appropriate incentives and track records of treating minorities fairly.

We have filtered the c. 5,000 companies from Greater China down to fewer than 150 that meet our quality criteria. We spend virtually all our time on these companies, and very little on the other 4,850.

The filtering process is ongoing and consists of the following:
- Visiting companies (>2,000 company visits over the past decade)
- Running proprietary quality screens
- Identifying business models that have worked elsewhere
- Networking with like-minded investors

We find many great companies in consumer staples, health care, internet, software and education. We find some in apparel, niche financial services such as asset management, retail, travel & leisure, home appliances, textiles, media and transportation. We find hardly any in autos, financials (excl. asset management), industrials, tech hardware, semi-conductors, energy, materials, telecoms and utilities.

Value is represented by the third M: we want to see a significant **margin of safety** (over 100% upside) before we invest. We value all companies using enterprise value to operating income, which we typically normalize over the next four years by excluding any non-recurring and non-cash items and subtracting an appropriate level of maintenance capex. We believe this is an appropriate metric, given our long investment horizon and our focus on quality compounders. The target multiple is typically in the 10-18x range, depending on the quality of the business and its long-term growth potential.

8. China is known for having dubious governance. How do you get over this hurdle?

China has certainly had its fair share of governance issues, however, in over 13 years' investing in Chinese equities I haven't experienced any blow-ups due to fraud or governance concerns. This can largely be attributed to our mindset and our process.

Firstly, it pays to be sceptical. Management will tell you anything, and the Big 4 auditors have all signed off on false statements. In China, one must assume a "guilty until proven innocent" mindset. We aim to verify important facts and figures independently. If this isn't possible, we move on.

Secondly, we do our own work. We typically spend several weeks analysing a single company, which not only entails detailed financial statement analysis but also extensive on-the-ground due diligence and contact with multiple sources of information including customers, suppliers, competitors, former employees and industry experts.

Thirdly, we rarely invest in companies with less than three years' listed history. The longer a company is listed, the easier it is to assess governance, capital allocation, what they say vs. what they do etc.

Finally, we focus on a company's cash flow generation over many years. While it is certainly possible for management to manipulate cash flows, it is hard to forge cash balances year in and year out. Moreover, fraudulent companies tend to raise debt and equity frequently, which is the opposite of what we're looking for in our holdings.

9. What are your return objectives for the strategy?

We aim to achieve mid-teen USD net returns over the next five to ten years. This would appear high given that long-term real returns from equities have been around 6% p.a., or 9 % in nominal terms. However, Chinese equity valuations remain low, and given that the asset class has structural inefficiencies which create opportunities for stock pickers, we believe it is a realistic objective for our strategy.

Put another way: our quality companies are growing their earnings at c. 20% p.a. and have an average dividend yield of 1%, whilst trading on reasonable valuations. If these figures are sustainable - and we believe they are for the next several years - a mid-teen USD net return objective appears achievable.

10. Do you make active sector calls, or do you focus solely on bottom up stock selection?

We are bottom up investors, spending hardly any time on macro-economic analysis, hence we don't make active sector calls based on our views of the economic cycle. However, we have made structural sector calls in our identification of certain sectors as "well-stocked ponds" likely to contain more long-term winners and fewer long-term losers. We focus our time exclusively on specific companies from these sectors and industries. As it happens, most of these sectors have structural tailwinds and are not particularly sensitive to economic growth e.g. media & internet, consumer staples and healthcare.

11. Do you require a recognized catalyst to be in place for every stock you purchase?

We don't; a quality company at a bargain price is what we're after. However, in every investment situation we ask ourselves 'what is the market missing?'. After all, even Chinese equity markets are efficient *most* of the time. We want to be certain that we have an edge over the market, be it through our analysis, our insights, or our time horizon, before we invest.

12. Do you always have to meet the management of a company before you invest in it?

We almost always meet with management. However, we tend to do so at the end of our research process to get more out of the meeting and to inoculate us against management's salesmanship.

13. You have invested in other parts of the world. Where do you put China on the efficiency spectrum?

We believe Chinese equities are significantly less efficient than developed markets, and even less efficient than some emerging markets like South Africa and Brazil, where I have invested in the past. These inefficiencies stem from a lack of decent equity research (two-thirds of Hong Kong-listed companies have zero coverage), a lack of institutional investor participation (retail investors represent over 70% of A-share market daily turnover) and a general lack of patient capital (average holding periods in China and Hong Kong are 2-3 months).

However, exploiting these inefficiencies requires local knowledge and patient capital. Without these, China can be a risky place to invest. That is why we spend a lot of time on the ground, and why we partner with long-term oriented clients.

14. How do you determine position sizing and the number of stocks you hold in the portfolio?

Since great ideas are scarce, we manage relatively concentrated portfolios, owning 15-20 holdings with a typical position size of 5-10%.

15. What is the research and decision-making structure of the team?

Our team consists of three analysts and myself as portfolio manager. We are all generalists, to ensure analysts don't fall in love with certain stocks or sectors, and to facilitate debate among ourselves. While we discuss ideas as a team, I have the final say. Though all analysts manage five-stock paper portfolios as a way to track their conviction and the performance of their investment calls.

16. How do you manage currency exposure within the portfolio?

Given the fund's focus on domestically-oriented Chinese companies, the bulk of our holdings' assets and cash flows are renminbi-denominated, irrespective of where their shares are listed. Our policy is to engage in hedging only for risk management purposes, that is, if we believed that a currency was meaningfully overvalued vs. the dollar, the fund's underlying currency. Based on Purchasing Power Parity ("PPP"), a good predictor of long-term currency valuations, the renminbi remains undervalued. Hence, we have not engaged in any FX hedging thus far.

17. What has been the range of annualized turnover and what environmental factors would cause turnover to reach the higher levels

The fund's annualized turnover has been c. 20% in recent years. Trading activity has tended to be higher during periods of market volatility, as intrinsic value targets are hit or as we switch into more compelling ideas that Mr. Market has marked down.

18. Can you generalize regarding the nature of your investment mistakes? Do they tend to be more frequently based on macro or micro mistakes?

Our investment mistakes can broadly be separated into two categories: selling winners too early and holding losers for too long. Whilst most people want to talk about the latter, the former is far more meaningful with respects to the impact on returns i.e. the performance our clients lost out on due to us selling long-term winners prematurely. With respect to holding on to losers, most of these occurred when we compromised on quality, i.e. buying less than outstanding businesses. Several of these have been brick-and-mortar retailers; we are highly selective these days when it comes to the category.

Our "Wall of Shame" in the office have framed examples of past mistakes, to ensure we continue to learn from them and that we don't repeat them.

19. What are the advantages and disadvantages of having offices in London and Shanghai?

Our research process can be divided into desk-based analysis - reading and phone calls, which could essentially be done anywhere - and fieldwork. Having a local office and a team of Chinese speakers enable us to do excellent on-the-ground research.

The main advantage of managing portfolios from a different time zone is that it is easier to control one's emotions, a major challenge all investors face. Chinese markets can be volatile hence the need to have "ice in my veins" to make rational, detached investment decisions; this is much easier to do when one is far away from the market chatter so prevalent in places like Hong Kong and Shanghai.

London is also an excellent place to attract and retain talent - notably from our London Business School internship program - as investment professionals tends to move more frequently in China and Hong Kong.

With regards to challenges: some of our Chinese competitors may claim to have better access to information, though whether this is obtained in a sustainable manner is an open question. The main challenge of having two offices in different time zones is ensuring good communication; as such we have regular conference calls and team members spend a lot of time together in China, London and elsewhere.

20. What gives you a competitive advantage?

The renowned investor Sir John Templeton once said: *'If you want to have a better performance than the crowd, you must do things differently from the crowd.'* We are intentionally different from most of our peers.

Firstly, we follow a <u>sound, repeatable approach</u>. There is strong academic evidence that both Quality and Value investing work. Furthermore, outperformance has been a *consequence* of our disciplined process in the past; we fully expect this to hold true in the future.

Secondly, we have a <u>unique perspective</u> that is both local and global compared to most of our peers who either have a local or a global perspective. This means our portfolios differ from those of our peers and from the index (active share is 85%).

Thirdly, our <u>interests are strongly aligned</u> with those of our clients through co-investment by the investment team (the bulk of my net worth is invested alongside our clients), a long-term fee structure with a high hurdle, and by disciplined capacity management.

Finally, having <u>long-term oriented partners</u> enables us to make long-term investment and business decisions. This is arguably our strongest competitive advantage. It is my firm belief that a business is only as good as the clients it serves; we are very fortunate to have attracted such an outstanding client base.