Samir Mehta, JOHCM Asia ex Japan Fund

A VIEW FROM ASIA

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Burgeon – begin to grow or increase rapidly; flourish

A crisis invariably accelerates trends already in motion. Every business has already been, or is in the process of being, reshaped by the forces of technology, the internet and online commerce. From the very initial stages, industries such as books, music, media, entertainment and online games were destined for almost an exclusively digital existence (will we ever go back to cassettes, vinyl records, or DVDs?). Other industries are trickier. We do need a physical manifestation of some products (think furniture, toothpaste or food). These industries are undergoing a radical transformation of business processes driven by technology. A complete rethink and redesign was called for. Covid-19 has sped up the timetable for disintermediation or restructuring of the existing chain of ordering, purchasing, manufacturing, logistics, warehousing, distribution and consumption. What we witness today is in many instances radically different from the established processes we were accustomed to.

It's difficult to think of any silver linings coming from Covid-19. The only saving grace was its timing. Imagine if the pandemic had hit before the technological advances of computing power, broadband capacity, smartphones and devices, payment systems, internet cloud computing, artificial intelligence, machine learning, security and if the internet had not developed to the extent it has.

I would even add monetary liquidity and low interest rates to this mix. You might think I'm paying a backhanded compliment to a futuristic Federal Reserve. After all, it's thanks to the abundant availability of cheap capital thrown toward crazy cash-burning ideas (which in some cases have blossomed into multi-billion dollar businesses) that we now have tech companies serving the immediate and real need of consumers in lockdown. Others like WeWork and Luckin Coffee didn't make it, but do not fret – no doubt they too will be digitised in the form of fodder for a Netflix docudrama series soon.

Food delivery transformed

Amongst the several industries undergoing transformation, the one that fascinates me most is food delivery. Growing up in India, I was accustomed to the power of relationships and trust forged between neighbourhoods and their next door 'mom and pop' stores. Even in the 1980s and 1990s, a pharmacist would deliver (via a bicycle courier) to your home, a strip of medicine which cost no more than \$1 - without any delivery charges. But no restaurant ever dreamt of delivering cooked food; restaurants were about the experience. Moreover, the better restaurants were popular and busy serving customers on premise. They had no appetite to cater to homes. Traditionally, a restaurant was setup with up to 15% space for the kitchen, while the rest of the space was for seating.

Therein lies the nemesis of the business model for restaurants – past preferences for physical presence and need for large and expensive space requirements. Through that lens, it's easy to visualise how profitable a restaurant might be without seating space, only if they could deliver. Yet for years, almost no business model around delivering food (except pizza delivery – which is a morsel for another missive) had profitably adjusted to a delivery paradigm. The restaurant industry needed an intermediary to force that change.

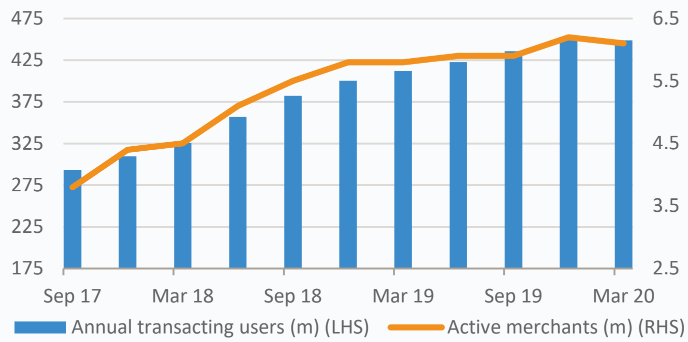
Things have changed dramatically, particularly in China. Usually the US is a beacon for spotting and learning about new trends and emerging business models. But Meituan Dianping (MD – owned in our portfolio) is an example of a firm that might hold lessons for others overseas.

Platforms and aggregators

MD can be best described as an aggregator. Learning from Ben Thompson of Stratecherry, who conceptualised 'the Aggregation Theory', it's educational to learn the difference between two types of entities – platforms and aggregators. Bill Gates is said to have remarked, 'a **platform** is when the economic value of everybody that uses it exceeds the value of the company that creates it.' Hence a platform is 'a facilitator', like Microsoft Windows or Amazon AWS. On the other hand, Thompson defines an **aggregator** as an entity 'who at scale, intermediates and controls the relationships with its users.' Both have network effects (incremental users enhance the value of the network), but for aggregators consumers are a priority and customer experience is the critical differentiator. The best examples are probably Amazon within retail and Facebook within social media.

MD was founded in 2003 as a site for user-generated content, primarily restaurant reviews. Over time it started to connect users to restaurants and progressed to deliver food to consumers by building an owned delivery network. Subsequently it has provided connectivity to and bookings for restaurants, hotels and several hyperlocal services such as wedding planners, florists, beauty salons and the like.

Provide value and customers flock to your service



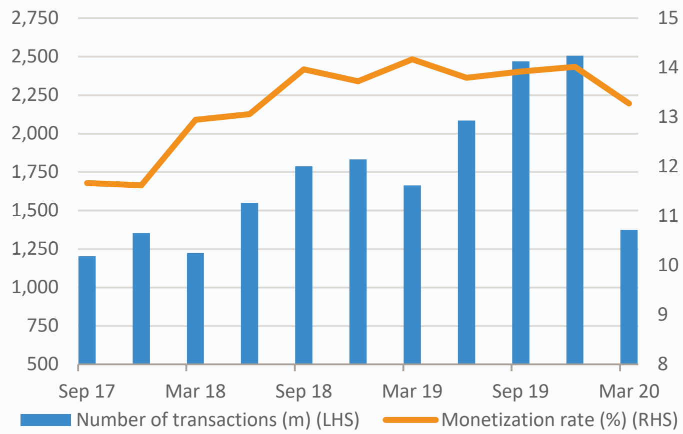
Source: Bernstein Research; Company filings.

With a vast geography and different regional preferences across the country, any successful business in China has to grapple with several hurdles. It helps that the underlying telecom network in China is robust, while Tencent, as a 20% shareholder in MD, provides assistance on the payments front as well as incremental user traffic. Yet, to develop from a pure user-generated-content platform to become the dominant (61% market share vs Ele.me owned by Alibaba with 36% market share) and most efficient aggregator in food delivery is a remarkable achievement.

The variables that it can scale are multiple:

1. Number of customers (unlikely to grow rapidly from here)
2. Daily active consumers (this can grow steadily over time as habits solidify)
3. Number of orders per active consumer (this, too, can grow)
4. Value of average order per day (may rise marginally)
5. Take rate or commission from merchants (depends on competition)
6. Number of merchants (might reduce after the downturn)
7. Persistence and exclusivity of merchants (MD provides cloud ERP, supply chain assistance, payment options and more)
8. Number of riders (own network versus third party network)
9. Optimisation of rider network (MD is the largest intra-city delivery network)

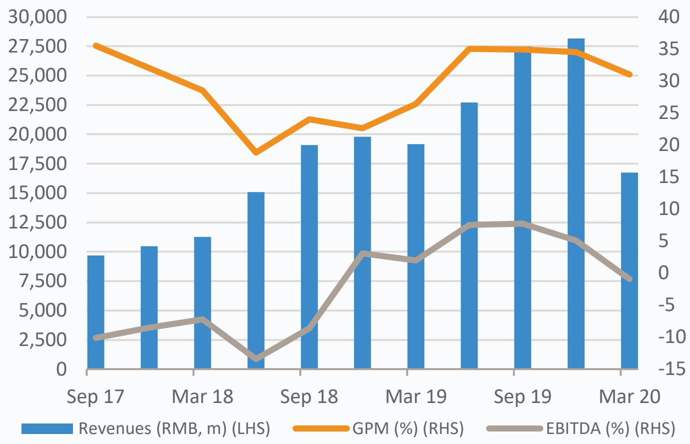
Sheer complexity managed almost flawlessly



Source: Bernstein Research; Company filings.

As the company has scaled from 2017 to 2020, blended revenue per order has risen approximately 20%, from Rmb 5.1 to Rmb 6.6, while the rider cost per order has stayed flattish around Rmb 4.6. MD achieved 2.5bn transactions per quarter in 2019, with a goal of reaching 100m transactions a day or 3bn transactions per quarter – which I think is possible by 2021. Just pause to put that in perspective. If MD can consistently achieve 100m transactions a day and is able to optimise its costs a bit and boost revenues per order over time, the benefits of scale are staggering. Q1 2020 has temporarily knocked the company off course, but the graph right shows the progression in revenues and margins as it moved from 2018 into 2019.

Incentives, losses and an explosion in profits



Source: Bloomberg.

Yet, like every other business in China, MD's business also demands vigilance. The hyper-competitive nature of that country is evident in the proliferation of several 'super apps', such as Tencent, Alibaba, Pinduoduo, Bytedance and Kuaishou. I vividly remember how Weibo used to be the undisputed leader in advertising and was unceremoniously ousted from its perch by several new forms of social apps (I owned the stock in the portfolio and was late at recognising this shift). Competition is always just a click away (subsidies and incentives for customers or riders) and so too is the possibility of regulations (riders and labour laws; food safety; disposable packaging).

Having solidified its leadership in 2019, this pandemic has proven that MD has been able to thrive through some of the toughest challenges and provide a much needed service. It has acted as a partner to restaurants, riders and customers in assisting and innovating when needed. The company has sacrificed margins and profits in the near-term but, in my view, strengthened its long-term position.

Once formed, habits take a long time to change. But younger generations grow up on some version of technology or ways of doing business, and once that trend is in place even the older, tech neophyte generation adapts. I can vouch for that – even I have managed to order food in the past couple of months, a prospect that should warm the hearts of aggregators like Meituan Dianping.

JOHCM Asia Ex Japan Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	31.05.20	31.05.19	31.05.18	31.05.17	31.05.16
A USD Class	5.95	-10.51	0.46	22.47	-11.61
Benchmark	-0.51	-11.00	17.09	28.13	-17.34
Relative return	6.49	0.55	-14.21	-4.41	6.92

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 31 May 2020. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.