Manager's Letter
2nd Quarter 2019

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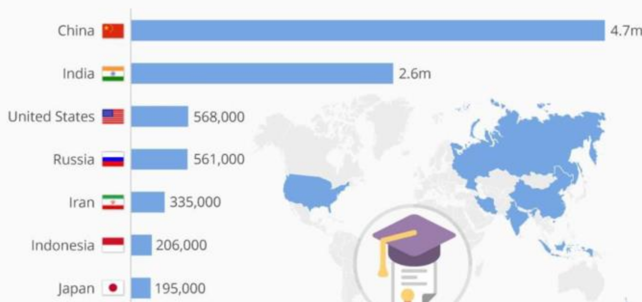
1. Economic and market environment

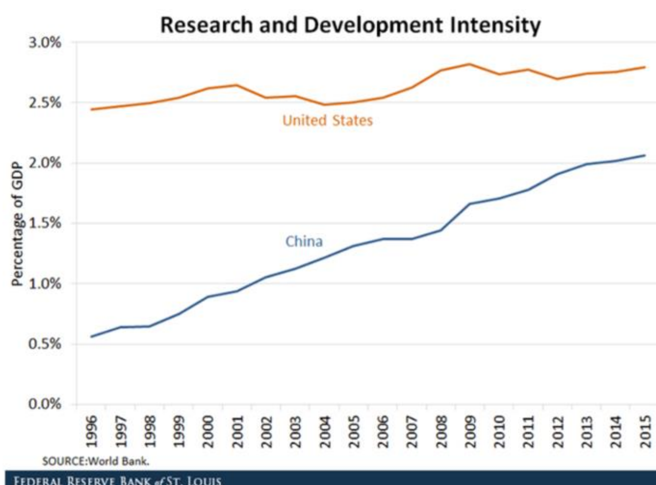
A major headline affecting the markets in recent weeks has been the abrupt cancellation of trade talks between China and the United States by the American president. We generally don't spend much time on headlines (as the British like to say "yesterday's news is today's fish-and-chips paper"), but we think that the current tensions reflect more of a structural trend and are likely to regularly flare up in the coming years. More importantly, the tensions will likely create opportunities but also risks for the long-term global investor which need to be properly understood.

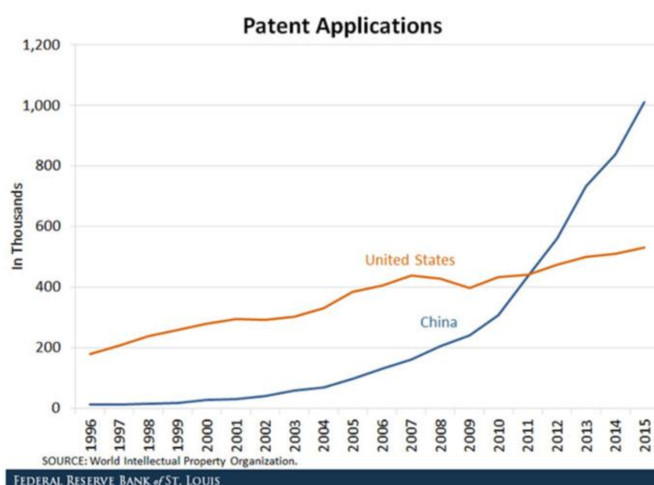
We think that a reason behind these tensions is the rise of China as an economic and scientific super-power, challenging the hegemony of the United States. When China entered the World Trade Organization in 2001, the country was still mostly agricultural and had just become a low-cost manufacturing base for the rest of the world. This has dramatically changed in recent years due mainly to excellent education, hard work and productive investments in China. One major generational change has been the massive increase in higher education. According to the World Economic Forum, China had 4.6 million STEM graduates (science, technology, engineering & mathematics) in 2016 compared to 2.6 million in India and 568,000 graduates in the United States, which is a lot more in absolute number but also per capita.



This significant increase in the number of scientific graduates has started to yield results with China quickly catching up with the United States for the number of patents filed. The impact is only starting to be felt as most Chinese graduates are still in their thirties and the United States still spends a larger proportion of its GDP on R&D at 2.8% compared to 2% in China.[1]

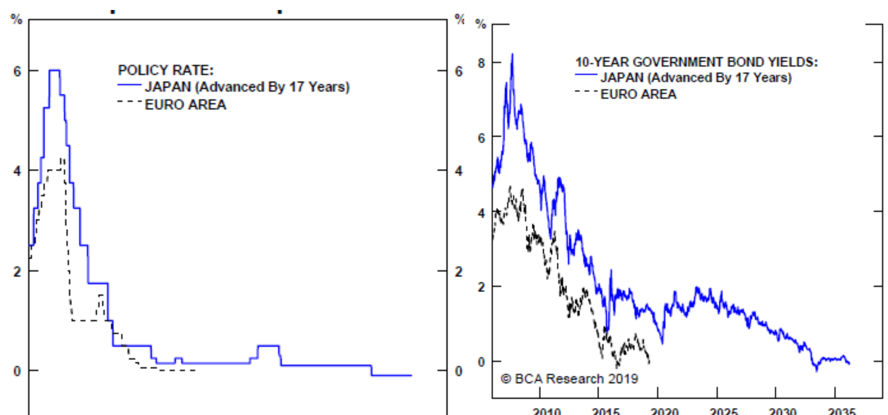
[1] https://digital.rdmag.com/researchanddevelopment/2018_global_r_d_funding_forecast?pg=5#pg5





This massive increase in brain power in Asia will create new opportunities in the form of sophisticated businesses but will also lead to a rise in global competition. The increase in global competition appears to be what the current American administration is the most worried about. More and more American journalists, politicians and consultants have started to present China as a competitive threat[2], which has led to more drastic measures, like the recent tariff increase and denying Huawei's access to American technology products and services. The famous American engineering & business school, MIT Sloan, recently completed an extensive study on Chinese corporate innovation and identified three types of emerging innovators: **the hidden champions, the tech underdogs** and **the change makers.**[3] These companies are not always well known in Europe and the US but have already disrupted major industries like appliances, technology hardware and solar power. For equity investors, having a good understanding of what is happening in China will be increasingly important. Over the years, we have developed an extensive network of companies, financial analysts and other investors in China. We think that in the long term a good understanding of China, and Asia in general, will be crucial to generate good investment returns.

Another major evolution in the economic and investment world in recent weeks has been the collapse of interest rates particularly in Europe, where most German and French government debt now generates negative yields. This has made the life of European savers difficult as it has become nearly impossible to find good quality fixed income investments generating positive yields. This phenomenon has a precedent in Japan, an evolution analysed by the economic consultant's BCA in a report comparing the state of the European economy today and the Japanese economy 17 years ago.

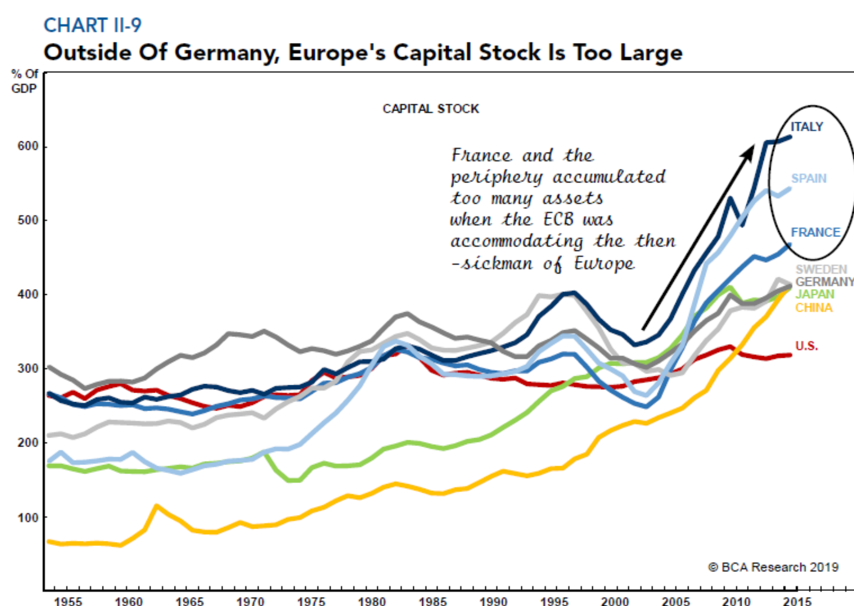


Unfortunately for European investors, it appears that the European economy has a lot of similarities with Japan: a rapidly aging population, an excess of aggregate savings depressing financial returns and a distressed banking system.

[2] https://www.forbes.com/sites/arthurherman/2018/09/10/americas-high-tech-stem-crisis/#1965e4e0f0a2

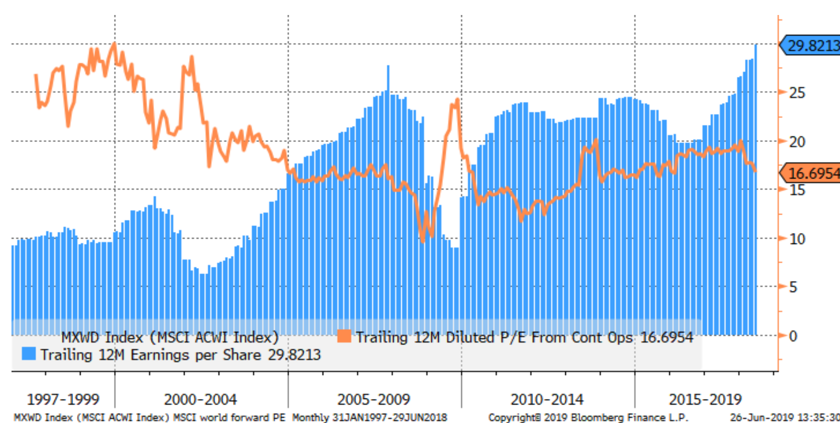
[3] https://sloanreview.mit.edu/article/understanding-chinas-next-wave-of-innovation/

As investors, what is the most concerning is the accumulation of assets as a percentage of GDP, which has reached an all-time high in a number of countries and is especially concerning in countries like Italy, France and Spain.



An economy can only support a maximum amount of remuneration of financial assets: for example, a government can only spend a fraction of its budget on interest payments. A deterioration of the ratio of capital stock to GDP generally ends up either in a sudden drop in value of the capital stock (a real estate crisis, a sovereign debt default…) or a slow rebalancing of the ratio through a long period of lower return on this capital stock. The European Central Bank has been very busy over the last few years trying to avoid this 'drop in value of the capital stock' propping up financial systems through interest rate cuts and government debt purchases. This has prevented economic disruption but has also caused asset bubbles in real estate and the debt markets, as lower and lower yields pushed investors to bid up any assets generating fixed returns.

Fortunately for TreeTop Asset Management, one of the few asset classes not too affected by the action of central banks is the global stock market. Somewhat surprisingly, the global stock market actually trades on a lower valuation multiple than 20 years ago. Two major crises in 1999 and 2009 appeared to have had a lasting effect with investors constantly asking about the next crisis. At TreeTop Asset Management, while we suffered significantly from the volatility of the last ten years, we think that it creates an opportunity to buy the world stock market, which has an excellent 100 years track-record[4] and does not trade at record valuation levels.



Source: Bloomberg

[4] Past performances are not a reliable indicator of future performance. Investing in stock markets entails risks of capital loss.

2. Our convictions

The strong rebound of our strategy in the first quarter of the year has fizzled out a little bit in recent weeks mainly due to tensions between China and the United States, but also thanks to ongoing financial strains in India. As we mentioned in previous letters, the Indian wholesale financial system has undergone some turmoil in recent months due to poor lending by some financial actors and a structural reform of the real estate sector, a necessary long-term change creating some short-term pain. These tensions affected our investment in **INDIABULLS HOUSING FINANCE,** whose underlying business remains strong with excellent growth prospects, but whose stock got somewhat dragged down in the turmoil.

Our first corporate trip of the year was in India to assess the strength of the housing finance sector and **INDIABULLS HOUSING FINANCE** specifically. We came back thinking that the sector needed some time to stabilize, that the long-term growth prospects were intact and that **INDIABULLS HOUSING FINANCE** was well placed to weather the storm. Recent weeks have been busy in India with the re-election of the pro-business, pro-reform government and an interest rate cut but also continued strain on the weaker financial businesses in the country. Unlike the subprime crisis in the US or the real estate bubble in Spain, the core issue is not inflated prices and excess supply but a financing structure which is too heavily dependent on wholesale funding and short-term financing. This issue affected **INDIABULLS HOUSING FINANCE**, as it is not a bank so has no access to deposit funding and instead relies on wholesale funding. Unlike some of its peers, the Company always kept a significant liquidity buffer in case such crises arose and had a good asset/liability duration match. This proved sufficient for rating agencies, and the Company continued to deliver strong results, but equity investors remain worried about the difficult financing environment. To definitively put a halt to these financing worries, **INDIABULLS HOUSING FINANCE** announced in recent weeks its intention to merge with a small private bank. In the long term, **INDIABULLS HOUSING FINANCE**' asset franchise, combined with a deposit license, should create significant value for shareholders, but in the short-term trust needs to be rebuilt and the stock is at the mercy of rumors. Accusations of bribery were made, which despite being retracted very quickly created volatility in the stock. These short-term problems, while painful, must be put into the context of the long-term potential of housing finance in India. Unlike Japan, Europe, the US and China, India has a huge lack of housing and muted real estate prices. These two factors combined with increasing disposable income and the ability to cut interest rates further should result in multiple years of growth. We continue to think that **INDIABULLS HOUSING FINANCE** is one of the most interesting financial companies in the world and is a bargain on 5.9x FY2020 PE (fiscal year ending March) with a 8% dividend yield. A successful merger should also lead to a re-rating of the stock, as quality private banks trade on 20x price/earnings and 3.5x book value.

Another large investment, **FUFENG GROUP** hasn't been affected by any news in particular but the stock hasn't done much in recent weeks probably due to the US & China turmoil. In May we spent a full three days with the CFO in China visiting factories all over the country and were impressed by the work management has done to structurally improve profitability. After two years of price war in their main product, mono-sodium glutamate (MSG, a very popular food additive in Asian cuisine), the Company has now reduced capacity as most of the market is serviced by them and their competitor, Meihua. This new market structure should enable **FUFENG GROUP** to generate strong cashflows, pay dividends and buy back stocks and finance their expansion into other amino acids. Our factories and research center visits also confirmed our impression that the Company has built a significant process know-how over the years giving them a significant cost edge, the ability to respect the increasingly strict pollution measures in China and the capacity to profitably expand into new products and geographies. This transition from a volatile, one-product commodity business to a multi-products oligopolistic company with stable cashflow should lead to a rerating of the stock, which now trades on 5x 2019 PE with a 4.5% dividend yield.

We continue to look out for new attractive opportunities in the investment world and recently initiated a position in an American company. **FUNKO** is a pop culture consumer goods company that sells novelty items relating to key franchises in popular culture, under license from those franchises. The company sell products across 600 licenses that include everything from Star Wars to Harry Potter to Game of Thrones. Growth is driven by expansion of the licensed

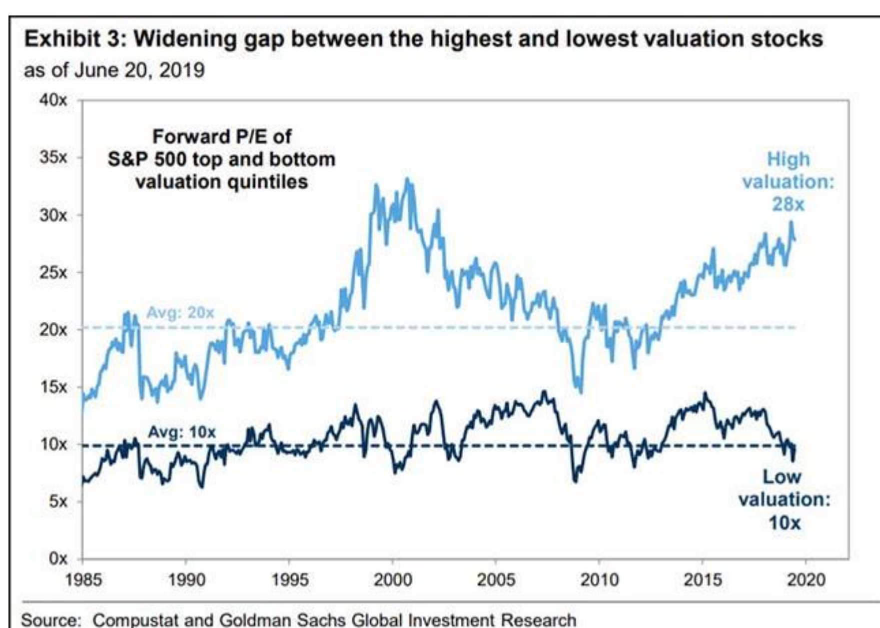
property portfolio (which is linked to broader growth in global content), expansion in distribution (including e-commerce growth), new products and international expansion. We forecast a revenue CAGR of 20%+ over the next 3-5 years and earnings growth should exceed this. Given this potential, the stock is cheap at just 15x 2020 earnings.

Another new investment is **CHINASOFT,** a leading IT business in China serving large corporates in the country, like HSBC, Huawei and Tencent. Its biggest client is Huawei, hence the recent significant derating creating an opportunity to buy. One of our key takeaways from our recent trip in China is the need for large corporates to invest in IT/software to become more efficient. Given how Trump has been treating China recently, we think that the companies most likely to benefit are homegrown businesses. **CHINASOFT** is a leading player in traditional IT and cloud implementation and should benefit from this trend. The stock trades on 10x 2019 and 8.7x 2020 P/E with 10%+ earnings growth p.a.

Our strategy continues to be focused on medium-sized businesses with good growth prospects, trading at discounted valuations. One major change we have made over the last few months is selling down all our positions in aeronautics **(SAFRAN, AIRBUS)** and reinvesting most of the proceeds in **UNITED RENTALS** and **ASHTEAD**. Airplane manufacturers were once derided as cyclical businesses unable to deliver consistent returns and earnings. Stocks were trading on single-digit price-to-earnings multiples and were highly volatile. A few years of supercharged growth driven by the boom in Asia and low-cost flying resulted in these companies becoming huge market capitalizations, trading at a premium to the overall market. We think that **UNITED RENTALS** and **ASHTEAD** are in the same situation as aeronautic stocks a few years ago. The stocks trade on mid to high single digit valuation multiples, as investors fear the impact of the next downturn. However, like for aeronautic stocks, barriers to entry are high as it is a scale business. There is also a structural growth trend as rental equipment replaces outright equipment purchase, and bigger rental businesses can consolidate smaller ones (77% of the industry is still-made up of small & medium-sized companies).

Since the beginning of the year, we have started to regain some of the lost ground of the last two years but we still have a long way to go. We think that part of the underperformance of the strategy was due to some investments being less successful than expected and part due to a cyclical evolution of the market. To improve our investment results, we have invested in our research process buying a stake in the asset manager Aubrey Capital Management as well as hiring a full-time analyst in China. We are working hard to make these investments generate positive results for our clients and our firm. The major cyclical factor affecting our performance has been the increasingly large valuation discrepancy between US growth stocks and everything else. The last time we saw this valuation spread was prior to the burst of the investment bubble in 1999.

'History may not repeat itself. But it rhymes' (commonly attributed to Mark Twain)



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