TRIP REPORT: MEXICO

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December 2021

Kieron Kader, Associate Portfolio Manager, spent 5 days of November in Mexico City visiting 17 companies including our 2 holdings, ASUR (Alquity ESG rating A) and Walmex (Alquity ESG rating B).

KEY TAKEAWAYS FROM THE TRIP

- Mexico suffered greatly due to the pandemic as mobility restrictions were strict, and little government support was offered. However, Mexico's vaccination programme has been strong and the economy has bounced back strongly since re-opening.
- In addition to the cyclical recovery, structural themes as such as e-commerce adoption have been rapid, thus benefiting our holding in Walmex. Furthermore, nearshoring is a key theme as foreign manufacturers aim to be closer to their US customers.
- Foreign travel to Mexico has picked up substantially, particularly from the US. Leisure travel is now above pre-pandemic levels, benefiting our holding in ASUR, whilst business travel is still lagging.
- Mexico is the second-largest greenhouse gas emitter in Latin America and has disappointed in its environmental targets and initiatives, particularly during COP26. Although the lack of political support results in a challenging environment for companies trying to access green energy, change is nevertheless still happening at the corporate level.

ASUR AEROPUERTOS DEL SURESTE

Walmart México y Centroamérica

Having spent almost 2 years working from home, I am delighted to be on the road again as we continue the path to normalcy. Clearly others were itching to get away too; my flight from London Heathrow to Mexico City was fully occupied with a mix of tourists and businesspeople. I arrived in Mexico City in the late evening and the streets were noticeably active. Street vendors were catering to large queues of people, buskers were singing loudly and creating fiestas in public – it was truly a vibrant and exciting environment.

In contrast to London, it was evident that everyone here is wearing face masks, even when walking around the street or in public parks. The use of masks in outdoor spaces is completely voluntary, but given Mexico's experience with the pandemic, the diligence of the general population is perhaps not a surprise. As of 20/11/21, Mexico had suffered almost four million COVID-19 cases and 292,000 deaths. The mobility and economic restrictions also had a deeply negative impact and caused GDP to decline by more than 8% in 2020. The support given to people during this time was unfortunately minimal, without any furlough schemes or meaningful tax breaks as seen in other countries.

On the more positive side, **Mexico has had one of the best vaccination drives in the world** with around 50% of the population fully vaccinated, which results in a top 25 positioning globally.

Figure 1: Vaccination in Mexico

Total doses given: 131M

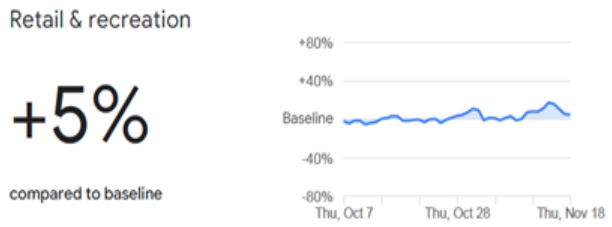
People fully vaccinated: 64.1M

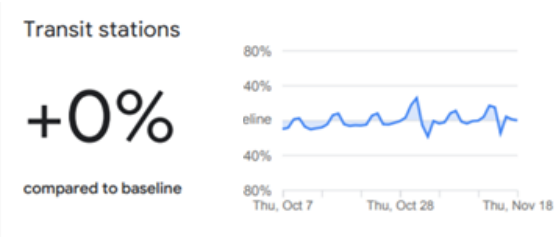
% fully vaccinated: 49.7%

Source: Google map of vaccinations, as of November 2021

Additionally, mobility restrictions have now eased, and we can see from the Google Mobility Index that retail traffic is above pre-pandemic levels, and mobility at transit stations has also returned to pre-pandemic levels.

Figure 2: Mobility returning to pre-pandemic levels





Source: Google mobility index, as of November 2021

This has thus created a fertile ground for a solid economic recovery. Consensus estimates for real GDP growth in 2021 are approximately 6% (which includes a period of mobility restrictions at the start of the year). The overall size of the economy is then expected to exceed pre-pandemic levels by the end of 2022. This is despite President Obrador's (AMLO) slightly waning popularity, where his party and the coalition lost their 2/3 lower house majority in the June mid-term elections.

Figure 3: Mexican GDP consensus

Source: Bloomberg, as of November 2021

Mexico also benefits from several positive structural long-term themes, as well as the aforementioned nearer term cyclical tailwinds. Firstly, e-commerce is growing rapidly, but remains deeply underpenetrated. This benefits our holding in Walmex, which is a pioneer in the omni-channel space in Mexico. Secondly, the long-term growth in leisure travel benefits our holding in ASUR, particularly where the destinations are not served by railroad or other means of transportation. And thirdly, nearshoring – where foreign companies build manufacturing bases in Mexico to be closer to the US. This has been an ongoing theme since the China-US trade tensions and has been catalysed by the pandemic, which further highlighted the need for supply chain diversification.

We have come away confident in our holdings in terms of both ESG and their significant growth tailwinds, both cyclical and structural, which we do not believe are reflected in current valuation levels.

> ***Mexico is our largest Latin American country weighting within the Alquity Future World Fund.***

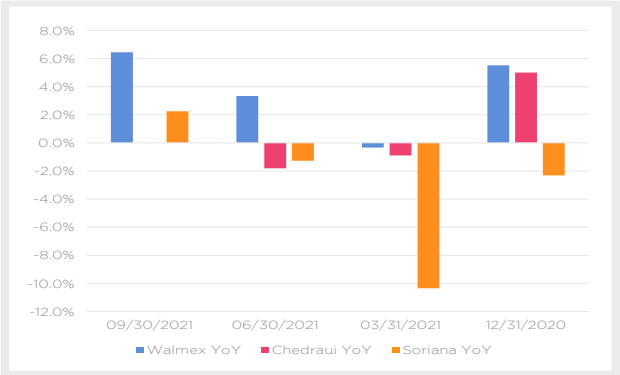
CONSUMER - A BUOYANT RECOVERY WITH STRUCTURAL TAILWINDS

The consumer is bouncing back strongly, with retail sales growing 8% year on year in Q3 2021. This was anecdotally confirmed by our own observations, as markets are packed with people and malls are bustling and getting ready for the festive season.

To gain greater insight into the consumer environment, we visited a number of retailers: Walmex, the operator of Walmart and other brands in Mexico; Chedraui, another grocery turned omnichannel retailer; Liverpool which operates multi-brand stores; and Grupo Carso which operates Sanborns and Sears, some of Mexico's oldest outlets.

All retailers suffered during the pandemic, but their experiences differed dramatically in magnitude. Soriana, Chedraui, Sanborns and Sears all suffered bigger declines, partly because of the more discretionary nature of their product mix, but also due to a lesser focus on e-commerce. Walmex on the other hand, only experienced one quarter of negative sales growth and to a much milder degree, followed by a sharper bounce back since March 2021. This was due to their competitive advantages of being the lowest priced retailer with the largest assortment of products, and their significant multi-year investment in e-commerce, particularly click and collect. Identifying companies that benefit from long term competitive advantages such as this is a key part of our investment process.

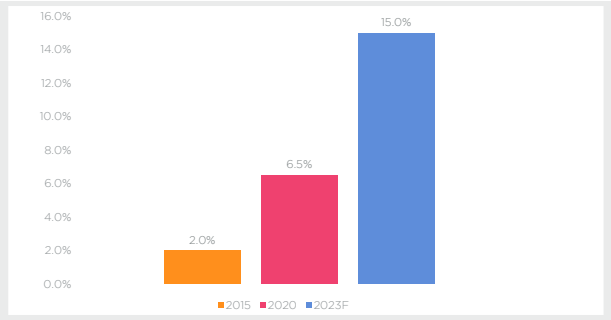
Figure 4: Mexican retailer sales growth



Source: Company filings, as of Q3 2021

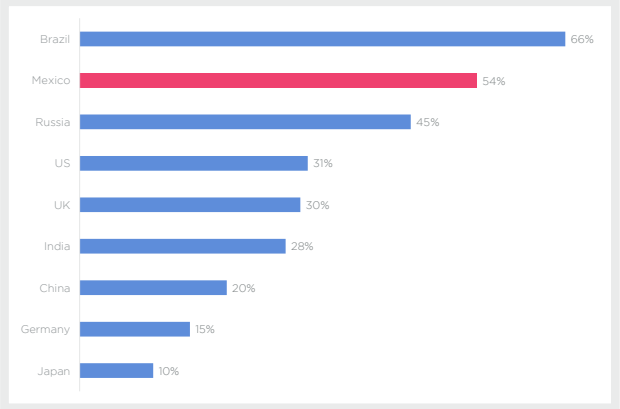
In addition, Walmex also benefits from our theme of domestic structural growth – both in terms in the shift in consumers from unorganized to organized retail (with unorganized retail still representing 49% of the overall market in 2018 per the latest available data from Euromonitor), and the shift from the physical to the digital economy. Mexico was initially expected to grow online sales at a CAGR 12.6% pre-pandemic according to JP Morgan – 6x faster growth than the overall retail market. However, we believe that the market will continue to grow above this level, even allowing for a slowdown from the 2020 numbers (Figure 6). In addition, **e-commerce is still hugely underpenetrated in Mexico at around 6% of total sales**, which is well below the likes of Chile at 12% and the US which exceeds 20% of total sales.

Figure 5: E-commerce penetration in Mexico



Source: Barclays Research, 2021

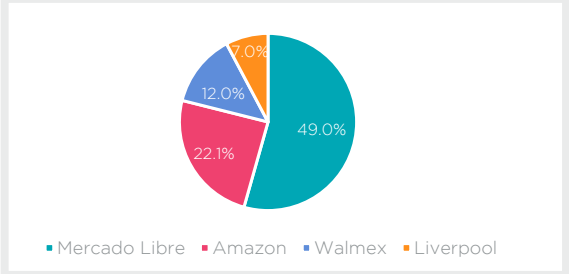
Figure 6: 2020 online sales growth



Source: Euromonitor international, Bloomberg, 2021

We also believe that the companies that are investing most heavily into the space i.e., Mercado Libre and Amazon as leaders of the online-only space, and Walmex as the largest omnichannel player, will likely continue to gain the lion's share of this growth.

Figure 7: Market share of e-commerce



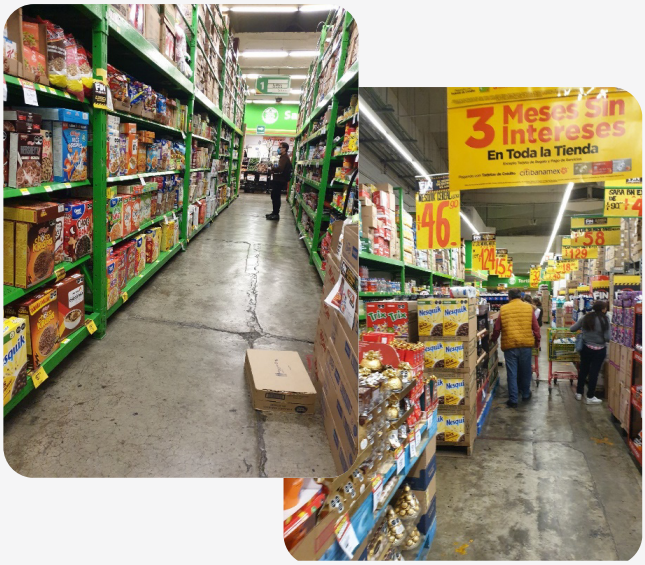
Source: Company filings, 2020

In addition, Walmex perform strongly on both Environmental and Social factors. They have best-in-class initiatives and targets such as 100% renewable energy by 2035 and net zero emissions by 2040. Currently, 88% of stores are supplied with renewable energy and renewables account for 51% of energy requirements. They are also the only Mexican retailer with a 'Certificate in Employment Equality and non-Discrimination', with women holding 38% of senior executive positions (the Emerging Market average is just 14%, per Euromonitor). That said, we engaged with them to directly link their ESG performance to the management compensation structure.

AN OVERVIEW ON WALMEX' FORMATS

WALMART EXPRESS: a condensed convenience format, it is well organised and plenished without feeling cramped.

BODEGA: the cheapest format store; strong on assortment, slightly less aesthetic, but most importantly is price competitive and cheaper than the mom-and-pop stores.



WALMART: the largest format which mostly caters to the middle class and above.

This has the greatest assortment, a wide range of fresh and imported foods whilst maintaining price competitiveness. It is also one of the only stores open 24/7 in Mexico.

TRANSPORTATION - A MIXED BAG, BUT LEISURE TRAVEL IS THE WINNER

In August 2020, we began to plan our investment strategy for when economies would begin to reopen. **We believe that travel is a long-term growth theme** - as economies become richer, total spend on leisure and recreation (including travel) increases. We believed that the willingness to travel had not disappeared during the pandemic, rather it was the ability to do so that was impaired. Fast forward 12 months later when restrictions have largely been removed and travellers indeed returned in full force. Having initiated a position in November 2020, **ASUR has since returned over 30%, a healthy outperformer versus all relevant benchmarks**. In the case of Mexico, international travel from the US has been the key driver. We had also hypothesised that leisure travel would be the first to resume, and that business travel would take longer due to structural changes to the way that we work (e.g., Zoom). This thesis was largely confirmed by our visits to the Mexican airport operators during this trip, including ASUR.

The majority of ASUR's revenues are derived from Cancun airport, a leisure destination for both domestic and foreign tourists in the southeast of the country. ASUR has seen a strong rebound in passengers as seen in the passenger growth chart below. This was largely driven by international tourists and particularly from the US. Canadian and European traffic growth still hasn't recovered to pre-pandemic levels due to the more recent lifting of restrictions, but this will be an important driver going forward. Another segment that has not fully recovered yet is the over-65s. Whilst vaccinations have been key, ASUR's management believe that advances in treatment such as anti-viral drugs will give this demographic more confidence to resume travel. Regardless, travellers from younger demographics have more than compensated for this as seen in the overall passenger growth data.

Figure 8: Cancun is a popular coastal city in southeast Mexico

Source: Google Maps

In contrast, we also met with OMA, another airport operator but whose revenues are largely derived from Monterrey which predominantly caters to business-oriented travellers. OMA's passenger traffic remains well below pre-pandemic levels. Parts of the business traveller segment have recovered, particularly blue-collar workers (such as engineers) where working from home was not a long-term option. But white-collar workers such as bankers, IT specialists etc have not resumed travel. Whilst we believe that this will continue to gradually recover, the trajectory will be slow due to the aforementioned changes to the way that we conduct business. As such, we remain confident in our exposure to the faster-recovering leisure market through ASUR, although are alive to the risks from any newly discovered Covid variants causing a relapse in the growth trajectory.

This confidence is compounded by our ESG analysis of ASUR, which is A rated. ASUR have set best-in-class initiatives such as to reduce carbon emissions per passenger by 50% within seven years. Management detailed the extensive plans to us, which included installing solar panels at three airport sites and their parking lots to generate an additional 5 gigawatts per year. In addition, the company demonstrated exemplary treatment of their staff during the pandemic. There were no staff layoffs or wage cuts, despite the difficult economic environment and lack of government furlough schemes.

Figure 9: ASUR PAX growth for 2021 vs 2019

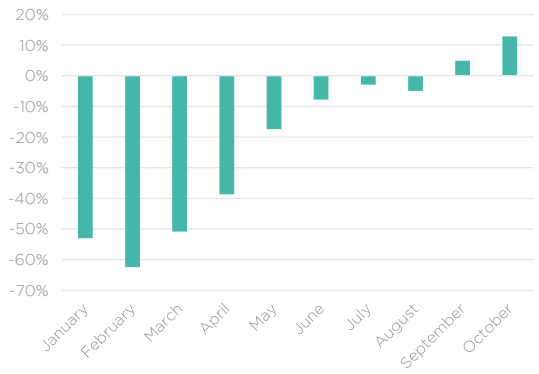
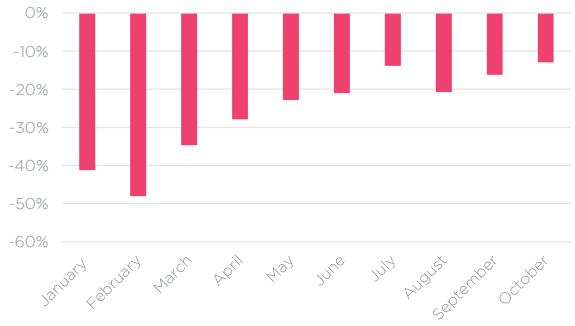


Figure 10: OMA PAX growth for 2021 vs 2019



Source: Company filings, November 2021

INFRASTRUCTURE AND REAL ESTATE - NEARSHORING IS THE KEY THEME

In addition to testing the economic pulse of consumers, we also met with several real estate and infrastructure companies to understand the outlook for private-sector investments in Mexico.

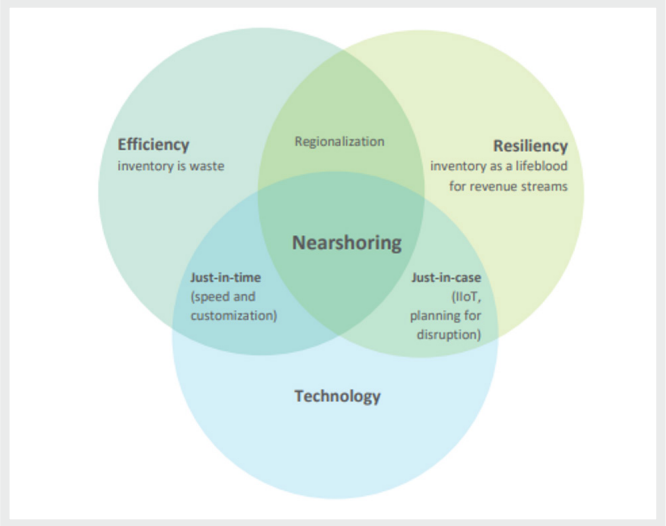
Resilient US economic growth has spilled over into Mexico, particularly in the Northern cities (near the border) such as Tijuana. This is structural, not merely cyclical, as it is advantageous for foreign companies to be geographically closer to the end customer in the US due to the flexibility in having a shorter supply chain. In addition, manufacturers believe that China-US trade tensions continue to contain tail-risks, despite the recent stabilisation in the relationship, and thus diversifying away from China remains a prudent strategy. Mexico also enjoys one of the lowest import tariffs with the US (0.02% on average versus 4.68% for the East Asian region.

Figure 11: The strongest beneficiaries of near-shoring

Source: Fibra Prologis, 2021

We had previously owned Vesta (ESG rating A), a specialised real estate developer with exposure to the aforementioned areas. Our meeting on this trip emphasized their record-breaking revenues and healthy order book. We had exited the position earlier in the year due to concerns on rising construction costs (as a result of increasing commodities and wages) and the more attractive outlook for both Walmex and ASUR. Vesta performs highly on ESG with best-in-class environmental initiatives, as well as social uplift programmes for the communities in which they are building their industrial parks. Therefore, this is a company that remains in our core research universe, given the longevity and attractiveness of the structural theme, and is a candidate to return to the portfolio at an appropriate time in the future.

Figure 12: Structural demand drivers for nearshoring



Source: Fibra Prologis, 2021

ENVIRONMENTAL PROGRESS - DISAPPOINTING, BUT CORPORATE WILLINGNESS IS IN PLACE

Following the recent COP26 conference, and in addition to our regular corporate-level engagement on a variety of Environmental, Social and Governance factors, we particularly focused our discussions on plans for greenhouse gas emissions reductions during this trip.

By 2030, Mexico has pledged to reduce greenhouse gas emissions by 22%. Mexico is also a participant in a global initiative to reduce methane emissions. Multiple research articles, however, would argue that **the country's policies result in a path to rising, rather than falling, emissions and are inconsistent with the Paris Agreement's 1.5 degrees Celsius temperature limit**. AMLO was absent from COP26 though he was a vocal critic from home, pointing to the contradiction of major world leaders travelling to the event by private jets.

Given this context, we asked each of the 17 companies for their stance on the use of renewables, and their path to decarbonisation, given our view that Mexico's national level response is inadequate. Interestingly, almost **all companies had plans to use more solar and wind energy, but with varying degrees of likely success**.

For example, the airport operators ASUR and OMA have already achieved a high percentage contribution from renewable energy due to installing solar PVs themselves. Others, such as the real estate company Fibra Prologis, have agreements with solar generator/distributor companies, but the regulators won't allow the distributor to connect to Prologis's buildings. We know that Mexico can be a difficult environment for corporates to operate within, but AMLO's latest energy reform proposal would give the state even more power which would probably complicate matters further. Fortunately, however, the most likely scenario is that this measure will not pass Congress.

Nevertheless, we will continue to engage at the corporate level to push companies to provide and implement plans for carbon neutrality as soon as practical.

SUMMARY

This trip has confirmed our view that Mexico is well-positioned to benefit from our structural themes such as the shift from the physical to the digital world, as well as the cyclical recovery with a strong post-pandemic bounce back aided by strong US growth. We have come back confident in our country positioning and in our existing holdings.

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