CEDERBERG CAPITAL

Cederberg Greater China Equities 31 August 2019

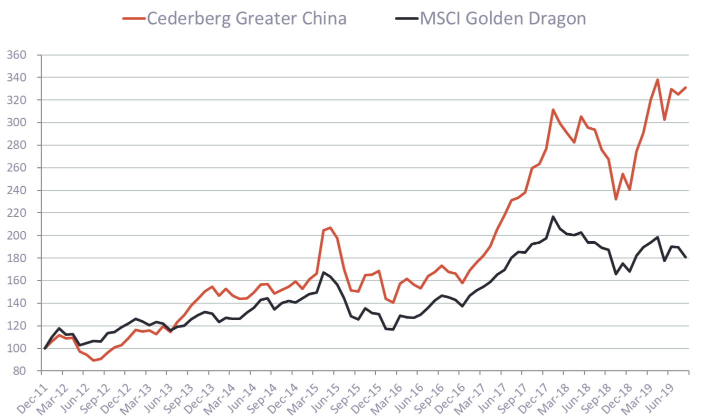
An introduction to Cederberg

- 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 the region's best companies
- In every investment, we look for a durable Moat, excellent Management, and a large Margin of Safety
- We manage a high conviction portfolio of long-term winners, with low portfolio turnover

Why Cederberg might not be right for you

- Our products are considered very risky; given our long-term focus and comfort with being different, **we are not for most investors**
- Chinese equities are highly volatile: declines of 70% are not uncommon
- Cederberg's returns have been more volatile than those of the index
- We manage a concentrated portfolio that typically differs substantially from those of our peers and from the market
- **Our past returns are unlikely to be repeated in the long run**
- Our strategy is only suitable for clients who invest for at least 10 years

Performance chart[1]

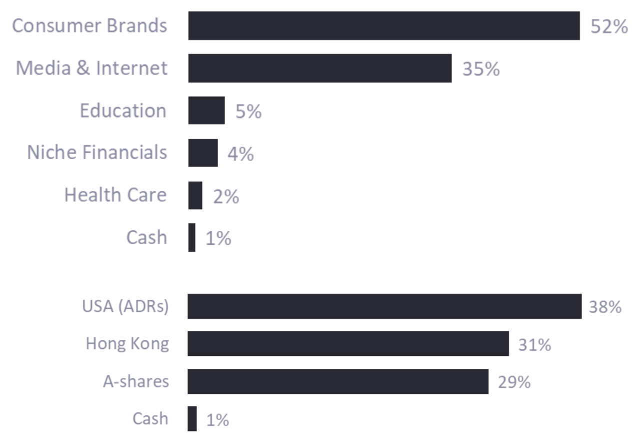


For Class A shares. All figures in US$ net of fees. MSCI Golden Dragon Index includes net dividends. Past performance is not indicative of future results - please see regulatory information on p3. Source: Bloomberg, Charter Group. 31 Aug 2019

Performance table[1]

Net Returns in US$	Class A	Index	Peer group	Percentile
Annualised				
Since inception (1/1/2012)	17%	8%	7%	100
5 years	16%	5%	4%	100
3 years	25%	8%	4%	100
2018	-13%	-15%	-23%	90
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	38%	8%	16%	94
3 months	9%	2%	3%	85
1 month	2%	-5%	-4%	93

Portfolio positioning[2]



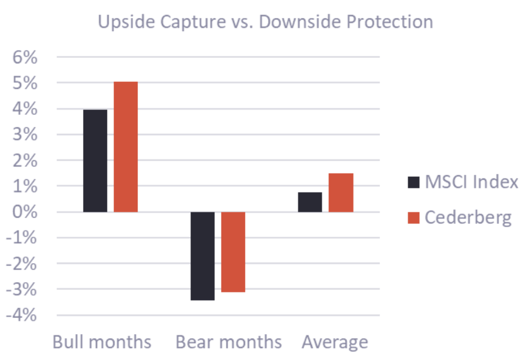
Major holdings[2]

Alibaba	Ecommerce	**Netease**	Online gaming
Haidilao	Restaurants	**New Oriental**	Education
JD.com	Ecommerce	**Tencent**	Social network
Jiangsu Yanghe	Distillers	**Wuliangye**	Distillers
Kweichow Moutai	Distillers	**Yihai**	Condiments

Median portfolio characteristics[4]

P/E (2020e)	21x	**ROE**	22%
EV/EBIT (2020e)	16x	**ROIC**	13%
EPS growth (2020e)	21%	**Market cap**	US$23bn
Net cash to equity	56%	**Number of holdings**	17
Dividend yield	2%	**Top 10 holdings**	81%

Risk[3]



Key features[5]

Strategy	Long-only equity	**Auditor**	PwC
Domiciles	Cayman, Delaware	**Custodian**	Standard Chartered
Fund assets	US$758mn	**Administrator**	Charter Group
Firm assets	US$1.7bn	**Cayman counsel**	Maples & Calder
Peer group	Greater China Equity	**US & UK counsel**	Schulte Roth & Zabel
Benchmark	MSCI Golden Dragon	**NAV - Class A**	331.12
Expenses	14 bps (2018)	**NAV - Class B**	112.10
Turnover	14% (2018)	**NAV - Class C**	115.64
Email	ir@cederbergcap.com	**Phone**	+44 203 745 1701

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BUSINESS UPDATE:

Firm AUM

Cederberg's objective is to generate attractive long-term returns for all our clients. It is our belief that being disciplined about capacity is fundamental to achieving this objective; indeed, unconstrained growth often leads to mediocrity. As such, **we will close to new investors on Dec 31st 2019**, with AUM of c.$2bn. Existing investors may still be able to add to their investments beyond this date, subject to ongoing assessment of capacity constraints and the opportunity set. We intend to remain disciplined with respect to our capital base to ensure nothing but excellent long-term outcomes for our clients. Indeed, we may even return capital should opportunities cease or firm AUM become too large.

Team update

Dan Tan has recently joined us as an investment analyst. Dan obtained a first-class economics degree from LSE and has impressed us with his passion, curiosity and maturity during his internship. He is the youngest member of the Cederberg team – we figured we could do with a Generation Z consumer in the team to offset some of my grey hair. Dan will initially be based in London, before moving to our Shanghai office early next year. Welcome, Dan!

New fund director

Rahul Moodgal has joined the fund's board as an independent director. Rahul has an MPhil from Cambridge and studied for a PhD at LSE. He brings more than 20 years of experience from top investment firms such as TCI (The Children's Investment Fund), Parvus and TT International. His obsession with putting clients first and his willingness to go the extra mile are legendary within the institutional investment community globally. We are thrilled that someone of Rahul's calibre has joined the fund's board. Rahul replaces YanYan Li, whose new employer doesn't allow external directorships. The board continues to have a majority of independent directors.

INVESTMENT UPDATE: AN OUTSIDER'S VIEW OF CHINA

Rob Vinall is one of the best investors we know – his global equity fund has compounded at 20% p.a. for over a decade. He is also a great guy. Hence, we were thrilled when he joined us on a recent China trip. Rob made some fascinating observations in a subsequent RV Capital newsletter, and we're delighted to be able to include an extract below.

'…..It is the sixth trip that I have made to China since 2012 and this time, as with every time before, I came back exhilarated by how much I had learnt. What makes China so fascinating is that it is large (at 1.4bn, its population is nearly 5x that of the US), important (what happens in China increasingly impacts everywhere else too), and different (most dominant companies in China are non-Western). Above all, the combination of all three characteristics that make China so fascinating. India is also large and different but has not developed as fast as China to take on the same importance. The US is large and important, but familiar.

What follows are some reflections on what I learnt from the trip.

Developed and developing

It is difficult to overstate how developed China already is and how fast the country is developing. It would be inaccurate to describe the infrastructure of Beijing as first world as I struggle to think of a Western city whose infrastructure is comparable. To pick one example, the high-speed train to Shijiazhuang took roughly an hour to take us over 300 km. Furthermore, the country continues to develop at a rapid rate. When I first visited Beijing in 2012, the air was unbreathable, and the city was a sea of cranes. Though not perfect, the air is now vastly improved (we had blue skies the entire week), and the cranes have largely departed as the city is basically built. Instead, I saw a similar sea of cranes at Shijiazhuang. Presumably, in a few years' time, they will have moved on again. If the development model of Beijing can be replicated across the country, it is only a matter of time before Chinese GDP per capita catches up with and then overtakes Western levels.

Overlooked

It strikes me that the average person in the West underestimates how rapidly China has progressed and how much runway is ahead of it. News reports on China are infrequent (generally coinciding with a State visit) and tend to focus on human rights abuses and the lack of democracy. Whilst these issues are real and important, the near exclusive focus on them results in people missing the wider picture. It's rather like visiting San Francisco and only taking away that it has a serious problem with homelessness. Yes, the problem is big and important, but if it is all you take away from a trip to Silicon Valley, I would suggest you are missing the bigger picture of the extraordinary societal changes being catalysed by the companies there.

The Chinese government has done a great job

The Chinese government has done a great job of improving the lives of its people. According to the World Bank, more than 850 million people have lifted themselves out of extreme poverty as China's poverty rate fell from 88% in 1981 to 0.7% in 2015. If worldwide poverty has decreased over the last 30 years, it is largely thanks to China, not Bob Geldof throwing a concert in Wembley.

It is difficult to imagine that the country would have developed as rapidly had the prodemocracy protests 25 years ago been successful given the slower pace of development in a democracy due to the need to build a consensus amongst multiple stakeholders. India is a case in point. This is not to say that I am in favour of one-party-rule. To the contrary, I firmly believe that democracy is the *best way to organise a society as it provides a correction mechanism if a leader develops destructive tendencies (which, absent democratic controls, has tended to be the norm rather than the exception historically). However, just because the facts on the ground do not accord with our political convictions does not mean they can be denied.*

Though my small sample may not be representative, all the Chinese people and Western experts I met in China told me that there is broad satisfaction with the job the Chinese government is doing and zero appetite for systemic change. Given the daily coverage in the West of the protests in Hong Kong, this is presumably counterintuitive for many of my readers. Again, I emphasise this is not an endorsement of China's political system, just a recounting of what I learnt.

The implication is clear: people's allegiance is to the system that best delivers an improvement in their living standards, not an ideology (I suspect the root cause of the protests in Hong Kong is the decline in the former colony's relative position in China). This should be a wake-up call to the West that democracy is not an end but a means to an end – to improve the lives of its citizens. If our system of government does not deliver improving living standards to broad swathes of the population, it is not a given that our democratic system will persevere. It pains me to observe how Brexit has put government in the UK on hold for the last four years. Remainers and leavers should agree that this is a national tragedy. The Chinese economy has grown by almost a third whilst the UK's politicians have squabbled amongst themselves.

<u>Dynamic</u>

The Chinese economy is incredibly dynamic. I did my first road trip visiting Chinese Internet companies in August 2013. Back then JD ("the Amazon of China"), Baidu ("the Google of China"), and Ctrip ("the Booking.com of China") were all in the ascendancy. Today, they are shadows of their former selves, having been eclipsed by companies that in some cases did not even exist in 2013. In the West by contrast, Amazon, Google, Booking and most of the other Internet companies that were dominant six years ago remain dominant today.

From a societal perspective, the high level of creative destruction is fantastic. For an investor, it is humbling. Many of the companies that I thought had sustainable competitive advantages six years ago turned out not to have had. One of Business Owner's investment criteria is that a company should be around and flourishing ten or more years from now. I struggle to think of a Chinese Internet company that meets this criterion today with the possible exceptions of Alibaba and Tencent, whereby even here I am not 100% certain.

<u>Competitive</u>

The Chinese economy is incredibly competitive. There is perhaps a sense in the West that a gentler form of capitalism operates in China given the country's nominally communist roots. Nothing could be further from the truth. Competition is brutal. On the trip, one investor quipped: "The reason Western companies cannot compete with Chinese companies is because Chinese companies cannot compete with Chinese companies". His point was that all profits get competed away and then some.

Many moats in China are weaker than in the West and in some cases non-existent. For example, market shares in payment, rideshare, food delivery, and online travel agency have proven far more fluid in China than in the West despite these businesses supposedly being protected by network effects. In practice, new entrants have overcome network effects by subsidizing one or both sides of the network. Meituan was able to overtake Ctrip in hotel bookings. In the West, ByteDance is attempting to overcome the network effects in social media through massive investment in subscriber acquisition for its app TikTok.

In the rare instances where competition does not do the job of competing away extraordinary profits, the government is quick to regulate. For example, it introduced a central clearinghouse for online payments and raised the reserve fund ratio for 3rd party payment platforms to 100%, both with the explicit aim of reining in Tencent and Alibaba. To be clear, I think this is the right thing to do as it is great for society. The take rates on digital payments are many times higher in the West, a fact that benefits a handful of banks and payment networks, whilst penalising tens of millions of merchants. However, the proactive approach to regulation makes an already difficult task of finding great investment opportunities even more challenging.

….

<u>Innovative</u>

Chinese companies are incredibly innovative. I think this point is worth emphasising as there is perhaps a misperception in the West that Chinese companies are less innovative and more imitative. In the Internet sector, which I am most familiar with, but most likely elsewhere too, nothing could be further from the truth. For example, mobile payments have been ubiquitous in China for some time. WhatsApp, by contrast, will offer mobile payments to "most of its users within a year" according to Mark Zuckerberg on Facebook's Q2 2019 earnings call.

In "AI Superpowers," Kai-Fu Lee explains that whilst many Chinese companies start out as clones of US Internet companies, the intense competition this engenders – he likens it to a "coliseum where hundreds of internet gladiators fight to the death" - fosters rapid innovation:

"But it was precisely this widespread cloning – the onslaught of thousands of mimicking competitors – that forced companies to innovate. Survival in the internet coliseum required relentlessly iterating products, controlling costs, executing flawlessly, generating positive PR, raising money at exaggerated valuations and

seeking ways to build a robust business "moat" to keep the copycats out".

Meituan is highlighted in the book as an exemplar of this phenomenon. It started out as a Groupon clone and then branched out into all kinds of services including food delivery and travel bookings.

Chinese companies benefit from broad societal and governmental support for innovation. When I first started following tech companies in Silicon Valley, there was a similar sense of optimism about technology's ability to improve the world, but now it seems to have dissipated. Instead, the focus is almost exclusively on the potential downsides from any new technology. Facebook's announcement that it plans to launch Libra, a cryptocurrency, was met with near universal opprobrium even though payments are far from a solved problem in the West, especially for cross border money transfers.

The contrast in China could not be starker. I visited Sensetime, a Chinese leader in facial recognition. Its enthusiasm was almost endearing in its naivety given how problematic the technology is considered in the West. As we entered their offices, they proudly pointed out hundreds of cameras which were tracking us. One application claimed to be able to discern how happy you are. I did not score very highly, even though I was quite enjoying the tour, but, hey, who am I to know what I am feeling?

Facial recognition is a controversial subject where even techno-optimists in the West feel a certain queasiness. However, not all use cases are negative. Sensetime told us how its cameras helped locate a kidnapped child. I have no strong view on the technology. My point is that a society that dismisses technology a priori rather than carefully weighing the advantages against the disadvantages is destined to fall behind. Incidentally, the country where this risk is most acute is, in my opinion, Germany. New technologies are met with broad-based scepticism and the default regulatory response is to ban them.

<u>A window into the future?</u>

Chinese companies offer a window into the future given the faster pace of iteration and hence innovation. This alone makes them worthy of study.

When I first came across Tencent, I struggled to understand its business model as a large part of its revenues then (as now) came from in-game purchases of virtual items. It made no sense to me why anyone would pay real money for virtual jewellery. Fast forward five years and I observe my children enthusiastically purchasing "skins" and "dances" with their pocket money. The reason is now clear to me – they wish to signal credibility to other game participants in the same way that someone from my generation may want to walk into a party wearing a Rolex. I wish I had understood this better five years ago.

Insights can be gleaned from the study of Chinese companies with broader applicability beyond China. However, in the same way that not everything that happens in the West has applicability to China, I suspect the reverse is true also. As a Facebook shareholder, I hoped that WhatsApp would develop the multiple use cases of WeChat, but so far this has not materialised.

<u>Variable Interest Entities</u>

One aspect of investing in China that has bugged me since my first visit to China is Variable Interest Entities ("VIEs"). In industries that the Chinese government deems sensitive (which as far as I can judge is all industries), you do not invest directly in the Chinese company but in the ADRs of an offshore company that has a contract with it. Ownership of the onshore Chinese company remains with Chinese citizens (usually the founders), but contracts confer rights, including to the company's cash flow, to the offshore entity. The structure is elegant in that it squares the apparent circle of China's insistence on local ownership, Chinese companies' need for capital and foreign expertise, and overseas investors' desire to profit from the growth in Chinese companies' earnings.

The structure has always struck me as fragile, especially in a country where property rights are not particularly robust. Furthermore, it puzzles me that the Chinese government is seemingly unbothered that vast swathes of its economy (including all its Internet champions) are majority "owned" by foreigners when even a small acquisition by a Chinese company in Europe triggers handwringing and headlines in European capitals.

As such, I have taken every opportunity to ask Chinese officials and investors whether they think the VIE structure is sustainable. Oddly enough, my question is always met with a blank look. It struck me as odd that something I viewed as the elephant in the room was not even on their radar screens. During the last trip, it dawned on me why.

The VIE structure is incredibly favourable from a Chinese perspective. Control of the companies remains in China. The contractual right to cashflow is mainly theoretical as most companies reinvest most of their earnings (which makes sense given the opportunities for growth). Finally, it aligns with the government's legitimate aim to foster a competitive and vigorous economy that the costs of said competition are borne in part by foreign capital whilst the benefits accrue exclusively to its citizens. Why would China ever do anything to risk the VIE structure when anything that superseded it could only possibly be less favourable?

Hence the blank looks.

It will be interesting to see what happens when the economy matures, is less reliant on foreign expertise and capital, and companies enter capital return mode. What will China make of Tencent paying tens of billions of dollars to the South African Naspers when it runs out of places to put its cash? We will most likely not *find out for a long time as it will be many years or decades before this happens.*

By then, China will be a different place than today, where, if things go to plan, the legal system will be more robust, and China will have large interests in companies overseas and hence an interest in the reciprocal recognition of ownership rights. In the meantime, I can see no benefit to China from delegitimising the VIE structure. Foreign investors will certainly not. As such, the VIE structure strikes me as highly sustainable. It has persisted since Sina's IPO in 2000, so this conclusion is perhaps not all that surprising.'

CONCLUSION:

Rob's account makes some fascinating observations on China, and highlights the importance of visiting the country - rather than relying on the financial press for information. There is much to agree on (and on areas where opinions may vary, we continue to keep an open mind!).

To our clients: thank you for taking the long-term view.
To our team: thank you for your world-class work.

Warm regards,

Dawid Krige

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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] Upside Capture show the fund's average return vs. the index's average return for those months in which the index had a positive return. Downside Capture shows the fund's average return vs. the index's average return for those months in which the index had a negative return. Source: Bloomberg, Cederberg

[4] Median portfolio characteristics are quoted as of 05 August 2019. Source: Bloomberg, Cederberg.

[5] Data as of 31 July 2019. Expenses include all fund level expenses excluding investment management fees divided by the fund's average AUM in 2018. Portfolio turnover is for 2019 and is calculated as the lower of all buy and sell transactions divided by fund's average AUM. 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 (closed for new subscriptions)	Class B	Class C	Delaware LP - Class B	Delaware LP - Class C
Inception date	1 Jan 2012	1 Jul 2018	1 Jul 2018	1 Aug 2018	1 Aug 2018
Status	Closed	Open	Open	Open	Open
Min initial investment	US$100k	US$100k	US$100k	US$1mn	US$1mn
Subscription	Monthly	Monthly	Monthly	Monthly	Monthly
Redemption notice	30 days	90 days	90 days	180 days	180 days
Redemption fee (payable to the Fund)	3% if redemption within first 6m	5% if redemption first 3yrs, thereafter zero	N/A—3yr hard lockup	5% if redemption first 3yrs, thereafter zero	N/A—3yr hard lockup
Management fee	1.50% p.a.	1.25% p.a.	0%	1.25% p.a.	0%
Performance fee	20% of net alpha over MSCI Golden Dragon if Fund generated >6% p.a. US$ returns; payable for the first time in Jan 2015 and annually thereafter	20% of net alpha over MSCI Golden Dragon if Fund generated >6% p.a. US$ returns; payable for the first time in Jan 2022 and annually thereafter	25% of returns over 6% p.a. US$ hard hurdle; payable for the first time in Jan 2022 and annually thereafter	20% of returns over 8% p.a. US$ hard hurdle; payable annually	25% of returns over 6% p.a. US$ hard hurdle; payable annually
High water mark	Yes	Yes	Yes	Yes	Yes
Investor level gates (max redemption per investor)	N/A	25% per quarter	25% per quarter	N/A	N/A
ISIN	KYG2030A1004	KYG2030A1186	KYG2030A1269	N/A	N/A
Sedol	BMM1R81	BFYZYW5	BD31D23	N/A	N/A