SOMERSET CAPITAL MANAGEMENT LLP

31 July 2021

MI Somerset Global Emerging Markets Screened Fund OEIC

Investment Adviser's Monthly Report

Edward Roberston
Founding Partner & Lead Manager

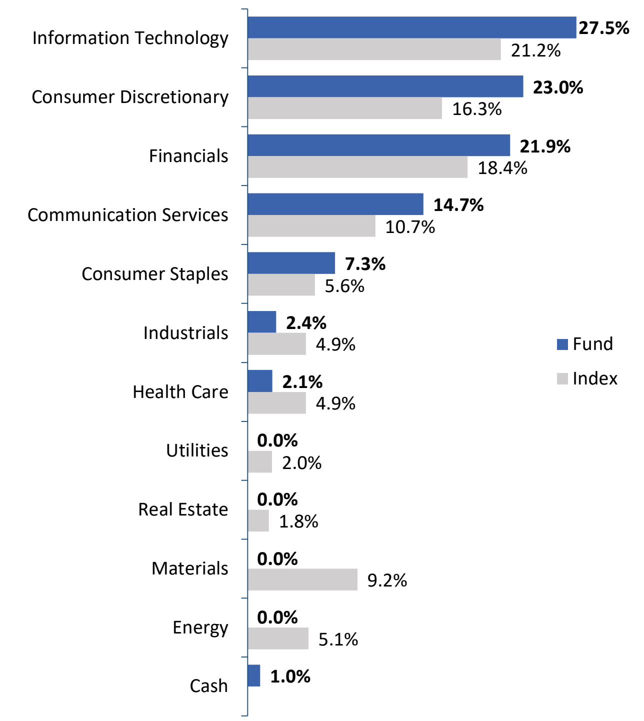
Fund Objectives

The Somerset Global EM Screened Fund seeks to achieve capital appreciation by investing in a concentrated portfolio of c.45 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. This fund will invest in Global Emerging Market securities with the exception of tobacco and gaming companies (as defined by GICS sector classification). Edward is supported by Somerset's team of fund managers and analysts based in London and Singapore.

Assets Under Management	
Somerset Capital Management LLP	$7,175 m
Global Emerging Markets Strategy	$5,026 m
Global Emerging Markets Screened Fund OEIC	£53 m

Model Portfolio Data	Portfolio
P/E (Historical)	28.8x
Dividend Yield (%)	1.3%
Wgt Ave Mkt Cap ($m)	137,816
No. of Stocks	38
Price (Accumulation)	112.12
Price (Income)	119.41

Sector Breakdown

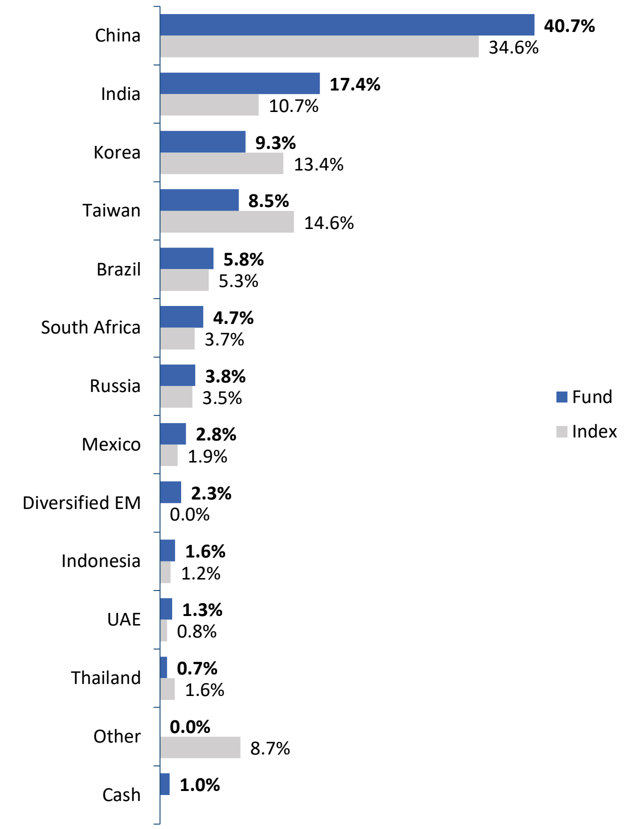


Inc GBP Performance Net (%)	Fund	Index⁺	+/-
1 Month	-8.75%	-7.33%	**-1.42%**
3 Months	-6.00%	-4.80%	**-1.20%**
YTD	-7.43%	-1.47%	**-5.96%**
Since Inception*	22.46%	35.12%	**-12.66%**
2020	13.21%	14.65%	**-1.44%**
2019	17.46%	13.86%	**+3.60%**
2018	-11.63%	-9.27%	**-2.36%**
2017*	12.57%	15.78%	**-3.21%**

Top 10 Holdings	Country	NAV %
Samsung Electronics Co.	Korea	6.3%
Taiwan Semiconductor Manufacturing Company	Taiwan	6.1%
ICICI Bank LTD	India	5.6%
Tencent Holdings Ltd	China	5.2%
Infosys LTD	India	5.1%
Alibaba Group Holding Ltd	China	4.3%
AIA Group LTD	China	4.2%
Yandex Nv-A	Russia	3.8%
China Mengniu Dairy Co	China	3.5%
Midea Group Co-A	China	3.4%

Model Portfolio Market Cap Breakdown	Fund
< $10bn	12.0%
$10-$20bn	13.3%
$20-$50bn	14.5%
> $50bn	53.1%

Country Breakdown



* Source: Maitland Institutional Services Limited & MSCI. The Fund inception date is 20th February 2017. 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.

Our view is that recent events in China don't herald an era of private sector profit destruction as the stock market reaction implies. Rather we believe the government has badly mishandled the communication of updates on long-standing policy stances on labour protection, anti-monopoly behaviour and data privacy concerns. The subsequent and hastily arranged clarification meetings and well-placed press articles constitute an admission of sorts that the communication was bungled, but the policy aims themselves are consistent and the direction of travel clear.

We believe there are fundamental differences between the recent regulations implemented in the education sector and the anti-trust regulations currently affecting technology platforms. Anti-trust regulations are aiming to level the playing field and ensure larger platforms continue to innovate, rather than directly looking to shrink the internet sector profit pool.

As a result, as long as internet platforms are willing to adapt and focus on providing better products and services to consumers (as opposed to rent-seeking), they can still thrive. Over the medium to long term, having clearer rules, as opposed to a constant regulatory overhang, is also positive for the sector's development and valuation.

For Tencent, Alibaba and Meituan, we acknowledge that these businesses face regulatory headwinds but believe that they are still fundamentally durable and profitable franchises. In Tencent's case, we see them facing slightly lower regulatory risk than Alibaba, and we are confident with management's capability and track record to handle regulatory changes. For instance, Tencent faced a gaming approval moratorium in 2018 in China but managed to navigate through it successfully. For Alibaba, we believe corporate governance has improved post Jack Ma's retirement and the company seemed to learn its lesson after the Ant Financial debacle. For Meituan, we are confident that the higher costs resulting from the recently published guidelines around labour protection will be manageable for the company. Furthermore, government guidelines emphasised the importance of platform companies to the wider economy - a positive indication that regulations are aiming to ensure the long-term success of the industry rather than reducing profits. Finally, we believe valuations remain attractive given the long-term business outlook for these companies.

Overall, we believe that our holdings in China are well placed to succeed given the current regulatory environment. We continue to hold and have been adding selectively in this period of market weakness.

Regulatory risk has always been an integral part of our stock analysis. The speed and extent of the impact on share prices and profitability of the education sector illustrates that thorough due diligence and an active, long-term approach is essential in China.

Recent regulatory updates

The catalyst for the meltdown was the publication of updated draft policy proposals on several long-standing policy aims (technology self-sufficiency, common prosperity i.e. reducing living cost burdens, data protection and privacy, and carbon neutrality), as well as new sector specific implications for education, property, fintech and gig economy workers such as delivery drivers.

The most eye-catching phrases were directed at the online education space, a popular sector with investors looking to capitalise on proud Chinese parents doing all they can (at great time and cost) to improve their progeny's future prospects. Here the draft proposals indicated an intention to morph key service provisions of the listed companies into "not for profit" activities, a term that wiped tens of billions of USD value off the market capitalisation of US listed Chinese education stocks. These measures, on the back of Didi's very public chastisement by the authorities and high-profile fines against Tencent and BABA (relating to abusing their dominant market positions), have sent many in the market into a tailspin.

Restricting the use of VIEs and offshore listings were highlighted in the draft documents specifically relating to companies housing sensitive data (such as educational details of children) and also have particular relevance to the recent listing of ride hailing app Didi Chuxing, a now US listed Chinese company that uses a VIE and that holds geolocation data of hundreds of millions of Chinese residents. The company discovered its app had been removed from domestic app stores by government decree in the days following the listing. Leaving aside what this means for future litigation brought by Didi shareholders, what is clear is that the government are very sensitive to data privacy, the policy direction was well-flagged and non-compliance will not be tolerated by the ultimate Compliance Department.

This theme of poorly timed announcements of well-flagged policies can be applied to food delivery/community group buying super App Meituan Dianping (HK listed, VIE), which was also caught up in the sell-off. Taken in the abstract a set of policy guidelines to encourage social insurance participation by delivery workers, medical provision for injuries on the job and fair pay mechanisms are very sensible measures designed to promote long term sustainability of the industry and prevent worker mistreatment. Announced in the week the online education sector has been decimated and Didi has been brought to heel and suddenly the policy takes on a more sinister, interventionist air.

It would be inaccurate to label all the recent policy announcements as poorly communicated, but essentially well-designed objectives which do not have any long-term implications for our investment universe in China. We are working through the lingering consequences of the recent policy updates and what they mean for all of our portfolio holdings, new research ideas and Chinese equities as a whole. The online gaming sector was previously warned in a high-profile regulatory review in 2018, and any company that has not tightened up its practices of monitoring game usage by minors and inappropriate content will be under scrutiny. This week Tencent and Netease announced some more steps they would introduce to limit game usage by children and police game content, but in both instances the changes are very minor and have almost no impact on earnings, reflecting the work both companies have done in the past. Profit pools arising from purely rent seeking market dominators squeezing workers and those upstream and downstream are at risk; branded companies in contestable markets that create profitability through innovation less so. There will be an element of strong companies now moderating their intentions on pricing and growth, and this will inevitably have an impact on future earnings power, the question is to what degree and what has been priced in by the falls of this week.

What is the impact on VIE structures?

It is worth highlighting that we don't think this is an attack on VIEs as a structure, rather a number of companies under the spotlight of the regulator happen to have VIE structures, and PRC authorities would prefer those companies dealing with sensitive data to list onshore, not in the US (Didi) because of greater regulatory demands from the SEC.

Essentially, there are good and bad VIEs as characterised by:

- Their beneficial ownership structure
- If they are used to house assets, or simply the licence to operate
- Proof of cash moving out of the VIE into the WFOE and onto minority shareholders by way of actual cash distributions
- The recognition of future tax obligations

When we look at a stock and there is a VIE in place, we assess stock risk through this framework.

How do we view regulatory risk in China?

In order to understand recent policy changes it is important to consider the broader aims of the government. The Chinese Communist Party has a number of core social and economic objectives, which include:

- To promote innovation & self-sufficiency in technology
- To promote common prosperity
- Data privacy & security
- Environmental protection and green energy

As discussed above, the goal of "common prosperity" – bearing down on the cost of living and the perceived drivers of inequality – motivated recent changes in the education sector.

Other areas of the market which may be affected by conflicts with government objectives are:

- Companies with high market share (>50%) and margins that are using their dominance to extract excessive profits from customers or from suppliers that are struggling to turn a profit
- Sectors most closely related to the cost of living: property development, education and healthcare most notably
- Sectors handling large amounts of data on private Chinese citizens
- Chinese companies with US listings but no Chinese listing given geopolitical tensions with the US

However, we do not believe that the Chinese government is about to engage in a generalised campaign against the private sector. We expect companies that are aligned with policy objectives (or are simply below the radar) to be relatively well protected from regulatory action. Potentially attractive areas include:

- Local IP leaders that are helping to increase Chinese self-sufficiency or support continued national industrialisation efforts
- Consumer companies catering to consumer demand, especially rural / semi-rural consumers and the middle class
- Companies helping to promote environmental sustainability or green energy

Investing in areas of policy support such as those listed above can provide a modicum of comfort but the bottom up case has to be intact; we are wary of swapping regulatory risk for SOE risk or valuation risk.

The bear argument goes that discount rates have risen to reflect higher regulatory worries and China Inc as a whole should carry a lower valuation. Looking at asset prices today, that is an accurate description. However, we don't think the events of the past few days reflect a new-found regulatory zeal or constitute new information and now means there is a long-term "China Discount". Any long-time investor in the Chinese market can tell you that the authorities have always been there in the background, perhaps not as visible as they have been in recent weeks but nonetheless a constant presence, and there is a long list of policy interventions in areas such as property, banking (shadow and formal), online gaming and gas distribution to name but a few. A key part of investing in China is understanding the extent to which the Party can undermine the business model of the company in question, some companies are more exposed than others, sometimes the Party gets more involved (education).

New information that would change our mind on the "China Discount" argument include widespread price controls or profitability guidance put in place across the private sector particularly the consumer space, or China deciding it wants to decouple itself from global financial markets, banning overseas listings or reversing the trend of opening up to foreign investors.

Edward Robertson, Lead Manager

Fees
0.75% AMC

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