COOPER INVESTORS ASIAN EQUITIES FUND

# QUARTERLY COMMENTARY REPORT

Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

For current performance information please refer to the Monthly Performance Report.

## DECEMBER 2019

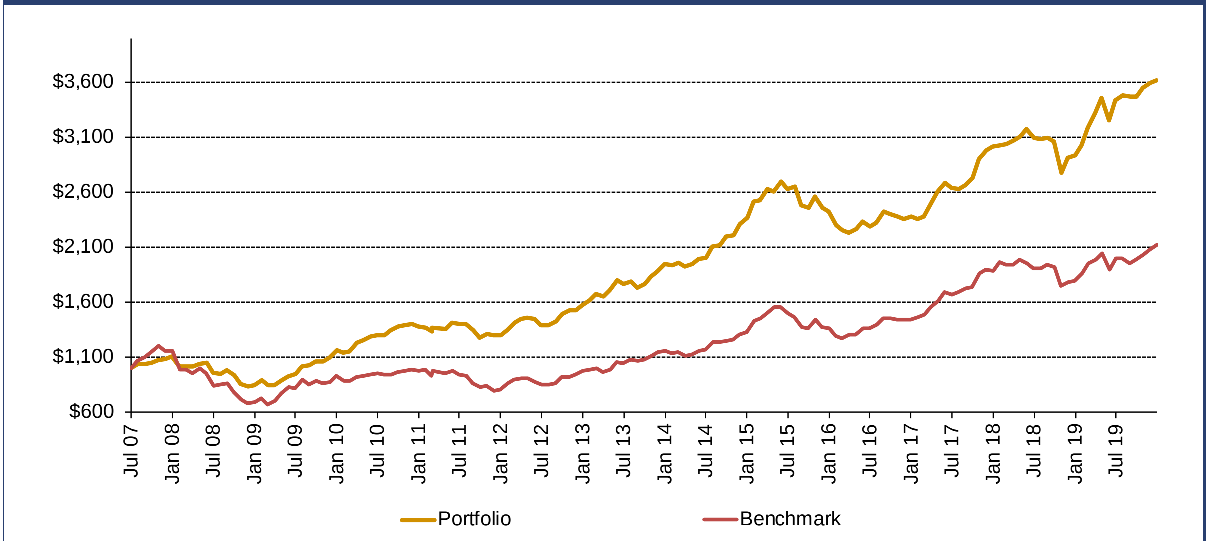
***"Take the stones people throw at you, and use them to build a monument." – Ratan Tata, Founder of the Tata Group***

***"Being outside China helps me think about China. There is a saying in China that you don't know the true colour of a mountain if you are standing on it." – Ji Qi, Founder of China Lodging***

| | **PORTFOLIO | #BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 4.53% | 7.25% | -2.72% |
| ROLLING 1 YEAR | 24.37% | 18.35% | 6.03% |
| ROLLING 2 YEAR | 10.80% | 6.11% | 4.69% |
| ROLLING 3 YEAR | 16.34% | 13.90% | 2.44% |
| ROLLING 5 YEAR | 10.21% | 9.84% | 0.37% |
| ROLLING 7 YEAR | 14.18% | 11.86% | 2.32% |
| ROLLING 10 YEAR | 13.90% | 8.67% | 5.23% |
| SINCE INCEPTION* | 12.53% | 6.21% | 6.32% |
| SINCE INCEPTION^ | 337.65% | 112.45% | 225.20% |

*Annualised
^Cumulative (2 July 2007)
**Before fees and expenses
# MSCI AC Asia ex Japan Net Divs in AUD

**$1000 Invested Since Portfolio Inception (Net of Fees)**



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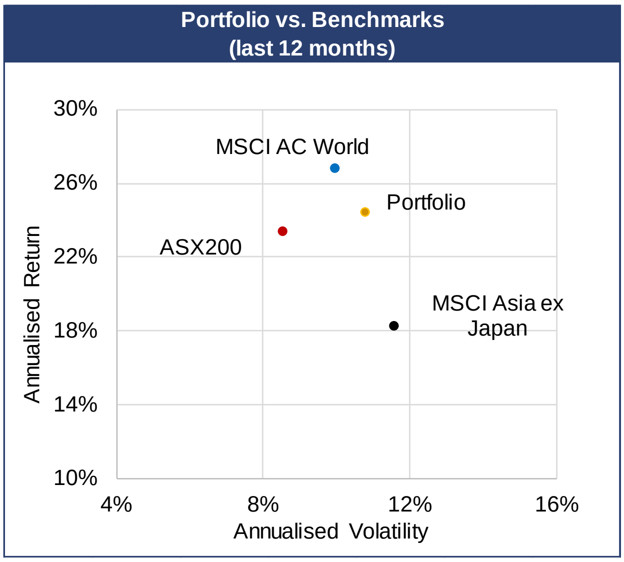
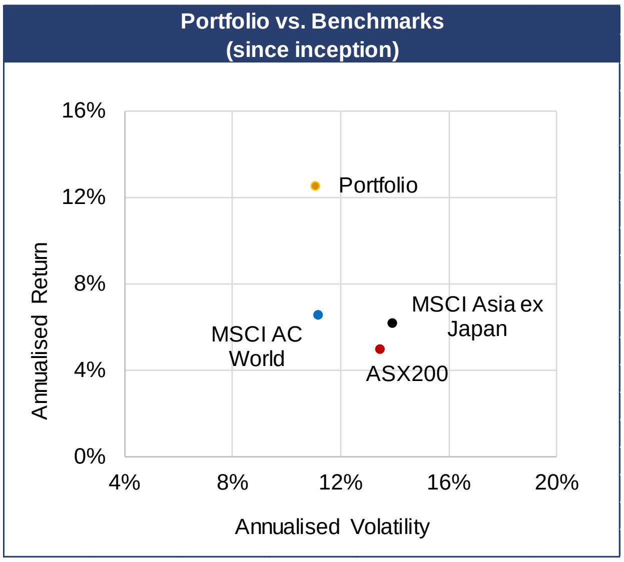
### Market and Portfolio Performance

The last calendar quarter of 2019 saw the global markets rise strongly. The portfolio gained 4.53% whilst our benchmark (the MSCI Asia ex Japan index) gained 7.25%. Roughly half of the underperformance was attributed to individual stocks, and the rest was due to the rebound of cyclical companies which the portfolio has relatively low exposure to, together with the drag from our cash holding. We conducted detailed research into the stock specific reasons and have shared some of the insights in this letter, and believe the rest was a natural short term outcome of a conservatively positioned portfolio.

On an annual basis, the portfolio performed well. For the calendar year ended on December 31st 2019, the portfolio gained 24.37% whilst the benchmark rose by 18.35%. The outperformance was driven by stock selection. We were pleased to see the portfolio held up in a strong market and maintained the characteristic of outperformance in the down markets. For instance, it recorded a smaller loss of 1.31% over the calendar year of 2018 when the index fell 4.87%.




Looking forward to 2020 and beyond, we are excited about our portfolio. In a year filled with geopolitical and macro-economic uncertainties, our forty portfolio stock management teams kept their heads down, rolled up their sleeves and grew earnings and free cash flows by over 15% year over year[1]. Many of them also put their strong balance sheet to good use and invested counter-cyclically, creating even more value latencies for the years to come. 2018 and 2019 proved to us the value in investing alongside management who think and act like owners. We look forward to finding more of these proprietorial management teams and putting capital behind them.

Our China and Hong Kong portfolio holdings detracted 190bps from the December quarter but contributed positively 460bps to full year 2019 performance.

[1] Full year 2019 figures, calculated using reported first 9 months results and Cooper Investors' estimate for the Dec quarter

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Two internet stocks detracted from performance in the short term. Huya, the leading eSports broadcasting platform in China, saw its share price decline precipitously despite posting better-than-expected September results. Investors are concerned about heightened competition from other larger short video platforms. These concerns called into question Huya's prospects in attracting new users and expanding operating margins. We do not share these concerns. We believe a focused game broadcasting company like Huya offers the most seamless and interactive viewing experience for the eSports fans, which in return attracts the most skilful and talented broadcasters. As the industry matures, we expect it to evolve into a classic platform structure where the winner (in this case Huya) takes the lion share of viewership and revenues. Huya is profitable and generating cash. It is trading at less than 30x free cash flows even though the business is still in hyper growth phase.

Autohome also posted weak performance. The cyclical downturn in the automobile industry in China continued. New car sales were likely to record a bigger decline in 2019 than in 2018. We are not overly concerned about the near term headwinds, and believe the Company's new data products could sustain double digit free cash flow growth for the next few years. However, its CEO, Mr. Lu Min, who is key to Autohome's new product development, was appointed the co-CEO of Ping An, Autohome's parent company, in November 2019. Whilst we believe this is a testament to Mr. Lu's talent and expertise, we do have concerns on the additional responsibilities he will assume that could distract his focus from Autohome.

In general, we find the internet industry a fertile ground for new ideas. Over the past decade, Chinese internet companies completed the first development phase, focusing on user acquisition, market share growth, and heavy technology investments. Revenue and profit growth were often staggering, but free cash flow generation lagged, as a result of these upfront investments. In the next decade, as overall internet user growth normalizes (mobile internet penetration is already at 70%), some investors worry about growth. We see this very differently. We think as the need for new user acquisition diminishes, some of these internet companies have the potential to become cash generation machines. Operational expertise and good cost discipline are likely to stand out in the future, and our portfolio companies such as Alibaba, Tencent, and Momo are best in class in these aspects.

Our Chinese consumer portfolio holdings contributed the highest share to outperformance. 2019 was a very good year for high quality consumer companies that excel in product innovation and cost controls. We expect the favourable operating trends in revenue and profit growth to continue in 2020 and beyond.

We are also getting more excited around the deepening technology expertise of various leading consumer companies. We believe they are building a significant long term moat in data and software that is under-appreciated by investors. Take YUM China for example, its software to map out efficient delivery routes as well as making personalized menu recommendations is industry leading. Using management's own words, 'we are an IT company that happens to be selling fried chicken and pizzas'. We observe the same trait in China Lodging for its advanced membership, auto check-in, and service tracking capabilities. It is not an exaggeration to say that China Lodging is also an IT company that happens to be running hotels. We expect these technology-savvy consumer companies to continue contributing outperformance for our investors over the long term.

Our Indian portfolio holdings detracted 8bps from the December quarter but contributed positively 145bps to full year 2019 performance.

2019 was a challenging year for the Indian economy. GDP growth slowed throughout the year, dipping below 5% over the December quarter. The Indian government initiated various supportive policies including corporate tax cuts, approval of the Industrial Relations Code to improve on the ease of doing business, and announcement of infrastructure projects totalling over US$1 trillion. We look forward to seeing the positive impact of these policies in the next 6 to 18 months.

We also observed heightened religious conflicts in India over the past few months. A number of initiatives by Prime Minister Modi, such as amendment to the citizen laws and outlawing a Muslim divorce practice, were perceived negatively by the Muslim minorities in India, sparking widespread protests. We are actively monitoring the development on this front. As of now, we take the view that these protests are likely to be temporary. The present government was democratically elected in May 2019 with a clear majority and the next national election will not happen until 2024, ensuring government stability for the next four years.

Our portfolio companies in private banks such as HDFC and Kotak Bank continue to accelerate their market share gains despite the challenging macroeconomic backdrop. In the last three months of 2019, HDFC Bank grew loans by 20% and deposits by 25%, almost three times the pace of industry growth. The stringent underwriting standards, investments in digital, and progressive expansion into rural regions are all paying off, especially as their state-owned competitors are mired in a credit and trust crisis. We expect solid performance from private banks to continue into 2020.

For the Indian IT services sector, we observed some short term weakness in end demand from select industries, notably banking and other UK companies affected by Brexit. Over the long term, however, we remain confident that our portfolio companies, TCS and WNS, have invested ahead of the industry and will reap the benefits of deep domain knowledge that will eventually translate into higher market share.

We were also pleased to see positive contributions from smaller Asian regions for 2019. Korea and Southeast Asia contributed 141bps and 67bps, respectively.

For the last quarter, the biggest contributors to performance in terms of total shareholder return in AUD included:

- A2 Milk (better-than-expected profit guidance)
- Sun Art (positive operating trends, especially around its offline-to-online initiatives)
- Techtronic (relief from reduction in trade tension between the US and China)
- 58.com (positive earnings and improvement in cyclical sectors such as real estate)
- Taiwan Semiconductor Manufacturing Co. (strong earnings momentum from early 5G deployment)

The biggest detractors to performance in terms of total shareholder return in AUD included:

- Huya (concerns around competition)
- Autohome (continued downturn of the auto industry. Weaker than expected earnings)
- 3SBio (potential price reduction for one of its key drugs)
- Momo (concerns around slowing user growth)

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## Portfolio Review

| Portfolio by Industry Sectors | |
|---|---|
| Consumer | 27.5% |
| Financial | 26.3% |
| Communication Services | 15.8% |
| Information Technology | 14.6% |
| Real Estate | 3.6% |
| Industrials | 2.7% |
| Health Care | 3.2% |
| Utilities | 0.0% |
| CASH | 6.3% |

| Portfolio by Country | |
|---|---|
| China and Hong Kong | 54.1% |
| ASEAN | 14.4% |
| India | 11.9% |
| Korea and Taiwan | 9.7% |
| Japan & Other | 3.6% |
| CASH | 6.3% |

| Portfolio Attributes[2] | |
|---|---|
| Number of stocks | 39 |
| Number of stocks outside of benchmark | 7 |
| Beta | 1.0 |
| P/E (x) | 19.3 |
| FCF Yield (%) | 3.6 |
| Dividend Yields | 1.7 |
| Historical EPS Growth % | 17.6 |
| Forecast EPS Growth % | 14.5 |
| ROE % | 17.7 |
| Net Cash / Equity % | 18 |
| Tracking Error vs Benchmark | 3.5 |

The portfolio is positioned around five subsets of values as follows:

- **Stalwarts (45%)** - sturdy, strong and generally larger companies with world class privileged market and competitive positions. (HDFC Bank)
- **Growth (36%)** – growing companies with identifiable value propositions using traditional value metrics and run by focused, prudent and experienced management. (Tencent)
- **Cyclicals (6%)** - stocks showing upside leverage to the cycle with experienced and contrarian managers who can allocate capital prudently and with good balance sheets. (Huazhu)
- **Low Risk Turnarounds (7%)** - sound businesses with good management in place and good balance sheets. We especially like spin offs and government to private turnarounds. (Sun Art Retail)
- **Bond-Like Equities (2%)** - businesses with secure, low-volatile dividends that can be grown and recapture inflationary effects over time. (Link Real Estate Investment Trust)

[2] Source: UBS PAS

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We believe the management types that produce the most attractive investment opportunities in Asia are 1) Founder-led, where the original founder aligns his/her interest with investors and remains committed to leading the business to bigger successes; or 2) owner operator, where the strong and unique culture permeates the organization, and 'thinking like an owner' becomes second nature to the management team. Together these two management types account for nearly 60% of our portfolio.

| Portfolio by Management Type | |
|---|---|
| Founder Led | 32.5% |
| Owner Operator | 25.9% |
| Focussed Management | 35.3% |
| CASH | 6.3% |

**Recent Portfolio Changes**

The Fund initiated a position in **Yum China** ("YUMC") during the quarter. As the largest restaurant group in China, YUMC owns and operates the vast majority of its over 8,000 restaurants, ensuring strict quality control and consistent execution. YUMC was fully spun off from its former US parent, YUM! Brands, in November 2016. Other than a 3% royalty fee in exchange for exclusive rights for KFC and Pizza Huts in China, YUMC does not have business ties with YUM! Brands. It is free to make all business decisions independently, including appointing senior management, rolling out new stores, designing marketing campaigns and menus, and expanding into new brands.

Over the past 30 years, YUMC has become a distinctly Chinese business instead of a subsidiary of a multi-national company. It has developed an owner-operator culture that is highly agile and entrepreneurial. The best showcase is its rich, unique and fast evolving menu. Some of our personal favourites include congee for breakfast, spicy Sichuan-styled chicken, and even duck wraps. In 2018 alone, KFC China created 60 new menu items. Whilst KFC in other parts of the world has been unfortunately associated with an unhealthy diet, KFC in China has been promoting vegetable soup for years and even recently developed mushroom burgers.

Digital savviness is another major competitive advantage. KFC China is a leader in digital ordering and delivery. It has a sophisticated membership system with over 200mm members, contributing to half of total sales and generating valuable consumer and operational insights. It has an advanced proprietary delivery routing system, handling over 15% of total orders. As far as we know, it is the only fast food chain in the world that can deliver to customers' seats on high speed trains. The latencies around digital capabilities are very substantial - with over 50% of its orders come from digital channels, YUMC is already seeing initial success in AI menu recommendation and personalized menus.

We also see exciting additional value latencies including new KFC roll outs, improvement of Pizza Hut margins and development of new products such as automated dessert kiosks and coffee. In addition to these growth opportunities, a net cash balance sheet and strong cash flow profile means it can provide attractive and growing distributions (currently ~3% combined dividend and buyback).

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### Stock News

We are observing a clear pattern of successful domestic Chinese companies buying highly reputable foreign brands and accelerating their development in China. In our opinion, these acquisitions are win-win. The Chinese companies have deep understanding of the local markets, strong distribution capabilities, and a sophisticated IT system. But they cannot replicate the history, brand depth and reputation built over decades. The international brands, on the other hand, do not have the organizational capabilities or financial strength to invest in deep distribution networks in a vast market like China. We have written about Anta's acquisition of Amer Brands in the past, and now there are two further examples in Mengniu and China Lodging.

**Mengniu** announced the acquisition of Kirin's Australian business, under the name Lion Dairy and Drinks, for A$600mm. We believe this is another well thought-out acquisition with a clear path of generating returns and future growth. Mengniu will use Lion's procurement network and ultra-high-temperature processing capabilities to import Australian milk to China. The economic argument is clear - raw milk prices continued to rise in China while remained low in Australia. The pricing gap is over 30% by our estimate. Over the longer term, Mengniu will also be able to bring Lion's portfolio of high quality brands, including Yoplait and Big M Iced Coffee to China. It will also invest behind Lion's further penetration into Southeast Asia, with Indonesia being the first focus market. Mengniu's balance sheet remains net cash after the acquisition.

**China Lodging** acquired Deutsche Hospitality ("DH"), which operates 118 hotels in Europe, 60 of which are under their luxury flagship brand Steigenberger, for €700 mm. China Lodging has been highly successful at developing mid-scale and economy hotels in the past, but has had limited success in luxury hotels. Currently, luxury hotels in China remain dominated by foreign brands such as Marriott and Hyatt. This is a substantial value latency and potential future profit driver for China Lodging. The acquisition of Deutsche Hospitality will not only bring a reputable hotel brand to grow in China, but also provide valuable organizational know-how of running high service-level operations. China Lodging is confident that it can develop 100+ hotels under the DH brands in a reasonably short time frame. That's as many hotels as DH has in Germany after nearly a century of operations.

**AIA** appointed Mr. Lee Yuansiong to be the next CEO starting in June 2020. Mr. Lee was most recently one of the three co-CEOs in Ping An. Although Mr. Lee started his career with the Monetary Authority of Singapore and had meaningful experience in Southeast Asia, his main area of expertise is in China. We believe this is a clear sign to elevate the China business further within AIA. The Company will also convert the mainland business from a branch of its Hong Kong subsidiary to a standalone subsidiary. The change in status has positive implications for capital, regulatory oversight, investment, and a faster pace in geographical expansion within the mainland.

### Trip and Meeting Notes

We travelled to Chennai, India, to meet the CEO and key executive team at **City Union Bank**. We also visited a few branches in Mumbai & Chennai. We were impressed by the consistent execution across regions for both underwriting and sales. The bank is particularly strong in building business relationships with small-and-medium businesses. However, we also observed weak operating trends for some of the bank's business clients over the near term. Some of these clients have not taken up the full loan allotment or are extending working capital days. We have also noticed a step-up in competition from larger private banks such as HDFC and Kotak. We will continue monitoring this closely.

We spoke to the management of **Asian Paints**. It has maintained a market share of over 50% in household paints over the last four decades. Asian Paints is continuously innovating within a mundane product category like paints. It has a relentless focus on customer service, and stays very close to both its distributors and end customers. This creates a continuous feedback loop for innovation. Their distribution capability is also unparalleled in the industry, covering 65% of India's tradesmen. It delivers to the distributors as frequently as 4 times a day, keeping lean inventory levels. Additional value latencies include the décor segment of kitchen and bath fittings.

We hosted the Chairman & MD of **HDFC Ltd** in our Melbourne office. Long term industry positioning remains favourable, with multiple supportive government initiatives including tax breaks and direct subsidies for first time home buyers. We also continue to be impressed by HDFC Group's credit culture, and its consistency in execution, especially in rural and semi-urban areas.

We had our first meeting with **Astral Poly Technik**. It's a market leader in pipes for residential plumbing and drainage in India. Similar to Asian Paints, Astral created a strong consumer franchise within a mundane product category. It has been aggressively building distribution network with 900 distributors and 30,000 dealers. Demand for building materials continue to remain healthy across new projects & renovation.

We visited Cambodia and Vietnam, where we toured **Shenzhou** International's apparel and garment factories. We were impressed with both the scale and sophistication of Shenzhou's manufacturing footprint as well as the group's culture of being a long-term sustainable business partner to its key clients. Shenzhou has implemented multiple initiatives around environmental and social issues that is key to being an attractive partner for its employees, local governments, and its clients. Shenzhou's factories are mostly air-conditioned, workers are paid above average wages and have access to multiple benefits such as a free medical checks. Shenzhou has also invested in state of the art machinery that are more efficient in terms of water and energy usage. Several members of Shenzhou's management team were present and in addition to being excellent operators, we found them to be humble and extremely passionate about finding ways to improve their business.

We spoke with **Link REIT's** CFO. Link REIT's operations have held up despite the ongoing anti-government protests in Hong Kong. Link REIT's portfolio consists of mostly suburban shopping malls in Hong Kong with an higher mix of daily necessities such as food and beverage, and groceries. This has helped Link REIT's tenants achieve 1.4% sales growth over April to September compared to a 9.8% decline for Hong Kong overall. Link also announced that it has agreed to acquire an office asset in Sydney's CBD. The acquisition will be earnings accretive, offering Link a long duration income stream, with 4% annual rental escalations and no near-term lease expiries. This marks Link's first foray outside of Hong Kong and Mainland China and Link is now saying that up to 10% of its portfolio could be located outside of Hong Kong and Mainland China by 2025.

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