TRIP REPORT
MEXICO, APRIL 2018

LATIN AMERICA FUND

In the last few weeks, we toured 3 major Mexican cities: Mexico City, Monterrey and Guadalajara, to meet with 17 companies and measure the pulse of the economy before this weekend's presidential election. This trip was taken with an open mind; aiming to stress test our investment thesis for the country, which has been among the lowest allocation in our portfolios since Q4 2016.

As of the end of Q1 2018, the Alquity Latin America fund had its lowest allocation to Mexican equities since launch. We turned negative on Mexico at the end of 2016 as the Mexican economic cycle grew increasingly mature, becoming concerned about Trump's impact on business and consumer confidence, which could weigh on retail sales and private investment. The MXN depreciation also meant that the central bank would have to increase interest rates to defend the currency and fight inflation. All these factors would translate into lower top line growth, negative operating leverage for some companies and a higher cost of capital. As such, we struggled to find companies that were well positioned from a macro perspective. In addition, those high-quality companies with sustainable competitive advantage, were too highly priced based on our numbers. As a result, we maintained holdings only in some mid-cap names that benefit from more idiosyncratic monetizable structural growth trends and are trading below their intrinsic value.

For the most part our thesis played out in 2017 and we returned from this trip with an unchanged and cautious outlook for the country. Many risks are still clouding the horizon and valuations don't provide an attractive entry point for companies in our watchlist.

The risks we foresaw 18 months ago have started to materialise:

- Industrial production and private consumption decelareted until February 2018 (see figure 1 and 2)
- Investment declined, and some high-profile investment projects were postponed or abandoned

Figure 1: Mexico Industrial Production YOY (%)

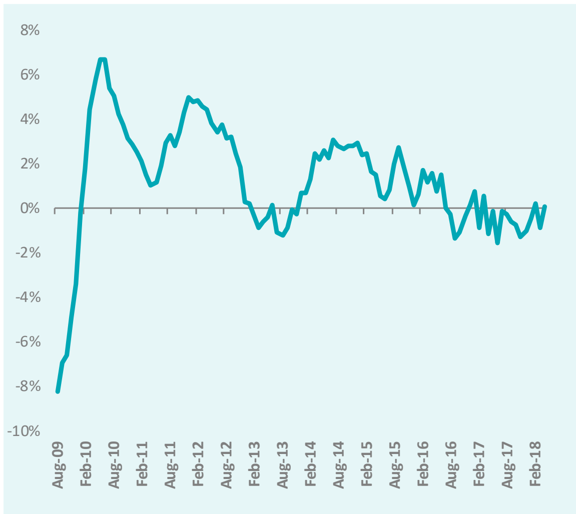
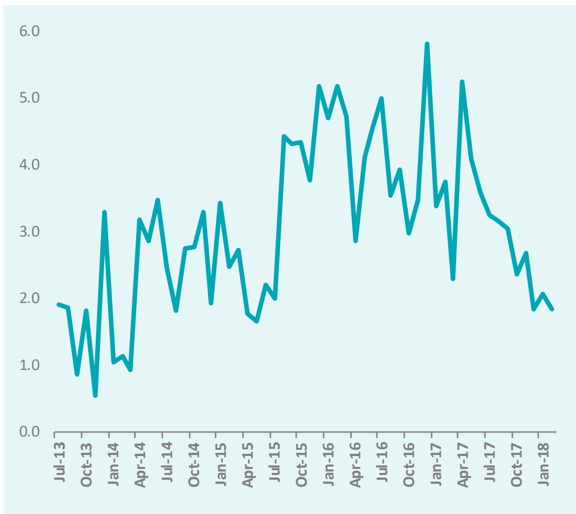


Figure 2: Mexico Private Consumption YOY (%)



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MEXICO

ECONOMIC CYCLE

The economic cycle is increasingly mature as illustrated by the recent increase in inflation, a flat yield curve and decelerating GDP growth (see figures 3 to 5).

Figure 3: Mexico Yield Curve 10 years (%)

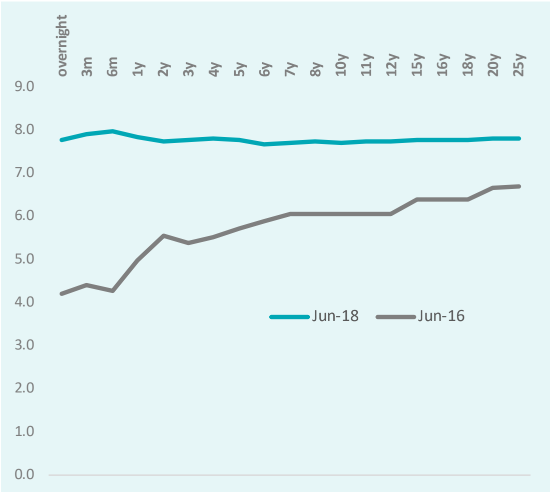


Figure 4: Mexico Inflation Rate (%)

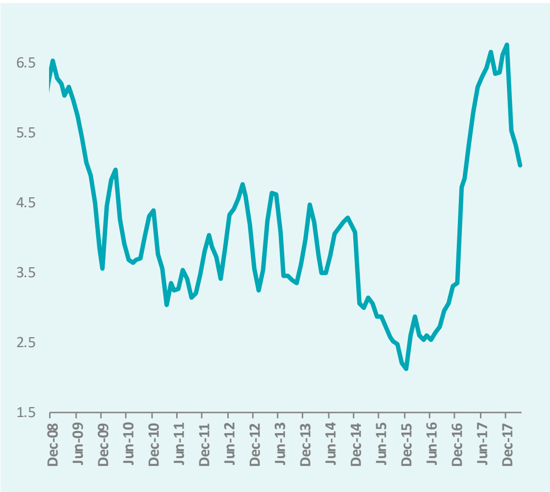


Figure 5: Mexico Real GDP (%)

One of the most interesting meetings regarding the Mexican cycle was with Mexico's largest real estate company, Fibra UNO aka FUNO. Its portfolio is well balance between retail, industrial and commercial assets. Over the past three decades, Grupo E, its majority shareholder, has stood out versus its peers for managing political and economic cycles exceptionally well, which have included the Latin America Balance of Payments crisis in the 1980s, the Tequila crisis in 1994, the banking crisis of mid-to-late 1990, and the GFC in 2008. This group of entrepreneurs has always been very patient and implemented Warren's Buffet recipe for growing rich: "be fearful when others are greedy, be greedy when others are fearful".

Therefore, I was eager to hear their point of view on Mexico's economic outlook. FUNO remains extremely positive on Mexico's long term structural fundamentals, however they are definitively cautious over the medium term. FUNO's head of investor relations explained it clearly: "Economies are cyclical, the probability of a downturn is higher when we are 10 years into the current economic expansion and risks are mounting". A week before I met them, FUNO successfully placed a MXN 2bn bond in the local capital market, meaning that FUNO won't have any significant principal repayment between now and 2024, a conscious execution of a liability management strategy implemented over the last 2 years to significantly lengthen the duration of their liabilities and putting them on the front foot should opportunities arise - and opportunities will surely arise as the Mexican economy evolves under the likely new government led by Andres Lopez Obrador (AMLO). As Mr. Buffett says: "It's when the tide goes out that we see who has been swimming naked".

"Economies are cyclical, the probability of a downturn is higher when we are 10 years into the current economic expansion and risks are mounting"

Since 2016, two additional risks reinforced our cautious view on Mexico: politics and NAFTA.

POLITICS

Following elections this weekend, it is likely that Andrés Manuel López Obrador ("AMLO"), a populist candidate, will be sworn in as Mexico's president for a 6-year period. Everyone on the streets, in newspapers and in business circles acknowledges that corruption and violence are major points of concern. For example:

1. A visit to Coca-Cola FEMSA, among the largest Coke-bottlers in the world, confirmed that they recently abandoned certain delivery routes in Mexico, because they couldn't ensure the safety of their employees
2. Driving around Monterrey and Mexico City, I saw several 30-story buildings, which were supposed to host civil servants, but were empty because project funding was misappropriated

Events such as the latter create a strong support to end the quasi-monopoly of Mexican politics held by the PRI (Institutional revolutionary party).

Despite an unorthodox campaign, AMLO's popularity continues to rise in the polls (see figure 6), now totalling more voter intentions than his 2 closest rivals combined. AMLO's declining rejection rate (see figure 7) also bodes well for him and, the fact that an absolute majority is not required in Mexico, suggests he is extremely likely to win the presidential election on the 1st of July.

Figure 6: Average of gross voters preferences in high-credibility pollsters (%)

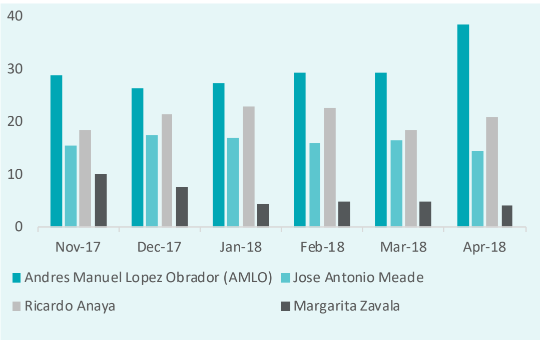
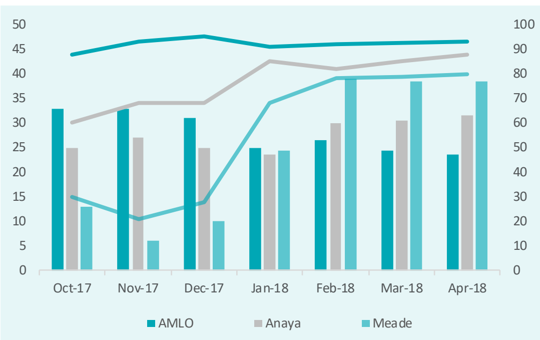


Figure 7: Average of name recognition and rejection rates in high-credibility pollsters (%)



AMLO's declining rejection rate is probably due to the populist slant in his program:

- Offering to implement a vote of confidence on the president every 2 years
- Taking a very tough stance against crime, corruption and violence
- Slowing down the pace of the energy reform program and privatisations
- Reviewing how contracts were awarded for Mexico City's 2nd international airport, a landmark project worth USD 13bn in investment, which was highly contested by AMLO
- Introducing interest rate caps, which will affect some of Mexico's retailers and banks that charge up to a 100% annualised interest rates
- Embarking on a witch hunt against corrupt judges, politicians, police forces and rich individuals

In short, we could see Mexico's version of the 'Lava Jato' scandal experienced in Brazil in 2016 or the "Mani Pulite" in Italy in the 1990s. After a period of equity market disruption, we see AMLO's impact delivering interesting investment opportunities. This is predicated on our particular focus on governance, deep understanding of business models, knowledge of the individuals stewarding each company and informed by our multi decade experience researching and investing in Latin America.

Anecdotally, the owner of a privately-owned large retailer in the north of Mexico recently paid himself a hefty dividend, probably to safe-guard his assets out of the country, in the fear of an anti-graft purge or interest cap. He probably is one of those retailers that charges consumers up to 100% APR, as a large part of his sales are done on credit.

On the economic front, the unpredictable nature of AMLO's policies do not bode well for foreign and domestic private investment. However, whilst we remain vigilant, we expect the debt and fiscal balance to remain largely under control.

NAFTA

The second most frequent topic of conversation was the NAFTA negotiation and Mexico's relationship with the US. At the time of my trip, most companies were still hopeful of an agreement in May; they were betting on Trump making a big announcement at the inter-American Summit and were counting on his need to reach an agreement before US mid-term elections. Unfortunately, they were disappointed.

Mexico retains great competitive advantages as an industrial partner for the US and a lot of capital has been committed over the past 24 years. Their supply chains are so integrated that NAFTA 2.0 can result in a lose-lose situation or at best a zero-sum game. However, one thing is clear: it is difficult to see how Mexico could get a better trade deal than the current one. Mexico has little bargaining power with its exports to the US representing almost 25% of its GDP, while the US relies significantly less on Mexico for its exports. This implies that NAFTA 2.0 is likely to result in higher costs for Mexican companies, in the form of tariffs or expenses that must be implemented to meet higher US standards, and probably lower export volumes, due to a change in the local content rule.

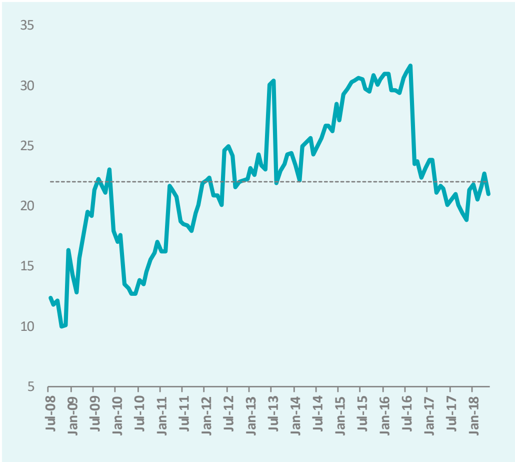
Since Trump's election we have seen him consistently delivering on his campaign promises: Iran deal, Tax cut, TPP, trade tariffs etc. It is thus highly likely that, in one way or another, he will follow through on re-negotiating a version of NAFTA more favourable to the US.

VALUATION

Factoring in the impact of AMLO's economic policy on the outlook of Mexican economic growth causes us to have a conservative outlook. We forecast lower sales growth compared to the past 7 years, NAFTA 2.0 causing margin compression, a weaker currency and additional imposed costs. Consequently, most of the companies we evaluated have an intrinsic value below the current share price.

On a multiple-basis, Mexico doesn't look particularly cheap either (see figure 8). Consensus expectations are too optimistic, the market expects Mexbol EPS growth of 23.7% in 2018 and 17.1% in 2019 (source: Bloomberg consensus). These expectations will fall in light of declining industrial production, slower domestic consumption and declining confidence due to political and external uncertainties. Valuations are in line with the last 10 year average for what should be much lower sales growth, margin pressure and higher risks and volatility going forward.

Figure 8: Mexbol Index PE



CONCLUSION

The outlook for Mexico is less bright compared to the past 8 years and material risks are not totally discounted by the FX and equity markets, in our opinion. Earnings growth for most Mexican companies remain uncertain and valuations do not price in the risks we identified.

Having said that, I met with some exceptionally well-run companies, mostly in the consumer and infrastructure sectors, that benefit from structural growth trends, have built sustainable competitive advantages and are executing a well-thought strategy. Thus, would certain equities experience price corrections that more than discount the risks, we are ready to be contrarian and buy high quality companies trading at a discount to their intrinsic value.

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All data correct as of 30 April of 2018. Sources: Alquity, Bloomberg

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