CEDERBERG CAPITAL

Cederberg Greater China Equities 30 September 2018

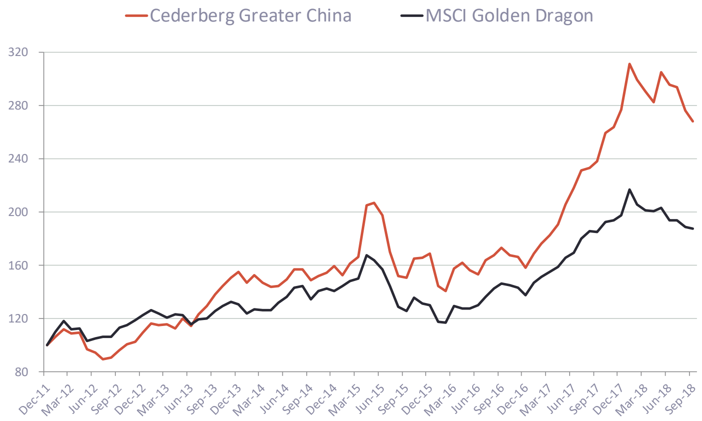
Cederberg Capital

- **Greater China specialists** founded in 2011, majority staff-owned
- **Mission**: Run client money like we run our own
- **Unique perspective** from team in London & Shanghai
- **Research-driven process** focused on region's best companies

Investment Principles

- **Moats** that are durable over our 4-year investment horizon
- **Management** that is excellent, honest and aligned with us
- **Margin of safety**: >100% upside to intrinsic value (at initiation)
- **High conviction portfolio** of long-term winners

Performance Chart[1]

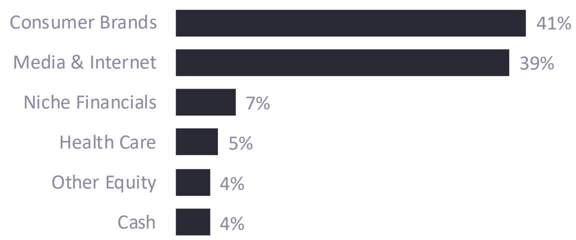


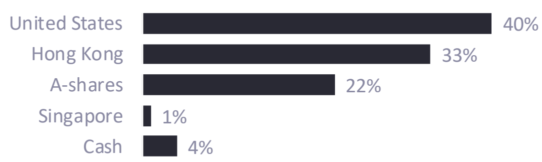
Past performance is not indicative of future results. Please see regulatory information on page 5. Source: Bloomberg, Charter Group, Cederberg. 30 Sep 2018

Performance Table[1]

Net Returns in US$	Fund	Index	Peer group	Percentile
Annualised				
Since Fund inception	16%	10%	8%	99
5 years	14%	8%	6%	99
3 years	21%	14%	7%	99
2017	75%	44%	36%	99
2016	-7%	5%	-5%	44
2015	6%	-7%	-5%	89
2014	3%	8%	3%	38
2013	42%	7%	10%	99
2012	9%	22%	18%	5
Not annualised				
Year-to-date	-3%	-5%	-13%	93
3 months	-9%	-3%	-8%	39
1 month	-3%	-1%	-1%	12

Portfolio Positioning[2]





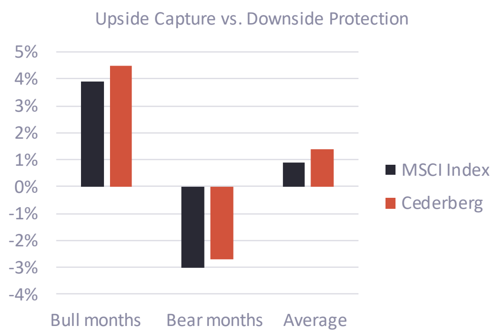
Major Holdings[3]

Alibaba	Ecommerce	**Midea Group**	Home appliances
BJ Tong Ren Tang	TCM	**Noah**	Asset management
China Foods	Bottler	**Tencent**	Social network
JD.com	Ecommerce	**Wuliangye**	Distillers
Kweichow Moutai	Distillers	**Yihai**	Condiments

Median Portfolio Characteristics[5]

P/E (2019e)	18x	**ROE**	21%
EV/EBIT (2019e)	14x	**ROIC**	13%
EPS growth (2019e)	22%	**Market cap**	US$22bn
Net cash to equity	45%	**Number of holdings**	18
Dividend yield	1%	**Top 10 holdings**	75%

Risk Metrics[4]



Fund Key Features[6]

Strategy	Long-only equity	**Auditor**	Deloitte
Domiciles	Cayman, Delaware	**Custodian**	Standard Chartered
Fund assets	US$328mn	**Administrator**	Charter Group
Firm assets	US$540mn	**Cayman counsel**	Maples & Calder
Peer group	Greater China Equity	**US & UK counsel**	Schulte Roth & Zabel
Benchmark	MSCI Golden Dragon	**Phone**	+44 207 871 7228
NAV	267.782	**Email**	info@cederbergcap.com

Please note: All performance figures on this page refer to Class A shares, please see page 5 for information on the fund's different share classes.

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A baker's dozen on Alibaba

Following Jack Ma's announcement that he plans to step down as chairman in a year, and the Cederberg team's attendance at last month's Hangzhou investor event, we revisit our thesis for owning Alibaba via 13 questions and answers.

1. What does Alibaba do?

In the broadest sense, the company helps its customers – mostly small and medium enterprises – to engage with consumers and to operate more efficiently by leveraging data and technology.

It operates several businesses, the major ones being:

- *Taobao*: the world's largest marketplace, where 600mn+ users browse 1.5bn product listings posted by 10mn+ sellers
- *Tmall*: China's largest business-to-consumer ("B2C") ecommerce platform, where global and Chinese brands sell to 500mn+ users
- *Cainiao*: a logistics network to help Alibaba achieve its vision of fulfilling orders within 24hrs in China and within 72hrs elsewhere in the world
- *Ele.me*: a food delivery business operating across China
- *Hema*: a fresh food-focused supermarket chain integrating online and offline retail
- *Lingshoutong*: a platform that currently helps over 1mn of China's 6mn mom-and-pop stores to operate better
- *Youku*: a top 3 online video site in China
- *Ant Financial*: the world's leading fintech business, currently valued at USD150bn; Alibaba owns 33%
- *Alibaba Cloud*: China's leading cloud computing company

Alibaba makes money in several ways, including: merchants and brands bidding for advertising resources on Taobao, Tmall, Ele.me and Youku; sellers paying commission on each sale in Tmall; subscribers paying subscription fees to watch movies on Youku; enterprises paying hosting fees on Alibaba Cloud; consumers and SMEs paying interest on loans and commission on wealth management products at Ant Financial.

2. What is Cederberg's thesis for owning shares in Alibaba?

Alibaba owns the world's most valuable collection of consumer data, which it will monetize for years to come.

Like most marketplaces, Alibaba's **moat** stems from the network effects of its ecommerce properties: more buyers attract more sellers, who attract more buyers etc. However, it differs from other marketplaces – in China and elsewhere – because of the range of services the company and its associates offer. As such, it is better to think of it as an ecosystem rather than merely a marketplace. We believe this ecosystem will prove to be exceedingly durable.

The second way in which Alibaba differs from other ecommerce companies, is in terms of the depth and breadth of the data it captures. From the moment Chinese consumers wake until the moment they go to bed, Alibaba is gathering their data: where they live, how they commute to work, which shows they watch, which items they browse/buy online, how and when they want their shopping to be delivered, which products and services they buy offline, what they order for dinner etc. All this data is kept secure, analysed, and then used for personalizing advertisements and recommendations, planning where to build offline shops and which goods they should stock, choosing which shows the company should invest in etc.

The third way in which Alibaba differs, is the advantage it gains from its stake in Alipay, the leading mobile wallet in China – and the world – which generates invaluable data regarding online and offline transactions for the company. In short: Alibaba knows your income, your spending behaviour, your savings habits.

Lastly, the company has a wonderful culture and a **management** team that invests for the long run to widen the business' moat.

Source: Cederberg Capital

3. What will be the impact of Jack Ma leaving?

In short, we expect the impact to be minimal as Jack Ma built a strong team that has effectively run the business for the past few years. If anything, we've been impressed with his gradual exit – it is rare for tech founders to pass on the baton – as it is an example of good corporate governance. The 36 members of the Alibaba Partnership – which owns tens of billions of dollars' worth of shares – will grow to 100 over time to ensure a greater proportion of the company's talent is incentivised.

4. Speaking of governance, isn't Alibaba's so-so?

For many years, the popular narrative has been that Alibaba is poorly governed: didn't Jack Ma steal Ant Financial from Yahoo! and Softbank back in the day? What about its opaque corporate structure? Is it even possible to govern a company consisting of 920 different businesses?

We believe the company's governance has improved tremendously over the years:

- Its disclosure and investor communication are world-class
- It hosts an excellent, multi-day investor event annually
- It has an effective and highly-aligned governance structure
- It has improved its legal structure as the Alibaba Partnership took over the ownership of key entities from Jack Ma

5. Is the company perhaps too complex to analyse?

We don't think so. Yes, Alibaba is a big beast – it is one of the world's largest companies and operates in over 200 countries and territories. Yet its actions are consistent with its vision: **to make it easy to do business anywhere**. Viewed through this lens, its business strategy and capital allocation decisions appear sensible and not overly-complicated.

6. Is it the "Amazon of China"?

There are certainly parallels between the two companies: they are synonymous with ecommerce and disruption; they are extremely long term-oriented; they have invested meaningfully in things like cloud computing, AI, and entertainment; they are both high quality companies with rapid growth potential.

Yet in many ways they are quite different: Alibaba purely acts as a middleman connecting buyers and sellers vs. Amazon which also has a large direct sales business; its ecommerce business is currently much more profitable vs. Amazon's; it has followed an asset-light strategy vs. Amazon's asset-heavy approach; Amazon doesn't have nearly the same level of user data; the companies operate in very different environments.

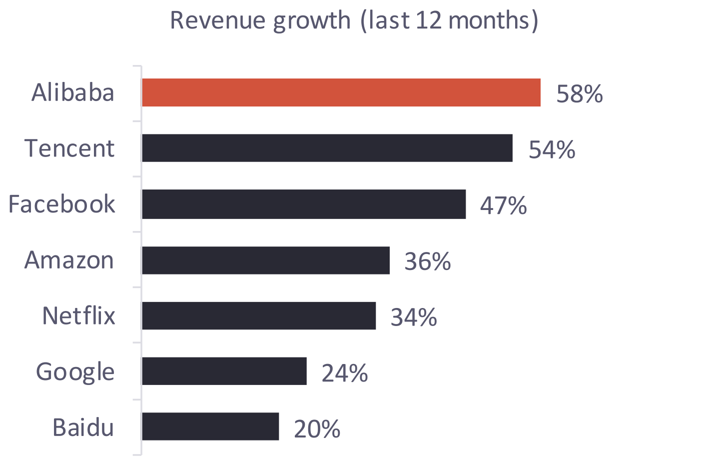
So, while we think both companies are great, a simple heuristic such as "Alibaba is the Amazon of China" is not that useful.

7. How meaningful is Alibaba's cloud business?

While Alibaba Cloud is the leading provider of cloud computing services in China, its revenue in the past financial year was a mere USD2bn vs. Amazon Web Services' USD17.5bn. Unlike AWS, it continues to be lossmaking, partly because of its very rapid growth – it is growing at +100% yoy. We are confident that Alibaba Cloud will ultimately be quite profitable, but it is unlikely to become a big part of the value of the overall business given the scope of the core commerce segment.

8. Did Amazon fail in China because of an uneven playing field?

It has become popular to attribute the dominance of local ecommerce players – Alibaba has c. 80% market share and JD.com 10% – to the government not wanting foreign players to succeed. The reality is quite different. eBay has been in China since 2002, and Amazon since 2004, yet both companies have less than 1% market share today because they were outmanoeuvred by nimbler, local players that did a better job of catering to Chinese consumers' tastes. While it is easy to blame the "communists" for Amazon's failure, the real reason is its capitalist Chinese competitors!



Source: Company, Cederberg Capital

9. Given Alibaba's size, how much further can it grow?

Despite its size, we believe Alibaba can continue its rapid growth for the next several years.

The first growth driver is sticky users spending more money in the Alibaba ecosystem, which the company will ultimately monetize. A new user of the company's China retail marketplaces might spend RMB3k (USD400) making 27 orders from 6 different categories in the first year. By year five, (s)he will typically spend RMB12k (USD1,700) on 132 orders from 23 different categories. Of the 100mn+ users that spend at least RMB10k per year, 98% will spend at least RMB10k the next year. Customer stickiness is likely to persist: in August, Alibaba launched its VIP88 loyalty program, which is similar to Prime, Amazon's hugely successful loyalty program.

The second growth driver is adding more users to the company's platforms, which would make them even more profitable. Alibaba is making a big push into smaller Chinese cities and the countryside. It has also identified cross-selling as a source of new users: Ele.me and Youku have 168mn and 400mn users respectively, a long way from Taobao's 634mn and Alipay's 870mn users.

The third growth driver is Alibaba's customers – the merchant sellers and brands using its retail marketplaces and other businesses – paying the company more money for more services. Traditionally, its services helped customers to generate more revenue; increasingly they help to reduce customers' logistics, operations and marketing expenses.

The fourth, and potentially most lucrative, growth driver is offline consumption. The size of China's consumer economy is RMB36trn (USD5trn), of which only RMB6trn takes place online. Alibaba has historically focused on this smaller piece of the pie. It is increasingly going after the other 80% of China's consumer economy by helping traditional retailers – those in its own group such as Hema but also third parties – to do a better job. We don't know how this will play out, but we salivate at the prospect!

10. What are Alibaba's prospects in the rest of the world?

On this score we are less excited. The company has grand ambitions: it is targeting 2bn consumers worldwide, which suggests a billion or so users in the rest of the world. Yet in most other countries, Alibaba won't enjoy the same competitive advantages it has in China, not to mention markets a fraction the size of its domestic opportunity.

11. How do you value the business? Does the trade war impact its valuation?

We value Alibaba over a 4-year investment horizon, appraising its major businesses separately and adding back excess cash. Given its quality and long term growth potential, we value the core commerce business using a 17x multiple of its normalized operating income, which we expect to double over the next 4 years to USD36bn. Hence, the core business alone could be worth more than USD600bn. The stakes in Ant Financial and other investee companies are worth over USD80bn today; they are likely to become more valuable over time. The other business units – Digital media & entertainment, Alibaba Cloud, AI etc – are attractive but less meaningful, representing less than 10% of the company's intrinsic value. Putting it all together, we think the business is worth more than USD800bn vs. its current market cap of USD381bn, a significant **margin of safety** given its quality and growth potential.

Regarding the trade war, Alibaba's revenue and profits are largely domestically-oriented, hence it is unlikely to have much of an impact.

12. How can such a big company be mispriced?

We don't subscribe to the school of thought that bigger companies are more efficiently priced than smaller ones. Take Amazon for example: over the past year, Mr Market has valued it at as low as USD470bn and as high as USD1,000bn. Even though it is covered by 50 sell-side analysts and thousands of buy-side analysts, its share price has been all over the place.

This has also been true of Alibaba – with its share price at a 52-week low, it seems Mr Market is currently taking a "glass nearly empty" view. But on top of dealing with the vagaries of Mr Market, in Alibaba's case the bulk of its shareholders have *never* used its services – the company's shares are listed in the US, where most Chinese savers are unable to invest because of capital controls. This is the exact inverse of Amazon, where its customers have frequently become fervent shareholders. We believe this partly explains the large difference in the companies' valuations. It might also explain why Alibaba is the most shorted company in the world.

Add to this the torrent of negative news international investors face daily – trade wars, anti-China rhetoric, a weakening currency, conspiracy theories on why Jack Ma will be stepping down – and one can understand why Alibaba is significantly undervalued today.

13. What could go wrong?

Like most tech businesses, the biggest risk Alibaba faces is regulation, though on this score we actually think the company is reasonably well-placed considering how proud and supportive the Chinese government is of the domestic tech behemoths. Other risks include capital misallocation, competition within specific categories from the likes of JD.com and new entrant Pinduoduo, and cost pressures leading to no/negative operating leverage. On balance, we are comfortable with the company's risk profile.

Final thoughts

I would like to thank our clients for your long term-orientation during these tumultuous times, and my wonderful team for all their hard work.

Warm regards,

David Krige

Additional commentary by Cederberg Capital Head of Research, Daniel Ng

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Regulatory information and risk warning

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Disclosure

[1] Past performance is not indicative of future performance. Investors whose reference currency differs from the US dollar may be subject to exchange rate movements that alter the value of their investments. MSCI Golden Dragon Total Return Index includes net dividends reinvested. Peer group is Bloomberg universe of equity funds with Greater China geographical focus. Source: Charter Group Admin, Bloomberg, Cederberg.

[2] Category definitions as per Cederberg. Source: Bloomberg, Cederberg

[3] Source: Cederberg

[4] Upside Capture is calculated by dividing the fund’s average NAV return during months in which the index had a positive return by the average index return during those months. Downside Capture is calculated by dividing the fund’s average NAV return during months in which the index had a negative return by the average index return during those months.

[5] Median portfolio characteristics are quoted as of 4 October 2018. Source: Bloomberg, Cederberg.

[6] As of 30 September 2018. Source: Cederberg.

Investors should note investment involves risk. The price of units may go down as well as up and past performance is not indicative of future results. Investors should read the Fund’s Offering Memorandum for further details and risk factors, in particular those associated with investment in emerging markets. Information in this report has been obtained from sources believed to be reliable but Cederberg Capital does not guarantee the accuracy or completeness of the information provided by third parties.

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	Class A	Class B	Class C	Delaware LP - Class B
Inception date	1 Jan 2012	1 Jul 2018	1 Jul 2018	1 Feb 2018
Status	Closed	Open	Open	Open
Min initial investment	US$100k	US$100k	US$100k	US$1mn
Subscription	Monthly	Monthly	Monthly	Monthly
Redemption notice	30 days	90 days	90 days	180 days
Redemption fee (payable to the Fund)	3% if redemption within first 6m	5% if redemption first 3yrs, thereafter zero	N/A—3yr hard lockup	5% if redemption first 3yrs, thereafter zero
Management fee	1.50% p.a.	1.25% p.a.	0%	1.25% p.a.
Performance fee	20% of net alpha over MSCI Golden Dragon; payable after 3yrs if Fund generated >6% p.a. US$	20% of net alpha over MSCI Golden Dragon; payable after 3yrs if fund generated >6% p.a. US$	25% of returns over 6% p.a. US$ hard hurdle; payable after 3yrs	20% of returns over 8% p.a. US$ hard hurdle; payable annually
High water mark	Yes	Yes	Yes	Yes
Investor level gates (max redemption per investor)	N/A	25% per quarter	25% per quarter	N/A
ISIN	KYG2030A1004	KYG2030A1186	KYG2030A1269	N/A
Sedol	BMM1R81	BFYZYW5	BD31D23	N/A