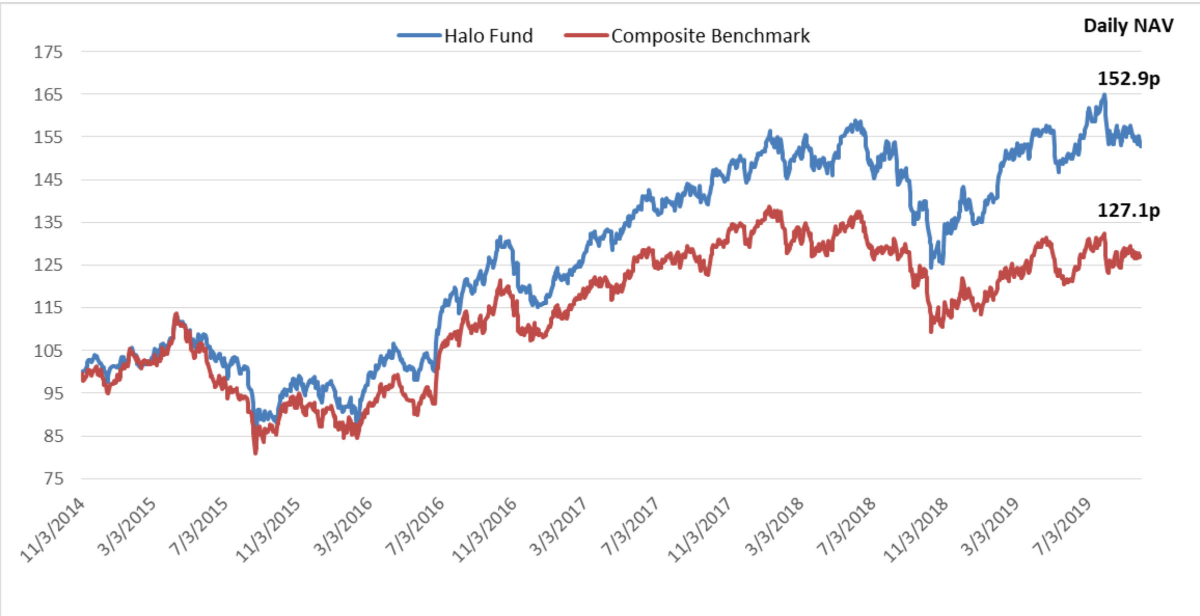
# VT HALO Global Asian Consumer Fund

## September 2019 Quarterly Letter

The third quarter of 2019 started well with markets climbing through July aided by initial hopes of US-China trade talks and looser US Federal Reserve policy. But with President Trump announcing a further escalation in the trade war at the beginning of August, markets duly sold off. This has also not been helped by the global concerns of the increased likelihood of a recession in economies such as Germany and the US, as manufacturing PMI numbers have taken a turn for the worse in the last couple of months. Asia has been cutting interest rates as the countries operate text book monetary policy with interest rates above current inflation rates. But with concerns over a slowing global economy the fall in the cost of funding for Asia has not been able to offset investor pessimism and markets declined from July levels in August and September. We have seen very little downgrades to GDP numbers in the emerging Asian economies, bar India and Thailand, who have been impacted by non banking credit squeeze in India and slowing exports and tourism in Thailand. The Fund has fallen 2.4% over the last 3 months, which is slightly worse than the composite index, but the longer performance is still respectable with an annualised return of 9.3% since our launch.

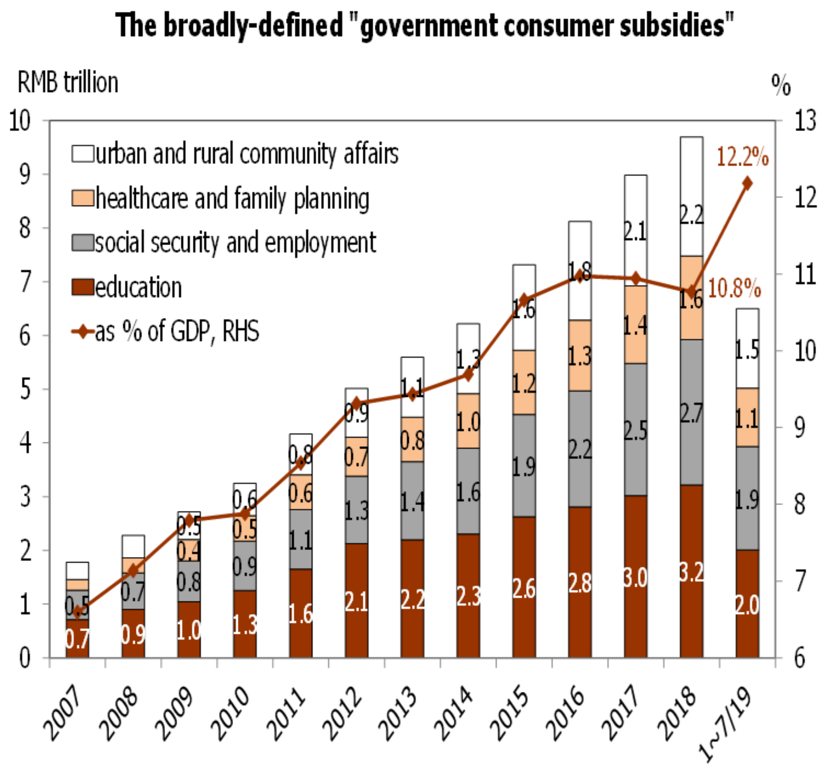
Given the slowing US economy we may see President Trump baulk again at imposing the tariffs proposed in October and December of this year; he knows it hurts his electorate, as the tariffs are on consumer goods and they are products which will be hard to source outside China. If this is the case then we may see a bounce in China and other Asian markets as a result, but as we have all learnt we cannot predict anything with certainty when it comes to President Trump and his actions.




*Performance data shown is of the B £ Net Acc. share class. Custom Benchmark, 30% MSCI AC Asia ex Jap Consumer Staples, 30% MSCI AC Asia ex Jap Consumer Discretionary, 10% MSCI Communication Services and 30% MSCI AC Asia ex Japan Index. From 01/12/18 Custom Benchmark reduced Consumer Discretionary to 30% and added 10% Communication Services, due to reclassification by MSCI. Past performance is not a guarantee of future returns. Data from Valu-Trac Administration Services and Reuters. This is for illustrative purposes only and in accordance with our Prospectus Halo does not benchmark against any index* in accordance with our Information Memorandum and Prospectus.

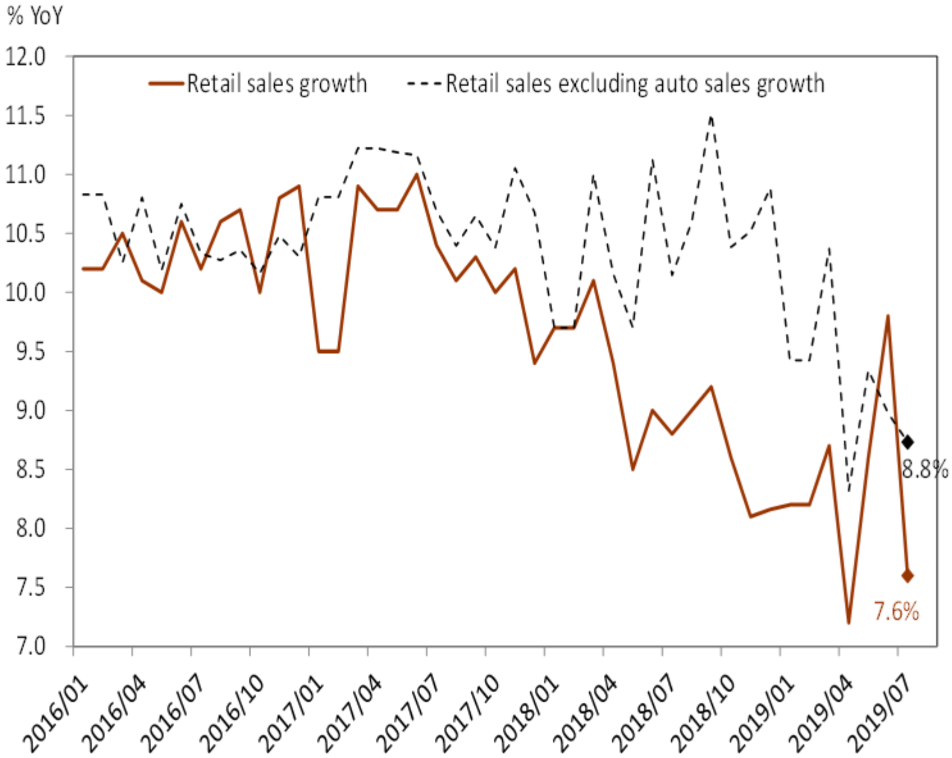
In the meantime Chinese GDP continues to grow at just above 6% in line with January's forecast. A question we have been receiving on a fairly regular basis is: given the headlines re the trade war and the evidence of a slowdown in manufacturing in China, why has the consumer remained so resilient? There are a number of factors, which are driven by the central government's focus on moving China to a consumption driven economy. We have mentioned in the past that consumers this year have received significant tax cuts, with the raising of the minimum tax threshold for monthly earnings from Rmb 3500 to Rmb 5000, and adding categories for tax relief against income tax, such as education and elderly care. In total the MOF estimates that this will add a further Rmb 600bn to consumers or 0.7% of GDP. VAT rates of 16% and 10% were cut to 13% and 9% respectively, which has also helped. This benefit will be shared between households and the corporate sector. Take home pay could rise by 4-8% depending in which tax threshold you are in and with wage growth on top, this provides a strong background for consumption growth.

As well as reducing the payroll taxes, which certainly make the headlines, there have been other reforms, whilst less headline grabbing, but just as dramatic and effective. It is these that have also encouraged consumers to open their wallets. Chinese have a reputation of having a high savings rate and the government has strived to draw on this and encourage further consumption. The millennials in China are certainly needing no encouragement and are happy to borrow money in order to spend today, just like consumers in the West. Those of an older generation may be less so. The diagram below illustrates the fiscal transfers from the government to the population is rising rapidly, especially in areas such as education, social security and healthcare. As the social safety net expands, this means the population need to save less of their income for retirement and unexpected events. So reducing the savings rate and diverting it to discretionary expenditure will help drive the expansion of the internal market, which is what 70% of China's manufacturing base is geared towards. This will all help mitigate any impact from the tariff wars.



One further point on retail sales in China. The headline retail sales includes car sales, which are volatile as over the last few years they have been subject at certain points in time to stimulus measures, pulling forward demand, resulting in an apparent slump the following year. This has occurred in the last 12 months. Below is a chart showing retail sales growth including autos, the brown line and then retail sales ex autos, the grey dash line. As you can see retail sales growth ex autos has remained at 10% or more until March this year and is currently still close to 9%. This rate is substantially better than anything else in the West and needs to be put into perspective when commentators and investors are bearish on China.

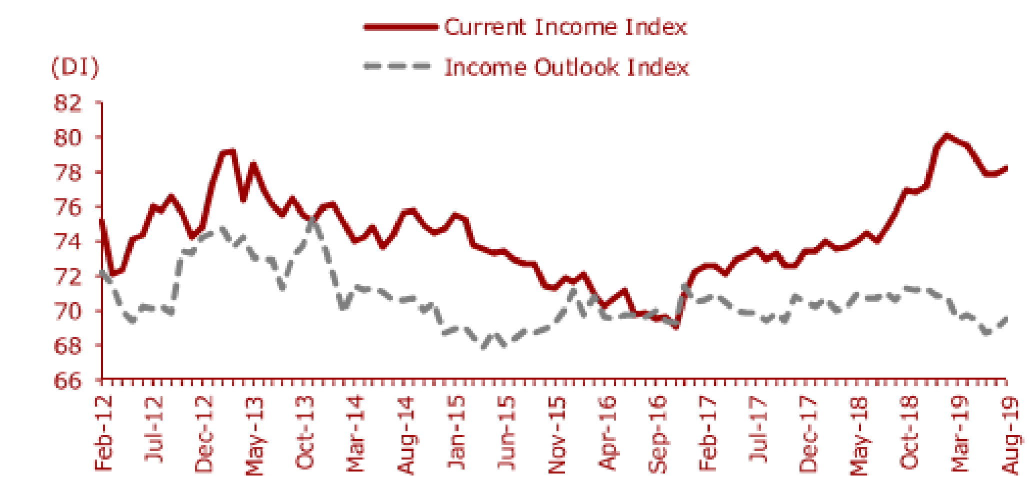
## Excluding auto sales, the underlying trend of retail sales growth YTD has been relatively stable



Below are a couple of charts from CLSA's China Reality Research, which illustrate the point that current income has improved, as has the Spending Power Index. The current income is close to an all-time high, with most respondents saying their income is higher today. The outlook for income has ticked up a bit recently remaining close to 70, which is tracking at a similar level to the last 4 years and is remarkably stable. We view this as a very positive sign when you consider all the headlines we read in the West about China and its economy. Likewise, the Spending Power Index is close to its high and the outlook is also within the long run average over the last 7 years. Neither point to a dramatic slowdown in the consumption outlook.

Figure 1

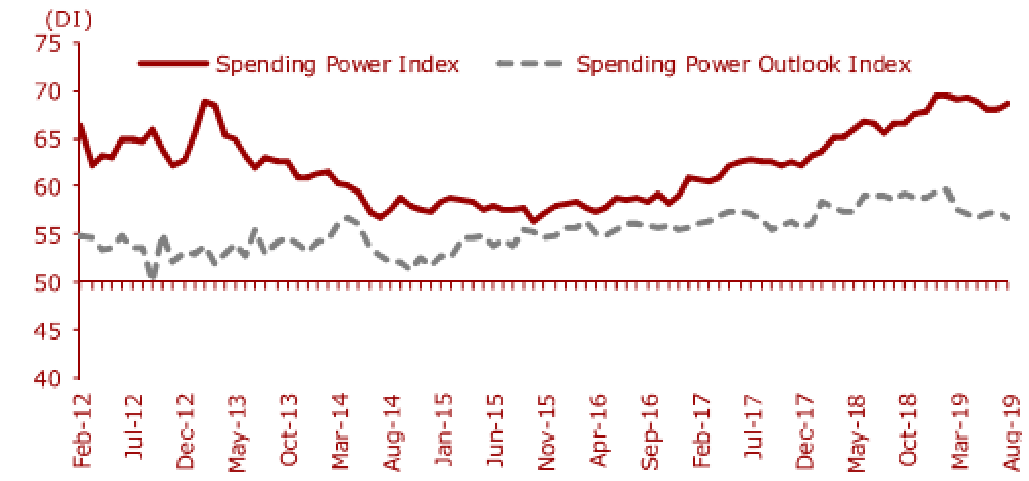
**CRR Middle Class Income Indices**




Note: The CRR Middle-Class Income Indices are composed of a current income index and an income 6M outlook index. The former is the sum of the responses that feel their income is "higher" plus half of the responses that feel it is the "same" as a year ago; the latter is the sum of the responses that expect their income to "rise" in the next six months plus half of the responses that expect it to be "same" as currently. An index reading above 50 indicates an overall increase in their income and income expectations. Source: CRR

Figure 2

**CRR Consumer Spending Power Indices**




Note: The CRR Consumer Spending Power Index and Outlook Index are diffusion indices created by counting the sum of the responses that feel or expect their spending power is/will be "stronger" compared with a year ago/in the next six months plus half of the responses that feel or expect it to be the "same". A reading above 50 indicates an overall improvement in the panel's assessment. Source: CRR

## Alibaba

Given these upbeat China consumption indicators I wanted to comment on the Fund's largest holding Alibaba, which is regarded by US investors as the best way to reflect their optimism or indeed pessimism on the Chinese economy and consumption.

I believe the market inherently undervalues Alibaba, especially when you break it down into its components. Take for instance its core business, the online market place of Taobao and Tmall. This business is growing at 25% and is expected to continue to grow at or above 20% for 2020 and 2021. This growth is driven by underlying retail sales growth in China growing in the 6-8% pa range and the rising penetration of online sales as a percentage of total retail sales. This division has EBITA margins of 66% and one has to ask what is the right PE multiple for this business. So a core EBITA of Rmb 200bn, for March 2020 and a conservative estimate of Rmb240bn for March 2021, assuming tax at 25%, and a USD/Rmb rate of 7.2, results in profits of $20.83bn and $25bn for March 20 and 21 respectively. What would investors be prepared to pay for a company that is growing its revenue and profits at 20% for the next 3 years? If you compared it to quality companies in the West such as a Unilever, Diageo, Nestle or even Estee Lauder that we own, the multiples are over 20x 12 months out or in some cases closer to 30x. Admittedly Alibaba is not considered a "bond proxy" and its cost of capital is higher as is the risk free rate. So perhaps 20x PE for a company growing 20% is fairer than Western staples companies growing their revenue at 3-5% and producing total returns of 10% trading at over 20x. Google might be a more appropriate comparison, which the market expects to produce revenue growth of 16-17% in 2020 and stripping out its cash holdings and adjusting for share options, the Non GAAP PE is only 16x December 2020. Part of the reason for Google's relatively low valuation compared to other US companies growing at a similar rate is the regulatory risk, with investigations potentially pending from the Department of Justice over its monopolistic practices. If we are generous and are willing to pay a PE of 20x for Alibaba 12 months out, given its faster profit and revenue growth, with little regulatory risk, then the value of its core business is $458bn. This equates to a share price of $173, which is $6 above the current market price. Effectively then all its other businesses are in for free.

What are the other businesses and how much are they worth? Firstly there is the investment in Ant Financial, the e-payments and wealth management business. The last funding round back in May 2018 valued it at $150bn. Being conservative, we assume the value today is unchanged, even though the number of transactions and customers has increased significantly since then. Alibaba owns a third of it and is thus worth $50bn. Other major investments are its cloud business, the largest in China by a significant margin and currently growing at about 80% a year. Admittedly it is still loss making as they choose to keep prices for its products low to drive further penetration in this space. So it has to be valued at a price to sales ratio and we use 6x 2020 sales is an appropriate benchmark, which gives a valuation of $45bn.

It then has numerous other investments and for ease I am using CLSA estimates as shown below, which equate to a value of $82.4bn or $31.4 per share. They also have cash on the balance sheet of $40bn or $16 per share.

| Strategic investments | | | | | |
|---|---|---|---|---|---|
| Other new businesses and investees | Valuation method | Equity value (US$bn) | Ali's holding (%) | Ali's share of value (US$bn) | Per Alibaba share (US$) |
| **New businesses** | | | | | |
| UCWeb | Capital invested in Jul 14 | 2.3 | 100 | 2.3 | 0.9 |
| Autonavi | Privatisation value in Jul-14 | 1.4 | 100 | 1.4 | 0.5 |
| Youku Tudou | Privatisation value in Oct 15 | 4.5 | 100 | 4.5 | 1.7 |
| Intime | Privatization offer in Jan 17 | 3.5 | 74.0 | 2.6 | 1.0 |
| Cainiao Network | Stake increase in 2017 | 20.0 | 51.0 | 10.2 | 3.9 |
| Eleme | Acquisition value in Apr 18 | 9.5 | 100.0 | 9.5 | 3.6 |
| Lazada | Stake increase in 2018 | 25.0 | 91.0 | 22.8 | 8.7 |
| **Key equity investees** | | | | | |
| Koubei | Last financing in Jan-17 | 8.0 | 38.0 | 3.0 | 1.2 |
| Didi Chuxing | Last financing in Apr-17 | 56.0 | 5.0 | 2.8 | 1.1 |
| Alibaba Pictures (1060 HK) | Market cap | 5.8 | 49.5 | 2.9 | 1.1 |
| Alibaba Health (241 HK) | Market cap | 14.0 | 56.0 | 7.8 | 3.0 |
| Weibo (WB US) | Market cap | 15.4 | 30.4 | 4.7 | 1.8 |
| Suning Commerce (002024 CH) | Market cap | 17.5 | 19.9 | 3.5 | 1.3 |
| Baozun (BZUN US) | Market cap | 2.8 | 15.6 | 0.4 | 0.2 |
| Sun Art (6808 HK) | Market cap | 8.5 | 31.0 | 2.6 | 1.0 |
| Focus Media (002027 CH) | Market cap | 13.3 | 10.0 | 1.3 | 0.5 |
| **Valuation of other new businesses/investees** | | | | **82.4** | **31.4** |

Source: CLSA

If we then add up all these other parts to their business the total value is $217bn or $84.

| Business division | Equity value $bn | Per Alibaba share $ |
|---|---|---|
| Ant Financial | 50 | 19 |
| Cloud | 45 | 18 |
| Other investments | 82 | 31 |
| Cash | 40 | 16 |
| **Total** | **217** | **84** |

One can then be conservative and apply a 20% conglomerate discount to these other divisions and the value to you as a shareholder is $67. Adding this to $174 for its core business equates to a market value per share of $241. We expect profit growth to continue in the region of 25% per annum for another 3 years. Profits are likely to grow faster than revenue growth over this time period as losses narrow in their cloud, international and new businesses. So there is 40% upside to the current market valuation over the next 12months. This is why Alibaba is the number one holding for us.

**Conclusion**

We are still believers that consumption growth is a long-term trend, whether it be in China or elsewhere in emerging Asia. We continue to take a top down approach as to which countries look attractive over the next 3-5 years and then look for the appropriate companies to invest in to play the industries that are experiencing the strong growth. We do not believe the medium to long term outlook has changed, irrespective of what might be happening in Western developed economies as the day to day decisions of these consumers are based on domestic issues, wage growth and prospects of their own economic outlook.

The 12 month forward earnings growth for the Fund remains above 20% compared to 11% for the MSCI Asia ex Japan index. The forward PE multiple of the Fund today of 14.3x remains below its long run average since launch of 15.5x and so to us remains good value, with the PEG ratio at an all time low at 0.7x.