INVESTMENT MANAGER COMMENTARY

Q3 2021

October 2021 | Mahomed Ibrahim

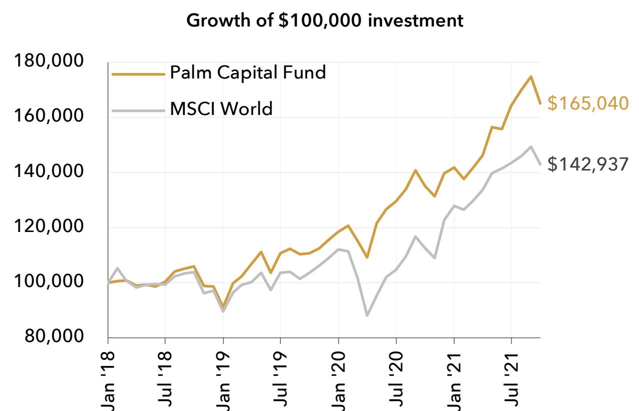
At Palm Capital, we look for businesses with durable competitive advantages run by exceptional managers. We patiently wait to invest when their prices are less than we think they are worth, aiming to benefit as they compound economic value over time. We only sell if fundamentals deteriorate, or we find others offering potentially better after-tax returns.

Our performance

Over the three months ending 30 June 2021 our portfolio increased by 0.5% after management fees & trading expenses.

Since we started, three and a half years ago, our portfolio has returned 14.3% per annum after management fees & expenses. We have outperformed the MSCI World Index by 3.9% per annum while holding better businesses and buying them below their worth.

Period ending 30 June 2021	Our Return$^{\lambda}$	MSCI World	Out-performance
Quarter	+0.5%	-0.4%	+4.7%
1 year	+22.2%	+27.0%	-3.8%
Since inception (annualised)	+14.3%	+10.0%	+3.9%



Why we don't invest in China

Over the past few months, political and regulatory turmoil has caused sharp collapses in the share prices of certain Chinese companies and clients have been increasingly asking us why we don't invest in the country.

When we've answered this question in the past, we've found it useful to use the example of Alibaba. On face value, Alibaba appears to be a phenomenal business. It is the world's largest e-commerce company[1] in the world's fastest-growing major economy. The marketplaces it operates are the most highly visited in China pointing to seemingly unassailable network effect advantages. These are solidified by its substantial investments and partnerships in an unrivalled logistics network. The company also has a crucial early mover advantage in cloud computing giving it a scale advantage that may quickly take it out of reach of competitors. And relative to its growth, the share often appears to be cheap.

However, if you dig beneath the surface, the investment case becomes less clear.

Alibaba's accounting is questionable and murky, and its disclosure is poor. The company's corporate structure is an intricate web of over 1,200 separate entities. And a staggering 890 of these entities were formed or acquired in the three years ending 2020[2]. A large portion of its revenue growth each year is from consolidation of acquisitions with little disclosure of just how much. Significant entities appear and disappear from the company's disclosures from year to year with no explanation. And almost three-quarters of the company's total retained earnings since its 2014 IPO is from asset write ups with little explanation to back these up.

Yet for all this complexity, its annual audit fee is about the same amount as that of a small, listed company in the US. Add to this the fact that the company's auditor and its audit work is not inspected by the Public Company Accounting Oversight Board - as other listed companies are – and this raises some serious worries about its accounting in a country where accounting fraud is common.

[1] Measured by gross merchandise value – or the sales facilitated on its various platforms
[2] The last time Alibaba disclosed these numbers

Alibaba's corporate governance is also shoddy. Because foreigners are banned from owning companies in sensitive sectors such as defense and technology in China, Alibaba's shares do not represent ownership over the company's operations, but rather contractual relationships with the founders who own the company in a complex piece of financial engineering and legally untested structure known as a 'Variable Interest Entity' (VIE).

These contracts are not approved by the Chinese government. Here is an excerpt from the company's annual statements warning of this:

"If the PRC government deems that the contractual arrangements… do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties, or be forced to relinquish our interests in those operations."

And their enforcement is questionable. Here is another excerpt highlights this:

"…these contracts would be interpreted in accordance with PRC law and any disputes would be resolved in accordance with PRC legal procedures. The legal system in the PRC is not as developed as in some other jurisdictions... Moreover, there are very few precedents and little formal guidance as to how contractual arrangements in the context of a variable interest entity should be interpreted or enforced under PRC law."

The other consequence of this structure is that owners of Alibaba's shares have little say in the operation of the company. They can't elect directors to the board and have no recourse if the directors do something untoward. For example, in 2011, Alibaba transferred ownership of its payment arm, Alipay, to a company mostly owned by its founder without shareholder approval. This is worrying for a business that is open about its directors being potentially misaligned with shareholders. Again, another excerpt explaining this:

"The equityholders, directors and executive officers of the variable interest entities may have potential conflicts of interest with our company."

These issues of accounting integrity and weak corporate governance aren't unique to Alibaba but also plague most Chinese shares. Alibaba is an easy example to use as it is so well known.

In addition to these risks, we also highlight to clients how different China is compared to Developed Markets. Because it is a Communist country, private ownership is a grey area, regulatory frameworks are complicated, decision-making is opaque, and policy changes are unpredictable. The government is not afraid to shut down large and profitable industries to achieve social and political goals.

Recent actions by the government have brought some of these risks to the forefront of investors' minds. Here is a timeline of these:

2 November 2020:	Regulators suspend the $37b IPO of Ant Financial, China's largest payments platform
12 April 2021:	China's Central Bank imposes a restructuring of Ant Group
3 July 2021:	Regulators launch an investigation into data security practices of ride-hailing company Didi
24 July 2021:	Education Ministry bans academic tuition groups ($140b industry) from making profit & using VIE structures
11 August 2021:	Anti-corruption watchdog discourages post-work drinking & Ministry of Culture bans 'harmful' karaoke songs
17 August 2021:	Regulators ban internet platforms from wide array of behaviour deemed to harm market competition
20 August 2021:	Financial regulators order Evergrande, China's second-largest property developer, to resolve its debt issues
27 August 2021:	Regulators ban US IPOs for data-heavy tech firms
30 August 2021:	Regulators ban children from playing video games for more than 3 hours per week

Notwithstanding the risks we have highlighted, many investment managers still advocate investing in China. Their arguments are centered on four points:

1. You can't afford to ignore such a large economy that is growing so quickly.
2. Regulatory headwinds are not unique to Chinese shares but also to many of the technology companies in the developed world.
3. The Chinese government is interested in attracting capital, so won't disrupt VIE structures or capital markets.
4. The regulatory actions being taken will position the Chinese economy for stronger growth in the long run.

Looking through the lens of our investment philosophy, we see holes in all these arguments.

For the first, there is a strong assumption that China's economy continues to grow as it has in the past. As we have no expertise in macroeconomics, this isn't an argument we can rely on. There are as many points for as there are against China's continued growth[3]. It's also worthwhile pointing out that there is no correlation between the growth of an economy and the country's stock market.

Furthermore, our investment approach is more likely to turn up investment opportunities in more mature countries than in nascent ones. This is because in more mature countries, you're more likely to find niche industries with monopolistic characteristics that allow companies within those industries to compound in value over time. And because China's market economy is young, consumer tastes and preferences and the needs of businesses are still developing. The existing moats of companies are therefore not as strong as those in the developed world.

Our last point against the first argument is that the most important determinant of returns is the price an investor pays for a business relative to its value, regardless of its growth. Buying shares of fast-growing companies doesn't always translate into high returns while shares of slow-growing companies bought at the right price can.

With regards to the second and third arguments, while it is true that a few of the companies we own are also under a cloud of regulatory uncertainty, regulation in China is more dictatorial and unpredictable than that in the developed world. There is no way for companies to contribute towards or appeal any changes in regulation. And as we witnessed recently with the government effectively shutting down the private education industry, it's clear that they will never put investor returns or the needs of a business before the needs of society or the strength of the party. Changes in the developed world are not as heavy handed, as sudden, or as extreme.

It's also worth remembering that China arguably does not need capital flows as it has a massive current account surplus. While it may need skills, it does not need foreign stock market investors.

The fourth argument does make intuitive sense, but we aren't entirely convinced. While the Chinese Communist Party has in the past done a remarkable job of steering the economy to achieve unparalleled growth, we can't be sure that its autocratic approach will continue to yield results. Not only is the increasing complexity of the economy making it more difficult to navigate, but the implementation of inflexible regulation that takes away choice and impinges on personal rights may well have adverse effects on the economy in the long run. With less freedom, there is less incentive to innovate and invest.

And there are always workarounds to bans that diminish their impact. For example, while the intention behind banning education is to ensure wealth does not influence academic outcomes, the very wealthy will still be able to hire one-on-one private tutors for their children.

Importantly, there is a major assumption underpinning all four arguments – that the Chinese Communist Party's policy objectives and policymaking approach under Xi Jinping have not changed compared to those of his predecessors in the 40 years prior. Of this we can't be sure either. Government has been playing a more active role in the economy, raising questions about a shift in policy away from a market economy. More importantly, the party's delays in responding to the recent Evergrande crisis seem to suggest that policymaking may also have changed. Having conviction in a view on this requires political expertise which we do not have.

So, in summary, poor accounting disclosures, weak corporate governance, and rigidity in the political system all create too much uncertainty for us to invest in China. There's a high chance of losing capital. We'd also like to point out that because the most important determinant of our investment return is the price we pay relative to its value, if we are patient enough, we could achieve the same or better returns by investing in less risky, more mature countries as we could in China.

Our activity over the quarter

We had a quiet quarter with very little trading over the period but did use the time to initiate research in two businesses. We have managed to invest in these subsequent to the quarter end and will summarise our investment thesis for each in our next commentary.

[3] China's ageing population, the slowdown in the property sector which accounts for 29% of GDP and the signs of a change in policies are all good arguments for a potential slowdown in growth

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