

# Asia Pacific UCITS Fund Commentary 1Q21

Longleaf/Partners  
Funds

For Professional Investors Only

## Portfolio Returns at 31/3/2021– Net of Fees

	1Q21	1 Year	3 Year	5 Year	Since Inception 2/12/2014
APAC UCITS (Class I USD)	8.07%	61.89%	3.76%	10.88%	8.35%
MSCI AC Asia Pacific Index (USD)	2.34%	51.77%	8.15%	12.18%	8.64%
Relative Returns	+5.73%	+10.12%	-4.39%	-1.30%	-0.29%

Selected Indices*	4Q20	1 Year	3 Year	5 Year
Hang Seng Index (HKD)	4.55%	23.71%	1.30%	10.09%
TOPIX Index (JPY)	9.15%	42.05%	6.84%	10.15%
TOPIX Index (USD)	1.88%	38.41%	5.41%	10.53%
MSCI Emerging Markets (USD)	2.29%	58.39%	6.48%	12.07%

\*Source: Bloomberg; Periods longer than one year are annualized.

The Longleaf Partners Asia Pacific Fund reported a solid first quarter, returning 8.07%, easily outpacing the MSCI AC Asia Pacific (MXAP) Index's 2.34% return. The Fund also posted strong absolute and relative performance over the last year, clearly rebounding from the lows experienced in March 2020.

Like the previous quarter and year, our overweight to China and the Chinese consumer continued to drive our returns, accounting for over half of the quarter's and the majority of last year's performance. Our Hong Kong-listed investments, collectively the largest absolute and relative detractor in 2020, began paying off this year. These Hong Kong businesses benefitted from an improvement in sentiment related to the relaxation of COVID lockdown measures, the beginning of mass vaccination programs, and the rotation from growth to value. Our concentration in real assets, which tend to benefit from inflation, including property, gaming, and infrastructure firms CK Hutchison, CK Asset, New World Development, Melco International, and MGM China, helped our Hong Kong returns. Civil liberties and political opposition in Hong Kong have been quelled, with Mainland China now firmly in control of the former British colony. This has also meant an end to disruption from the violent anti-government protests that erupted two years ago, severely affecting the economy and keeping Mainlanders away. Mainlanders will be more confident in coming to Hong Kong to stay in hotels, purchase goods and

services, and invest in property and financial products as a store of value. This is positive for our HK-listed businesses and should allow them to prosper again as borders re-open between Hong Kong, Macau, and China. As a global financial center only rivaled by New York, Hong Kong's position was solidified this year. The value of multi-billion dollar listings on the Hong Kong stock exchange and the volume of mainland capital flowing into Hong Kong accelerated this quarter. The gradual integration of Hong Kong into the Greater Bay Area should allow Hong Kong and our investments to prosper as a market of 70 million people opens up more opportunities.

The portfolio benefited from our overweight to nations that controlled COVID-19 relatively well (China) and our underweight to countries with weaker health care systems that failed to control the pandemic and continue to lack access to vaccines (Southeast Asia). The Philippines, where we have an investment in restaurant operator Jollibee, has been weak, as it re-entered into stricter lockdowns in March amid another spike in COVID infections. However, Jollibee has a large and growing presence in two countries – China and the United States – that are rebounding strongly from COVID and should help it achieve pre-pandemic profitability levels, despite challenging conditions in the Philippines.

We believe that the journey back to pre-COVID conditions is likely to be uneven, producing winners and losers, as determined by the health of corporate balance sheets, the extent of accommodative policy measures, vaccine access and policy, and the different pace of re-opening of economies. We expect China to drive economic growth in Asia (and the world), with real GDP projected to grow around 18% in Q1 and 7.9% in Q2. We have positioned our portfolio to capture Chinese consumption growth at attractive valuations, and over half of our portfolio is directly exposed to China. Two key factors underpin our excitement for Chinese consumption growth. Real income per capita has grown at more than 7.5% CAGR over the last ten years in China compared to 2% CAGR in the US, and the average Chinese household balance sheet is strong, driven by a high savings rate.

Currency was a headwind for the quarter as the US dollar strengthened against several Asian currencies, in particular, against the Japanese Yen. However, given our low Japanese weight, the Fund was significantly less impacted by dollar strengthening than the Index. The yen depreciated 7% against the US dollar in the quarter, as US interest rates diverged from Japan's low interest rates, becoming a key funding source for the carry trade, placing further selling pressure on the yen.

Value outperformed growth for the second consecutive quarter. Value's outperformance also accelerated, from 3% in Q4 2020 to 8% in Q1 2021, led by the finance, energy, and real estate sectors substantially outperforming the Index. After many years, growth and technology names no longer dominate the MXAP Index's top contributors. Among the top seven contributors to the MXAP index in the quarter, technology names such as Tencent, TSMC, and Hon Hai ceded some ground to old economy banks – MUFJ, Westpac, and ANZ – beneficiaries of higher and steeper yield curves. Value has underperformed for over a decade in Asia. While value outperforming growth for two quarters may not firmly establish a trend, we have a long way to go for the value versus growth dynamic to revert to historical norms, which bodes well for future returns of value-oriented strategies like ours.

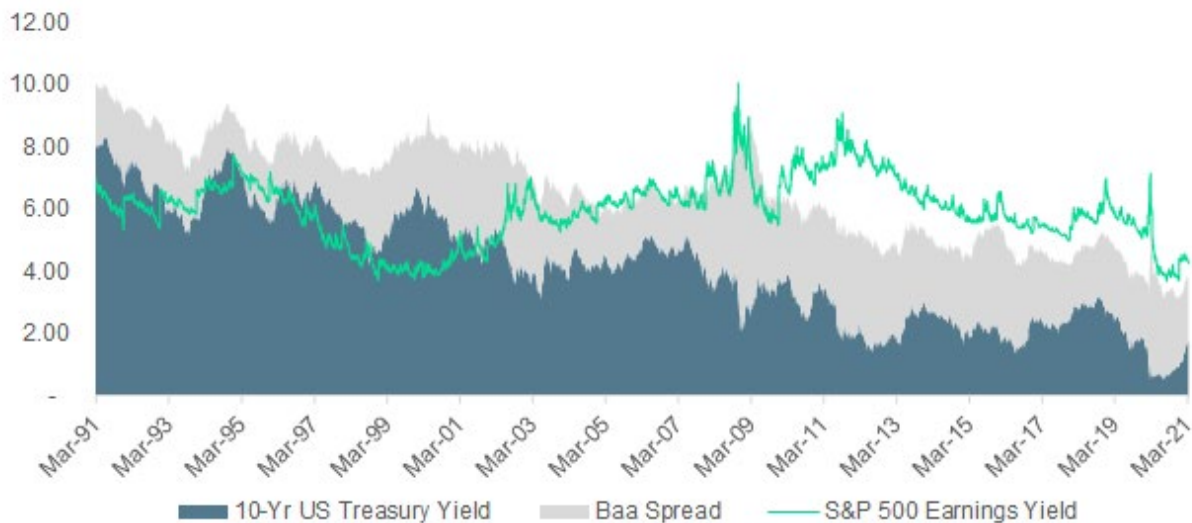
Fast-growing, long-duration, high valuation companies were negatively affected by poor sentiment from the rapid rise in benchmark rates, albeit from a low base. The 10-year Treasury notes' yield increased by 80 basis points to 1.74% during the quarter, up 87%. The Bloomberg Barclays Aggregate Bond Index returned -3.37%, the worst quarterly performance in many years, surpassing the negative returns incurred during the taper tantrums in 2013 and 2016. The longer duration 30-year Treasury bond had its worst Q1 return since 1919.

Although interest rates have increased rapidly, rates remain at historically low levels, and we believe that they will remain low. Central bank balance sheets will keep expanding, and fiscal stimulus will continue to be made available. Equity markets should benefit from the unprecedented amounts of liquidity in the financial markets. Fears over higher rates and inflation, the continuation of tense relations between the US and China, and massive amounts of liquidity looking for investment returns have created volatility in the markets. In this environment, we are optimistic about the prospects for Asian value equities. We believe they provide superior earnings yield and growth, setting the stage for attractive real risk-adjusted returns that provide a substantial margin of safety despite the risk of higher interest rates.

While equity markets have become nervous about a higher and steepening yield curve, the cost of debt (risk-free rate + corporate credit spread) for US investment-grade corporations remains at record low levels. Credit spreads have compressed, and base rates remain at historical lows. Today, an investment-grade borrower would borrow at 3.73%, which implies a forward looking P/E of 26x, which is still higher than the MXAP's 17x, the Hang Seng's 13x, and the S&P's 22x. The US market is trading at a forward

earnings yield of about 4.5%, which is at a 22% premium to a US investment-grade corporate's cost of long-term debt.

### US investment-grade debt cost vs. S&P 500 earnings yield



Source: FactSet

During the tech bubble in 2000, the S&P 500 was trading at 25x earnings or an earnings yield of 4%. However, the average cost of ten-year investment-grade debt was 8% in 2000 —double the S&P 500's earnings yield. Today, we have the opposite situation — the actual borrowing cost of an investment-grade US corporation is less than the earnings yield of the S&P 500. This gives us comfort that overall, equity valuation levels are not excessive relative to the cost of capital and available alternatives, especially when looking at Asian markets, which trade at higher earnings yields than the US markets. Several companies in our portfolio trade at a substantial earnings yield premium to their cost of capital.

**Portfolio Activity:**

During the quarter, the technology sector's strong performance tapered off. Some of the biggest losers in the Index, such as Luxshare Precision, Xinyi Solar, and Pinduoduo were very high multiple / long-duration type companies with minimal earnings yield. In the quarter, eight of the top ten detractors in the MXAP index were technology-oriented companies. Despite the prospect of higher rates, tightening regulatory oversight, increasing geopolitical risk, and higher market volatility, we allocated most of our incremental capital towards fallen angels in the Chinese tech sector as we find the risk-adjusted returns of these new investments particularly compelling.

We meaningfully increased our Chinese technology exposure to around 26% by initiating two investments – Alibaba and JOYY – in the quarter. We believe that our Chinese tech portfolio, including Prosus, Baidu, and Tongcheng Elong, together with the new positions in Alibaba and JOYY, is attractively priced for dominant companies with sustainable moats generating high returns on incremental capital with a long runway for profitable growth. Alibaba and JOYY de-rated because of concerns around increased industry anti-trust regulation, strengthened oversight over Chinese internet platforms, and a potential forced de-listing of their ADRs by the US government. Jack Ma's disappearance from public view and the last-minute cancellation of Alibaba's associate Ant Group IPO created fears that this was part of a government take-down of Jack Ma's empire. We took advantage of the situation and bought these businesses at compelling valuations, which we detail below.

However, we also trimmed Chinese tech investments during the quarter, as enthusiasm over multiple vaccines and global COVID re-openings drove a strong price rebound in online travel agency Trip.com, which we fully exited. Similarly, as margin-fueled momentum buying and excitement over electric vehicles (EV) drove Baidu's (and Hyundai Mobis's) stock price to record highs, we trimmed some of our EV exposure.

However, at the end of the quarter, we took advantage of the forced liquidation of Archegos Capital Management's substantial holdings in Baidu to add back to our investment at attractive prices. Lenders liquidated their margin collateral in Baidu stock through a series of block trade transactions. A massive \$24 billion and \$12 billion worth of Baidu traded on March 26<sup>th</sup> and 29<sup>th</sup>. We were happy to take advantage of the distress and top up our Baidu position at a significant discount to the price achieved through our sales just a few weeks prior.

For some tech companies that trade at high multiples, their earnings yield may be less than their cost of capital, as rates have begun to increase. We have seen a de-rating of certain tech companies, particularly money-losing or non-revenue-generating companies, during the quarter. However, in some cases, there is a substantial and attractive spread between a Chinese tech firm's cost of capital and its earnings yield, which we aim to capture. For example, Alibaba recently issued ten-year bonds at 2.1%, equivalent to a cash flow multiple of 47x. Alibaba trades at 19x earnings. However, excluding the value of cash, listed securities, and investments, and assigning a conservative value for all seed and loss-making businesses, its underlying core e-commerce business trades at a 13.5x free cash flow (FCF) multiple, at a 7.5% FCF yield. Alibaba recently increased its buyback program from \$6 billion to \$10 billion to take advantage of the severe undervaluation implied by the substantial spread between its FCF yield and cost of capital.

Chinese internet live streaming company JOYY may look like it is trading at high earnings multiples, but over 80% of its market capitalization is cash or soon-to-be cash and securities. If we exclude the value of cash, listed securities, and incoming proceeds from JOYY's sale of YY Live to Baidu and assign zero value for their loss-making Likee app, JOYY trades at 3x FCF. JOYY's BIGO live was the tenth top-grossing app worldwide in Q1 2021, according to [SensorTower](#). JOYY recently increased its dividend payout and signaled that the company is considering a further return of capital through buybacks or dividends once it completes YY's sale to Baidu.

Prosus recently issued 12-year bonds at 2%, much lower than the 7% FCF yield it generates from Tencent's operating business. This wide spread between FCF yield and cost of capital is why Prosus is issuing cheap debt and repurchasing its shares (and Naspers) under a \$5 billion buyback program launched in November 2020. In April, Prosus sold a 2% stake in Tencent, raising \$14.7 billion, equivalent to 8% of its market capitalization. We expect part of this capital raise to be spent on more share repurchase, given the steep 40% discount to NAV. Despite a strong performance based on domestic travel recovery, Chinese online travel agency Tongcheng Elong still trades at an attractive 7% FCF yield.

Baidu issued 10-year bonds at 2.375% last October, which implies a cash flow multiple of 42x. Baidu currently trades at 21x earnings, but excluding cash, listed securities, and investments, and assigning zero value for their loss-making Cloud and artificial intelligence (AI) businesses, Baidu trades at 13.4x FCF, equivalent to an FCF yield of 7.5%.

In December, Baidu upsized its buyback program from \$3 billion to \$4.5 billion to take advantage of its severe undervaluation. In 2020, the company repurchased \$2 billion of shares at an average price of \$120 per ADR. In March, Baidu re-issued shares at \$260 per ADR in its Hong Kong listing. After the Archegos liquidation event, we believe Baidu will utilize its remaining \$2.8 billion share repurchase authorization to buy back shares at attractive prices. In a recent call, Baidu CFO Herman Yu stated unequivocally that the highest and best use of capital today is a buyback.

### **New Investments:**

We initiated an investment in **Alibaba** during the quarter. This is not exactly a new investment for us. We have been closely following Alibaba since its IPO in 2014, and we had indirect exposure to Alibaba since this Fund's inception via our investment in SoftBank until Q3 2020.

Alibaba is the largest online retail platform in China with around 800 million annual active consumers, and it captures close to 50% of all incremental consumption in China. It commands ~60% online gross merchandise volume (GMV) share, over 70% revenue share, and over 90% of eCommerce profit share. Online represents 25% of total retail sales in China and is poised to keep growing in coming years. As evidenced by a better than 96% retention rate among users who spend over 2000 RMB per annum and average same-consumer spending growth at 32% CAGR over the last five years, consumers love Alibaba's platforms. In addition to growth in online GMV, Alibaba's take rate has room to increase as they deliver value for their merchants through sales, branding, marketing and distribution, digital customer relationship management (CRM), inventory management, and information technology. Alibaba's take rate has increased from 2.5% six years ago to 4.5%, but it is still much lower than Amazon's low teens take rate.

Beyond its core e-commerce platform that generates a 70% EBITDA margin, its Aliyun Cloud business is a key value driver. The Chinese cloud market is in hyper-growth mode given the low penetration of cloud solutions. Alibaba is the most significant player in the space with ~45% market share (3x larger than the next competitor). Aliyun's revenue has grown at 80% CAGR in the last five years, and its cloud offering has been battle-tested and optimized internally for its own businesses. The company has been investing in its salesforce, full stack of service offerings, and vertical-specific solutions since 2009.

At a \$10 billion revenue run rate, Aliyun has finally turned profitable and is poised to become an increasingly significant NAV component.

Alibaba has long been a market darling, but has recently lost favor for two key reasons:

1. China regulatory headwinds: The last-minute cancellation of Ant Group's IPO and the evolving anti-monopoly regulations for platform economies have hurt sentiment (and the stock price) a lot more than our intrinsic estimate of long-term value.
  - a. Ant Financial: In most jurisdictions, a fintech business the size of Ant with a \$350 billion loan book growing at 60% CAGR would be heavily regulated. The previously lax oversight in China before the scale of this business came to light during the IPO process is being tightened. Capital requirements, PBOC regulatory oversight, and many restrictions being put in place will hurt Ant's growth, margins, and valuation multiples. Our valuation is more than 50% lower than the rumored IPO valuation, and we believe it adequately captures the downside risk at Ant. Importantly, Alibaba's 33% stake in Ant comprises just 5% of Alibaba's value.
  - b. Anti-monopoly reforms aim to maintain orderly competition and quash practices like exclusive sales arrangements, selling below cost, and price discrimination. While Alibaba, being the behemoth in this space, is portrayed as the main target of these reforms, these regulations apply to all platform economies, including Pinduoduo, Meituan, Tencent, Didi, Baidu, etc. It is hard to quantify the impact, but we do not believe these regulations are aimed to cap market share or break up these platforms. These companies are national champions at the frontier of technological innovation (a priority for Beijing). The company has generated a considerable consumer surplus, millions of jobs and are critical enablers for millions of small and mid-size enterprises.
2. Competition: Platforms like Meituan and Pinduoduo have demonstrated explosive growth in social e-commerce (community group buying), especially in lower-tier cities. Admittedly, Alibaba is late to this party and is now investing heavily to establish a foothold in this space. They have all the key ingredients to win, given its massive user base (~800 million annual active users), market-leading supply chain and merchant base (4 million paying merchants), best-in-class logistics network (Cainiao), and strong capital position. The investments in newly launched initiatives like Taobao Deals and Taobao Groceries will negatively impact margins in the short term. Notably, the underlying EBITDA margin for Alibaba's core China eCommerce business (excluding these investments) is stable at around 70%.














Interestingly, PDD and Meituan get a free pass from the market despite their cash burn strategy because they are in the hyper-growth stage. However, Alibaba gets penalized for doing something similar for its seed businesses (like Taobao Deals, Taobao Live, and Taobao Groceries). In our view, what truly matters is any given platform's ability to convert GMV into FCF, and on that metric, Alibaba is best in class. Alibaba has a demonstrated track record of seeding new businesses and getting them to scale and profitability. Both the Aliyun Cloud and Cainiao businesses have now reached the profitability stage (at the operating cash flow level for Cainiao) after ten years of investments.











In April, Alibaba was fined \$2.8 billion by anti-trust regulators for abusing its dominant position in domestic online retail since 2015. The fine is equivalent to about 4% of Alibaba's 2019 China revenue and less than 0.5% of its market capitalization. Management doesn't expect any material impact on GMV as merchants already operate on multiple platforms, and Alibaba's huge customer base, with an average \$1400 annual customer spend, will retain merchants. According to the regulator, in 2019, Alibaba accounted for 71% of the top ten online retail platform service revenue and 62% of the entire online retail market's GMV. According to broker research, Alibaba captured 96% of the e-commerce profit pool in China in 2019 and is expected to have more than 80% market share in 2024. Merchants are highly dependent on Alibaba's platform. According to the regulator, Alibaba's platform has a strong network and lock-in effect on the merchants. The average consumption level far exceeds that of other competing platforms, and Alibaba's consumers are sticky, with a customer retention rate of 98%.

In addition to the core China eCommerce and Aliyun Cloud businesses discussed above, Alibaba also owns 63% in Cainiao (largest logistics platform in China), 73% in Ele.me (that competes with Meituan), 83% in Lazada (that competes with Shopee / Sea Limited), 75% in Sunart (largest hypermarket operator in China) and has about \$100 billion in cash and investment securities. Excluding these, we paid 13.5X FCF for the core China eCommerce business, which we expect will continue compounding at a mid-to-high teens rate in the short to medium term. Alibaba is one of the few internet companies that cares about valuation and shares a sum of the parts (SOTP) framework with the market (see charts below). Given the big difference between price and NAV, it is noteworthy that the company increased its buyback authorization from six to ten billion dollars in Dec 2020.

## Valuation Framework

CORE COMMERCE					
MARKETPLACE-BASED CORE COMMERCE	LAZADA	LOCAL SERVICES	NEW RETAIL	LOGISTICS	IMPORTS
					
METRICS					
No.1 Online Retail Marketplace <sup>(1)</sup> No.1 Online Wholesale Marketplaces <sup>(2)</sup> No.1 Online B2C Export Marketplace <sup>(3)</sup>  <b>RMB201 Bn (US\$29 Bn)</b> LTM Adjusted EBITA	Leading International Retail Marketplace  <b>80 Mn+ 100 Mn+</b> AAC <sup>(4)</sup> MAU <sup>(5)</sup>	Leading Local Consumer Service Platform  <b>290 Mn</b> AAC <sup>(6)</sup>	Leading New Retail Marketplace  <b>32%</b> SSSG <sup>(7)</sup> <b>65%</b> Online % of GMV <sup>(8)</sup>	Leading Digital Logistics Platform  <b>40 Bn+</b> Digitalized Packages <sup>(9)</sup> <b>4 Mn+</b> Daily Cross Border Packages <sup>(10)</sup>	No.1 Online Cross Border Marketplace <sup>(3)</sup>  <b>40%+</b> YoY Growth in GMV <sup>(11)</sup>
VALUATION COMPARISON PEERS					
				Leading logistics data technology company with no comparable peers	
EV/EBITDA 35-40x, 2021 P/GMV 1.5-2.5x, 2021	P/GMV 1-1.5x, 2021	P/S 5-10x, 2021 EV/EBITDA 25-35x, 2022	P/E 35-40x, 2021 P/S 0.7-1x, 2021		P/E 35-45x, 2021

## Valuation Framework

CORE COMMERCE		CLOUD COMPUTING	DIGITAL MEDIA & ENTERTAINMENT	INNOVATION INITIATIVES & OTHERS	INVESTMENT IN TECHFIN	STRATEGIC INVESTMENTS
						
REVENUE AND METRICS FOR THE LTM ENDED JUNE 30, 2020						
<b>RMB470 Bn</b> Revenue	<b>RMB176 Bn</b> Adjusted EBITA	<b>RMB45 Bn</b> Revenue	<b>60%</b> YoY	<b>52%</b> Paying Subscribers YoY <sup>(3)</sup>	<b>~90 Mn</b> Amap DAU <sup>(4)</sup>	<b>100 Mn+</b> DingTalk DAU <sup>(5)</sup>
<b>RMB7.3 Tn</b> Alibaba Digital Economy GMV <sup>(1)</sup>	<b>742 Mn</b> AAC <sup>(2)</sup>	Expected To Turn Profitable Within FY21				
VALUATION COMPARISON PEERS <sup>(6)</sup>						
						
E-commerce EV/EBITDA 35-40x, 2021 P/GMV 1.5-2.5x, 2021	SOTP/DCF DCF	P/S 10-15x, 2021 EV/EBITDA 35-40x, 2021	SOTP/DCF	DCF	VALUATION	VALUATION: US\$45 Bn <sup>(7)</sup>

Source: Alibaba Investor Day Slides

JOYY, a global video-based social media platform, is another new investment we initiated in the quarter. JOYY has two main segments: YY Live, live streaming in China, and BIGO, which focuses on overseas markets. The company caught our attention after it reached an agreement to sell YY Live to Baidu for US\$3.6 billion. Its share price initially reacted positively to this move, but a day later, Muddy Waters published a short report accusing 90% of YY Live as fraudulent, driving down the share price. The company has refuted the short report, committed to paying more dividends, and is executing a \$300 million share buyback program. After doing some more work, we got comfortable with YY Live and the remaining overseas BIGO business. Cash and cash equivalents (including proceeds from the sale of the YY business to Baidu) accounted for over 80% of the market capitalization of JOYY at certain times in the quarter. JOYY's remaining overseas business BIGO, which grew over 100% in 2020 and is already larger than the domestic YY Live business, turned cash flow positive in 2020. This business was available for only 0.5x revenue.

The two most important apps within BIGO are the overseas live streaming platform BIGO Live and the short video platform Likee. BIGO Live alone represents around 95% of total BIGO revenue and is a top 10 grossing app worldwide for non-game categories. While the entire BIGO business just turned cash flow positive in Q3 2020, BIGO Live has been making over 20% operating margins. The losses were caused by Likee, which is spending aggressively to acquire users and drive adoption. In Q4 2020, Likee monthly active users (MAU) were growing at 119% YoY on a like for like basis. Likee has more than four times the MAU of BIGO Live and could become a mid to long-term revenue driver when monetization ramps up.

Besides the business prospects and attractive valuation, we like our management partners in JOYY, who have demonstrated a good track record of capital allocation. In addition to selling YY Live to Baidu, management unlocked value for shareholders when it incubated Huya, the leading game-related live streaming platform in China, in 2018 and subsequently sold a controlling stake to Tencent in 2020. JOYY is also one of the few Chinese internet companies that pays dividends. In February, YY Live's sale was substantially completed, and JOYY has already received around \$2 billion from Baidu. When the deal closes in 2021, management can explore more dividends and share buybacks to maximize shareholder value, driving the share price closer to our appraisal.

## Performance Review

1Q21		
	Contribution to Portfolio Return (%)	Total Return (%)
<b>Top Five</b>		
China Lesso	+1.44	+38
Baidu	+1.36	+4
CK Hutchison	+0.95	+14
Trip.com*	+0.86	+30
Hyundai Mobis	+0.78	+13
<b>Bottom Five</b>		
Jollibee	-0.71	-11
WH Group	-0.11	-3
Undisclosed	-0.08	-14
JOYY	-0.07	+5
Alibaba Group	-0.07	-3

\*sold in 1Q21

### TOP PERFORMERS:

**China Lesso**—the largest plastic pipe manufacturer in China, was the top contributor for the quarter. Despite the pandemic that caused the company's sales to decline double digits in the first quarter of 2020, China Lesso grew full-year revenue by 7%, and plastic pipe volume in the second half grew 10%. Profit grew even faster due to China Lesso's pricing power and its ability to pass raw material cost inflation onto customers. Full-year net profits were up 24% YoY, and dividends declared were also up 25% YoY. The management team is optimistic about the outlook for 2021. The company stocked up inventory at lower costs, which should provide a cost advantage. End demand remains strong, with the company's production running at full capacity in March. China Lesso is confident in achieving its usual double-digit growth target this year. While the share price has gone up materially since we first bought it, so has our appraisal for the business, and we believe China Lesso is still attractively priced today, at less than 12x earnings.

**Baidu**—the dominant AI company in China, was a contributor for the quarter. Baidu reported fourth-quarter results ahead of market expectations. The advertising business has seen a gradual recovery compared to the first half of the year. A key area of outperformance was the non-advertising revenue, which grew 52% YoY and accounted for 18% of Baidu Core revenues. The total addressable market value of Baidu's non-advertising business (ex-autonomous driving) is 10x the size of online advertising, and Baidu expects the non-advertising business to grow three times faster than the online marketing business. The recent YY Live acquisition should help boost the non-advertising business. Baidu's cloud business grew 67% YoY in the quarter with an annualized run rate of US\$2.0 billion. Fourth-quarter growth in cloud revenue accelerated relative to the third quarter, which grew 41% YoY. Baidu also made progress in Apollo, the company's autonomous driving platform. Apollo was granted the first driverless testing permit and received permission to begin commercialized autonomous robotaxi operations, the first in China. Baidu entered into an EV joint venture with automotive maker Geely, which could accelerate Apollo's adoption in the industry. In March, Baidu completed a secondary listing in Hong Kong, hedging any potential risks from a forced de-listing in the US. We believe the share price weakness resulting from the previously mentioned forced liquidation was entirely unrelated to Baidu's fundamentals. We took the opportunity to add to our investment at a significant discount to the price achieved through our sales just a few weeks before.

**CK Hutchison**—a conglomerate of telecommunications, health & beauty, infrastructure, global ports, and energy, was a contributor for the quarter. COVID unavoidably impacted CK Hutchison's operations across the globe in 2020. Full-year revenues were down 8% YoY, and net profits were down 27% YoY. However, compared to the first half, there was a strong recovery in the second half of 2020. Retail divisions, helped by its Online plus Offline initiatives, delivered EBITDA growth of 12% YoY in the second half compared to an EBITDA decline of 43% in the first half. Telecom operations have also achieved a narrowing decline in EBITDA in the second half, despite the drop in roaming fees in 2020. The massive value-accretive tower sale, first announced in November 2020, is progressing according to plan. Close to 30% of the total deal proceeds have already been received, and the remaining transaction is expected to close in 2021. The merger between Husky and Cenovus Energy closed in January. CK Hutchison now owns around 17% of the combined company, which has a larger scale, lower production cost, and a more promising outlook. Although CK Hutchison's profits for 2020 were lower, the underlying FCF was up 29% YoY, primarily helped by working capital improvement. Leverage went down from 25% in the middle of 2020 to 22% at year-end. We were

encouraged to see the on-market share buyback right after the earnings release and expect more repurchase activity in 2021.

**Trip.com**—the largest online travel agency in China, was a top contributor for the quarter. We initiated this investment in 2019 when the stock price was under pressure due to social unrest in Hong Kong (which led to a slowdown in visitations from the mainland), noise around forced de-listing of Chinese ADRs, and overhang from Baidu selling its stake. We added to our investment in 2020 when the company faced further pressure due to COVID-induced travel restrictions globally. About 35% of Trip.com's pre-COVID revenue came from international travel, which ground to a halt due to COVID. Despite revenue down 49% YoY in 2020, the company managed well and reported positive non-GAAP operating profit thanks to its attractive business model. The company is a dominant player in a high barrier to entry market. It operates on an 80% gross margin, has a highly variable cost structure with minimal capital intensity, and enjoys a negative working capital cycle. Over the last 12 months, Trip.com further solidified its competitive position in the domestic market and emerged even stronger. With COVID largely contained in China, domestic travel is expected to grow in 2021 from pre-COVID levels (2019), and Trip.com is gaining share. At the same time, the optimism on vaccination rollout and eventual easing of cross-border travel restrictions (which is probably two to three quarters away) led to a sharp recovery in Trip.com's share price. We exited our position as it approached our value.

**Hyundai Mobis**—the Korean auto parts maker, was a contributor for the quarter. Its fourth-quarter results were in line with our expectations. Hyundai Mobis' electrification business continues to be the bright spot, posting +46.5% YoY growth backed by Hyundai Motor and Kia Motors' strong xEV production growth. The sales decline for module and core parts was less severe than the production decline because of favorable mix change towards SUV and premium segments. Its after-sales parts business, a high margin cash-cow business, has not fully recovered to pre-COVID levels due to weak demand and unfavorable FX. During the quarter, Hyundai Motor Group (HMG) announced multiple deals, including Mobis's acquisition of Hyundai Autron's semiconductor business at a mid-teen earnings multiple. We believe this deal is another indicator that Mobis is taking the Hyundai Group's core role in developing EV and mobility-related hardware. Many news articles highlighted the potential tie-up between Apple and HMG, and the share prices for all the related affiliates, including Mobis, have appreciated sharply. HMG is a global leading EV producer with a vertically integrated supply chain and accumulated know-how and experience on EV, making the group a great candidate for future

collaboration with Apple and other big tech companies. We trimmed our position at the peak of the excitement, but added some when the enthusiasm for the deal faded away and the price became more attractive relative to our value again. HMG under ES Chung has shown significant improvement in operations, as well as capital allocation. As part of the 3-year program announced in 2018, Mobis bought back around \$210 million of shares during the fourth quarter and announced a further \$220 million buyback in the first quarter.

#### **BOTTOM PERFORMERS:**

**Jollibee**—the largest restaurant company in the Philippines, was a detractor for the quarter after being one of the top contributors in 2020 and 4Q20. The company is still struggling with COVID and various lockdown measures, with its system-wide sales down by 32% YoY in the fourth quarter last year, unimproved from the previous quarter. However, we were encouraged to see its operating profit excluding business transformation costs and FCF turning positive. The business transformation program (BT program) announced in May 2020, costing 6.7 billion pesos, included rationalizing underperforming stores and the supply chain and rightsizing the labor force in stores and headquarters. The company completed the BT program in 2020, closing four commissaries in the Philippines and 486 stores in 2020. We are already seeing improved profitability and cash flow generation in the fourth quarter. Jollibee expects the BT program to save around 2.6 billion pesos per year and be realized in full this year, achieving a payback of about two years.

Jollibee also accelerated the restructuring of Smashburger and Coffee Bean & Tea Leaf. Both have been loss generating since their acquisition in 2018 and 2019, dragging down the group's profitability. The market has assigned negative values for these businesses. However, they are now near breakeven levels, and management expects them to turn profitable in 2021. Jollibee's domestic market continues to suffer from COVID, but its operating margin will be higher thanks to the BT program once it recovers to pre-pandemic levels. In contrast, Jollibee's overseas business is already back to pre-COVID levels. The operating environment still largely depends on how the COVID situation develops. Still, we continue to like the company's focus on return on invested capital (ROIC) and the long runway for profitable growth opportunities, especially overseas.

**WH Group**—the largest pork producer and marketer globally, was a slight detractor for the quarter. The company reported weak fourth quarter and 2020 results below consensus estimates. While the China business segment delivered strong operating

profit growth of 19%, reaching record highs (as COVID was contained quickly in China), this was more than offset by an over 55% decline in operating profit from its US Smithfield business. The company rightly prioritized its employees' health and safety and that of the US food supply, incurring over \$800 million in COVID-related expenses in the US on PPE, on-demand testing, barriers for social distancing, salary guarantees for at-risk older employees, and responsibility bonuses for employees in the plants. The disruption in the supply chain led to hogs' oversupply as slaughter-house utilization declined to almost 30% during peak COVID months, resulting in losses in US hog production. The higher-margin packaged meat segment was also negatively impacted as many foodservice channels (restaurants accounted for 30% of sales) were closed during COVID lockdowns.

We believe the Smithfield business's normalized earnings power is closer to \$1 billion operating profit vs. the \$415 million reported in 2020 due primarily to one-off costs. With COVID costs expected to decline by \$600-650 million in 2021, Smithfield is likely to produce over 100% operating profit growth YoY. At the same time, the China business should grow at a mid-to-high single-digit rate in 2021. Despite a dominant market position, strong brands, and solid growth outlook, WH Group is trading at 8.5x earnings. Taking the China-listed Shuanghui business at market, Smithfield is being valued at negative \$2 billion. In other words, the market is paying us \$2 billion to own a business that is expected to generate \$1 billion in operating profits! The balance sheet and cash flow generation remain strong, with operating cash flow up 61% YoY in 2020. The board maintained its historical payout ratio leading to a decline in absolute dividends, which was disappointing. However, we like the prospects of strong earnings growth and dividend recovery at oversold valuations and added to our position.



**Outlook**

The price-to-value (P/V) ratio of the portfolio remains attractive in the mid-60s%, and the Fund is fully invested. We believe undervalued Asian companies and currencies are set to outperform the US markets as they did in 2020 and begin to narrow the historic dispersion between value and growth.

This year, prospects for economic recovery have improved with the approval of several COVID vaccines and the accelerating rollout of mass vaccination campaigns. While the world is facing another spike in COVID infections, Asia stands out with its ability to control the pandemic most effectively. Asia will continue to drive global economic growth, and we are optimistic about the opportunity set and the portfolio's positioning.

We thank you for your continued faith, trust, and partnership during this highly volatile environment.

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