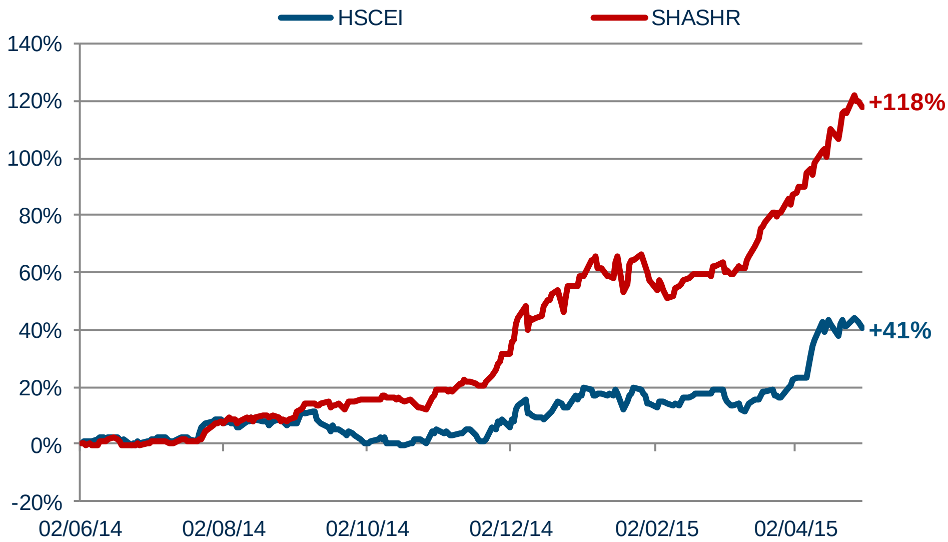
Mania Investing



Source: Bloomberg; since 01/06/2014

Since the Easter break, the Hong Kong stock exchange has been the subject of much interest. Markets that rise over +20% in 16 days with only one down day have a habit of doing this. The driver of this move is said to be the mainland investor...The Shanghai index has more than doubled since last July.

Recent months have seen exceptional market volatility. The HSCEI has rallied +23 percent in just 12 days. The Brazilian real has depreciated -23% in two months. Russian markets have rebounded +21% in the first 16 days of April.

Since the Easter break, the Hong Kong stock exchange has been the subject of much interest. Markets that rise over +20% in 16 days with only one down day have a habit of doing this. The driver of this move is said to be the mainland investor. The implementation of the Shanghai-Hong Kong Stock Connect, which we documented in last September's newsletter, was finally launched in November 2014. Up until recently though, the southbound quota was far below daily capacity. The Shanghai index has more than doubled since last July. Mainlanders didn't need to bother with H shares. A weak property market, a crackdown on trust products and some stimulative policies have seen excess capital move into the A-Share market fuelling the rally. It has quickly become the most expensive market in the region, provoking worries of a speculative bubble. On 28th March the Chinese authorities moved to encourage onshore money to move south to Hong Kong. $5bn of additional liquidity has obediently gone into Hong Kong from the mainland since . The government hopes to ease the upward pressure on Chinese listed companies by allowing progressively more money to flow southbound into Hong Kong. A very similar sequence of events happened in 2007 immediately prior to the GFC. It is this extra liquidity that has driven the Hong Kong stock market more than any change to the fundamental outlook that businesses face in China. Perversely we are continuing to see lacklustre GDP and import numbers and continued signals of weakness in corporate earnings reports.

We are agnostic about relative valuations of the two markets, the A/H share discount or the pent up demand for ownership of the companies that were only listed in Hong Kong, out of reach of mainland investors. Nor do we pretend to have strong insight into the immediate future path of A-Shares or the H-Shares. What we do find interesting is the slightly hysterical reaction of the market to this upward volatility. The rally in Hong Kong has been broad: Of the 50 stocks in the HSI just one is down over the month. Most commentary suggests that asset allocating fund managers are under-exposed. These moves are forcing benchmarked managers to chase the market for fear of missing out. In April, Morgan Stanley wrote to clients that "This means that investment strategies which might require several weeks to debate, plan and execute need instead to be acted on much faster – within a matter of days or even hours." Heady stuff indeed. Perhaps it is simply broker shock because of the length of time since the Hong Kong market last outperformed the rest of the world.

Investors are increasingly under pressure to get into the next big thing before asking too many questions. Internet stocks are a prime culprit. There is no doubt that the provision of fast and reliable internet access on affordable smartphones, combined

> *"What we do find interesting is the slightly hysterical reaction of the market to this upward volatility."*

with a consumers' willingness to use online resources has been truly transformational to markets emerging and otherwise. Already generations are not able to comprehend life without it. The substantial and fast paced success of a few leading companies in the internet space has accelerated a trend for investors to demand less for the risks they are taking and we are seeing traditional investors having to rush earlier and earlier so as not to miss out. Private equity houses are encroaching on the territory of the VC's, whilst traditional equity investors are increasingly investing pre-IPO. The natural result is that public equity investors are expected to swallow up ever bigger IPOs with their ever bigger valuations. When a chance to invest in the new new thing comes around, these investors are prepared to tolerate disadvantageous ownership and control structures (see Alibaba) for a chance of participation. The fact that traditionally most of the value at this point has been extracted by exiting investors is overlooked. We learnt at Matterhorn long ago not to buy anything that Brazilian private

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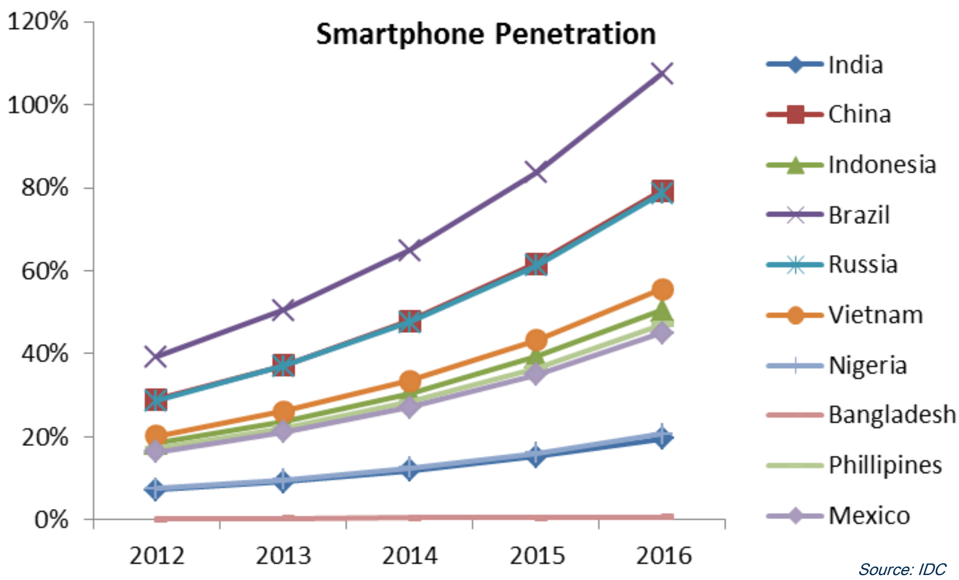
equity funds were peddling for example.

Excess liquidity and business model uncertainty wrought by the swift rise of the smart mobile device has meant that investors have no time to wait for profits or sustainability. Companies can merely demonstrate growth, not profitability to satisfy the street. Growth doesn't even need to be measured in revenues, subscribers will suffice . Who cares if they are spending or not, the company has a line to that potential customer in the future. This is creating massive wastage of investors' capital, a price war, funded by ever increasing flows of ultra-low cost capital. As the VC we met in India last year put it, QE funnelled through PE funds are providing a bigger stimulus for the Indian Middle Classes than anything the Congress party could ever dream of doing for the rural poor.

An example of this is found in the Chinese online travel market. Qunar, formerly an airline ticket meta-search portal, is shifting its business model to become an online travel agent. Revenues have grown +93% cagr over the last 4 years. The operating profit margin as a percentage of sales has fallen each year: -3.3%, -15.9%, -15.1%, -18%, -101%. They are getting less profitable as they grow. At last report, they have been able to enrol 32.1m hotel room nights per quarter onto their network. This has grown at nearly unimaginable pace. They have at best been using an aggressive system of discount vouchers which gives up the majority of their profit for the custom. There



Source: IDC

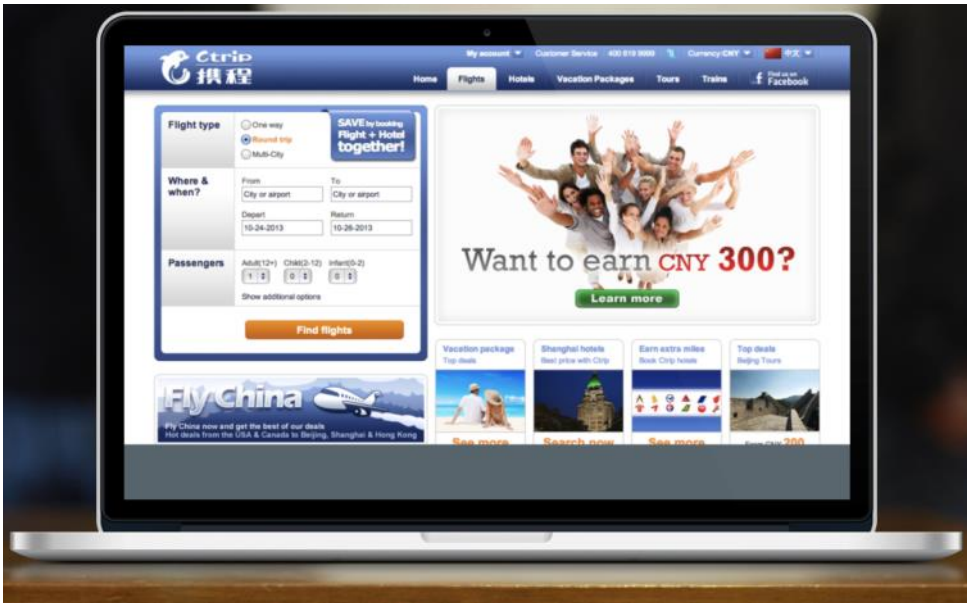
There is no doubt that the provision of fast and reliable internet access on affordable smartphones, combined with a consumers' willingness to use online resources has been truly transformational to markets emerging and otherwise.

are reports that many of the reported sales are not real. CTRIP, the incumbent, is being dragged in. Typically a 10-15% OPM business, reduced to losses as it is forced to compete. Internet companies are competing for traffic. Get the customer, worry about profitability later. Investors are tolerant.

Car rental / taxi-app's have tremendous potential. The customer wants a service that is easy, cheap and reliable. In order to retain business they are discounting fairs, funded seemingly by the shareholders.

The issue here is that the products are not significantly differentiated. The concepts are usually fairly simple and the ability to replicate relatively high. China is a breeding ground for replication. Customer loyalty can be easily challenged by give-away pricing. Car rental / taxi-app's have tremendous potential. The customer wants a service that is easy, cheap and reliable. In order to retain business they are discounting fairs, funded seemingly by the shareholders, and now even extending into auto leasing. Asset light is becoming a little heavier.

Search, e-commerce, classified portals, social media, etc have largely tended to a few dominant players. Eventually scale breeds scale. So what of the newcomers. It is not clear that they are trying to win with better service, i.e. with true disruption, rather than trying to win with a bigger tolerance of losses, fuelled by cheap and easy money. The only surety is that this is good for the EM consumer and bad for anyone who used to have a profitable business serving them before.



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Conclusion

With large amounts of capital chasing to get aboard the next story faster than anyone else, strong market moves forcing benchmark allocations, and huge volatility promising tantalising returns for a nimble trader. Yet returns through this behaviour are ephemeral. We maintain the maxim of value investing at the front of our minds: to avoid permanent loss of capital when markets get tougher.

The rush to get one over on the next investor, having to make ever greater assumptions of the future of these businesses, is going to force mistakes. There will no doubt be huge, well-earned successes, but in mania mode, we argue that in most cases the risk is high, the profitability uncertain and an investor is not left reliant on a constant long term earnings stream, rather a reliance on someone paying more for it than they did.

Sometimes future demand is an unrealistic extrapolation of current trends but more often than not future predictions of market growth are justified or even underestimated. There are many well documented examples to match McKinsey's 1980 predication that there might be at most 900,000 mobile subscribers in the US by 2000. The actual number was 109m. The problem is that the passage of time between now and the future throws up innumerable uncertainties, disruptive new comers, economic cycles etc that makes it unlikely you can pick a survivor now which won't be available to buy for considerably less in the interim.

It was famously said of the car industry at the beginning of the 20th century that it was a much better bet to short anything to do with horses than it was to try and pick a winner from the 100's of car producers operating at the time. Shorting organised retail in China has been a trade that has worked for years whilst the internet retailers slugged it out between them for dominance. Developing countries don't have a well-developed physical retail sector so it is even more vulnerable to the internet than in the west.

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