CEDERBERG CAPITAL

FAQs September 2019

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

In 2011, 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, independent-minded investors. We wanted to create a vehicle that would allow friends and family (and us!) to participate in this opportunity, utilising our extensive China investment experience. Today, China remains a fertile hunting ground for long-term investors.

2. Can you discuss the culture of your organisation?

Cederberg's mission is to run client money like we run our own. Our vision is to become a best-in-class investment manager by generating attractive long-term returns for all our clients in a transparent, ethical and sustainable way. With respects to culture, we seek to create a team environment that encourages diversity of opinions and continual learning, where excellent people are empowered to make a massive difference to our clients by being genuinely long-term focused. We don't have a company song (thankfully!), but if we did, it would include phrases such as process over outcomes, keep it simple, eyes on the horizon, what's best for clients will be best for us, go the extra mile, be an owner.

3. You define the strategy as following a 3M framework – what does that mean?

We look for three things in every investment:

- A **Moat** (i.e. an entry-barrier) that is likely to be durable beyond the next 3-4 years.
- A **Management** team that is excellent, honest and aligned with shareholders.
- A **Margin of safety**: we buy great companies when they offer >100% upside to intrinsic value.

4. Why do you take this approach to Chinese equities?

Chinese equities have a high proportion of "value traps": poorly-run companies on low valuations that tend to stay that way. As long-term investors, we believe we are better off focusing on the highest quality Chinese companies with the best long-term growth potential than to trade in and out of mediocre businesses.

5. What gives you a competitive advantage?

- We have a **unique perspective**: we do a lot of on-the-ground research in China, but the portfolio is managed from London; this often leads to variant perceptions and independent thinking.
- We are **highly aligned**: we have invested heavily alongside our clients (e.g. over 90% of the portfolio manager's net worth) and have grown our client base in a disciplined fashion.
- We have a **simple, repeatable** process: we identify, analyse and value great companies, then we patiently wait for an attractive price before we buy them.
- We have **great clients** who take a multi-year view of their investments, which enables us to make long-term investment and business decisions.

6. What is your investment process?

Our investment process is centred around our 3M framework and consists of five phases.

Firstly, we determine our investible universe. We've whittled the c.5,800 listed companies from Greater China with a market cap greater than $100mn down to 125 that meet two qualitative criteria: is the company's moat durable, and is its management excellent? This process helps us to focus on the 2% of companies with attractive long-term economics that we can reasonably predict ("the Cederberg Universe") while spending negligible time on the rest.

Secondly, we do deep-dive research on the Cederberg Universe, one company at a time. Desk-based research involves reading the company's financial reports stretching back many years, as well as any other information that can help us understand the business' moat, management and long-term drivers. Equally important is the fieldwork we do, which typically involves speaking with upwards of 20 primary sources of information such as former employees and customers. This approach has helped us to understand corporate culture and to avoid poorly-governed businesses.

Thirdly, we determine the company's intrinsic value based on its operating income, which we normalize over the next four years before assigning a target multiple of 10-18x, depending on the quality of the business (how wide is its moat, how good is its management) and its long-term growth potential.

Fourthly, we wait for the market to present us with a significant margin of safety. We want to buy these wonderful businesses when they offer 100%+ upside to intrinsic value, which doesn't happen very often. Hence, we frequently have to wait for months or even years before we get our chance.

Lastly, we sell out of a name when it no longer offers any margin of safety, its moat has narrowed, or when management has not met our expectations. Proceeds are recycled back into existing portfolio names or go towards establishing a new position.

7. How volatile are Chinese equities? What does this mean for potential investors?

Volatility is a defining feature of Chinese equities (over the past decade, A-shares 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 volatility, but instead to maximize long-term returns. Given our concentrated portfolio and the asset class' inherent volatility, our strategy is only suitable for investors who take a ten year or longer view on their investments.

8. How do you manage risk?

We define risk as permanently losing capital. Our main risk control tools are:

- Investing in companies with durable **moats** and excellent **management**: they are less likely to disappoint (or disappear) in the long run.
- Insisting on a large **margin of safety**: this should provide a degree of downside protection during protracted market declines.
- Diversification: by number of holdings, industries and market cap.

9. How do Greater Chinese equity markets differ from developed markets?

There are c. 5,800 listed companies from Greater China with a market cap greater than $100mn listed in Shanghai and Shenzhen (“A-shares”), Hong Kong (“H-shares”), Taipei, New York (“ADRs”) and elsewhere. The listed universe is dominated by state-owned entities (“SOEs”), which represent the bulk of the financials, telecoms, energy, materials and utilities sectors, i.e. roughly half of most Chinese indices. Most companies in these sectors don’t meet our quality criteria. 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, many of which are run by their founders.

10. How efficient are Chinese equities?

We believe Chinese equities are significantly less efficient than developed markets, and even less efficient than some emerging markets like South Africa and Brazil. These inefficiencies stem from a lack of decent equity research (c.70% of Hong Kong-listed companies have zero sell-side coverage), a lack of institutional investor participation (retail investors represent c.70% of A-share market daily turnover) and a general lack of patient capital (holding periods of 3-6 months). Exploiting these inefficiencies requires local knowledge and patient capital. That is why we conduct on-the-ground research and why we partner with long-term-oriented clients.

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

China has had its fair share of governance issues; however, primarily due to our mindset and process, we haven’t experienced any blow-ups due to fraud or governance concerns.

Firstly, we are naturally sceptical. Just because a company is covered by a large investment bank or a Big Four auditor, does not mean it isn’t a fraud. We assume a “guilty until proven innocent” mindset, seeking to verify critical facts and figures independently. If this isn’t possible, we move on.

Secondly, we do our own research. We typically spend several weeks analysing a single company, which entails both detailed financial statement analysis, as well as extensive on-the-ground duediligence meeting with upwards of 20 experts such as customers and former employees.

Thirdly, we focus on a company’s cash flow generation over many years, which is harder to manipulate than P&L or balance sheet items. Moreover, fraudulent companies tend to raise debt and equity frequently - the opposite of what we’re looking for in our holdings.

12. What are your return objectives for the strategy?

We aim to achieve low-teen USD net returns over rolling 10-year periods. This target would appear high, given equities as an asset class have returned 8-9% p.a. over the very long run. However, we believe it is a realistic objective for our strategy, given the structural inefficiencies in Chinese equities.

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

We are bottom-up investors; we don’t make active sector calls based on our views of the economic cycle. However, we have identified specific sectors as “well-stocked ponds” likely to contain more long-term winners and fewer long-term losers. We spend most of our time on particular 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. internet, consumer staples, education and healthcare.

14. Discuss portfolio management

Since great ideas are scarce, we manage relatively concentrated portfolios, typically owning 10-15 companies. We tend to let winners run, either up to intrinsic value or the maximum position size of 20%, before we sell them. We tend to sell positions when the investment thesis doesn't play out ("losers").

The team consists of a portfolio manager and four analysts, who are all generalists. Analysts present their research to the investment meetings, where the team discusses the company and agrees upon its valuation. Each analyst independently manages a 5-10 stock model portfolio, the performance of which is the key driver of their bonus. The portfolio manager picks ideas from the model portfolios and from other ideas that have been discussed by the team.

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

Given the strategy'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 currency hedging only for risk management purposes, that is if we believed that a currency was meaningfully overvalued vs the dollar, the strategy's reference 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.

16. What has been the portfolio's turnover? What would cause it to increase?

In recent years, the strategy's turnover has been 10-20% p.a. Trading activity has tended to be higher during periods of market volatility when more great companies trade at bargain prices.

17. Can you discuss past investment mistakes?

Our investment mistakes can broadly be separated into two categories: selling winners too early and holding losers for too long. While 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. Concerning holding on to losers, most of these occurred when we compromised on quality, i.e. buying mediocre businesses. The "Wall of Shame" in our London office has framed examples of past mistakes to ensure that we learn from them.

18. 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 enables us to do value-adding 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 significant challenge all investors face. Chinese markets can be volatile hence the need to have "ice in one's veins" to make rational, detached investment decisions; this is much easier to do when one is far away from the market chatter which is 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 tend to change employers 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 sustainably is an open question. The main issue having two offices in different time zones is ensuring excellent communication; as such, we have regular conference calls and team members spend a lot of time together in China, London and elsewhere.

19. How big is the team, and how do you see that changing?

The team consists of 10 people, of which half are in investments and the other half in investor relations, finance and operations. While we are likely to add one more analyst, we do not anticipate growing the team much beyond its current size.

20. What percentage of the business is owned by employees?

Employees currently own 73% of the company; this is expected to increase to 80% over the next few years.

21. Why are you closing to new investors?

Cederberg's objective is to generate attractive long-term returns for all our clients. We believe 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 becomes too large.

22. What lessons have you learned since founding Cederberg Capital?

- What's best for clients will ultimately be best for us.
- Focus on process, not on outcomes.
- Never invest with questionable or mediocre people.
- Always take a long-term view, no matter how foolish we might look in the short-term.

Cederberg Capital Limited

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