

Intelligent Investing: Wide-Moat Investing in Asian Equities

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Jon Xu, John Kum, and Nat Banyathipod, analysts at Amiral Gestion, joined Sid for a [LIVE session](#) at Wide-Moat Investing Summit 2019.

My philosophy is to invest in dominant niche businesses in Asia with pricing power that have significant reinvestment opportunities to earn high rates of returns on unlevered tangible equity relative to their cost of capital. The most important thing when I look for a wide moat is the predictability of this economic value added relative to other competitors and of the certainty of increasing revenues and profits reliably through economic cycles. Simply put, if I cannot predict the economic characteristics 5-10 years out, the business is in my “too hard” pile as time is finite and must be concentrated on great ideas only.

In 2013, I mailed a letter to Warren Buffett with an investment write-up on a 125 year old Japanese company that I judged to have a wide moat, a unique culture of creating “niche” products with high market shares and attractive reinvestment opportunities with limited capital employed. Ten days later, to my absolute surprise, I received a reply on my letter from Mr. Buffett writing “keep your eyes open!”. I was incredibly fortunate to have had this experience as studying the Berkshire partnership letters in my formative years had tremendously influenced my life. It reinforced my search for great businesses in Asia instead of cigar butts.

I focus my efforts in Asia as the region benefits from many of the world’s fastest growing economies, attractive demographics and more than half the world’s listed companies and growing. There is also limited competition for disciplined value investors in Asia relative to US and European markets. Over the years, I maintain a list of 70-80 wide-moat businesses in Asia that I track and add companies and remove companies diligently, if the moat shrinks or corporate governance disappoints. The key is to be disciplined on the purchase price and not look to Mr. Market as a predictor of value but as a moody friend to take advantage of short-term irrationality. Ideally, you want to own a portfolio of great businesses with huge pricing power but at discounted prices!

China offers a fertile hunting-ground to invest long-term in businesses with durable competitive advantages. It is a \$13 trillion economy, and growing at nearly 6.5%. This means China creates each year in incremental GDP the annual equivalent of Spain every 1.5 years, France and UK every three years, and Germany every 4.5 years! Chinese A-share domestic markets are also grossly inefficient because 80% of trading volume are contributed by retail investors who speculate rather than analyse fundamentals of businesses, creating significant disparity between stock price and intrinsic value. This creates huge opportunity.

Some examples of wide-moat companies in China are listed below:

Kweichow Moutai (600519 CH) is a \$170 billion market capitalization company with #1 consumer mind share entrenched in Chinese culture for hundreds of years, specializing in premium baijiu. Moutai is known as China’s Guojiu or “National Liquor” – an irreplaceable brand image built over decades of toasting by Chinese leaders and visiting head of states including former US President Nixon during his historic visit to China in 1972. The company has significant pricing power having

grown prices in 10 of the last 18 years, while expanding volumes. Moutai has achieved 22 years of consecutive revenue, EPS and tangible book growth and is still available at very reasonable prices. Impressively, Moutai is still growing revenue over 20% with high returns on unlevered tangible equity (over 30% over long periods) and reinvestment opportunities on a product that has stood the test of time.

Shanghai Airport (600009 CH) is a \$20 billion company that operates the Pudong International Airport in Shanghai, China's top airport for international passengers. Mr. Charlie Munger provided insights into its wide moat when he said, "Always look for durable competitive advantages. One of the things we got into was the Shanghai Airport, the main airport in China, with no debt net. How can you lose with the main airport of China?" Shanghai Airport has grown its revenues every year since 1999. Last year, the company signed a new long-term duty free concession which sets minimal guarantee payments each year until 2025 that is expected to predictably contribute the majority of its operating profits. Additionally, there is a very long runway for growth over the next 20 years as currently only 4% of Chinese hold passports — a number most certainly set to increase as Chinese tourists travel the world. We [presented the idea](#) at the last Best Ideas conference in January 2019 for members of MOI Global.

Foshan Haitian (603288 CH) is a \$40 billion company renowned and trusted in China for its soy sauce, condiments, flavouring and related products. The company has a rich, 300-year history and is one of the top "Chinese Time-honoured brands" recognized by the Ministry of Commerce. It is three times the size of its closest competitor, Lee Kum Kee. The moat of Foshan Haitian goes well beyond its proprietary fermentation process, brand or first mover advantage. The company also has a formidable distribution network and Chairman Pang was very early to heavily invest in an R&D system ahead of peers with long-term partnerships with top research institutions including Chinese Academy of Science, Oxford University etc. Almost half of its sales are sold to sticky customers who obsess about their condiments. Every year, Foshan Haitian has grown revenue double digits, paid dividends and consistently grown operating income and EPS while achieving 30%+ returns on unlevered equity.

Jiangsu Hengrui Medicine (600276 CH) is a \$42 billion innovative pharmaceutical company with 21 years of consecutive revenue and operating income growth and the company is still growing over 25% with over 25% returns on unlevered equity. Jiangsu Hengrui has a diversified portfolio focused on oncology, anaesthetics and contrast agents. Starting as a generic drug maker, Hengrui was the first among Chinese peers to invest its strong free cash flows to R&D of innovative drugs over ten years ago. The company spends around 12-15% of its sales in R&D, much more than its peers. Hengrui has an industry leading sales team of 12,000 supporting its existing drugs and strong pipeline. The company also benefits from its patent protection on its proprietary drugs.

There are several other companies in China with significant competitive advantages like **Yunnan Baiyao**, **Zhangzhou Pientzhuang**, **Fuyao Glass**, **Wuliangye** and **Beijing Tong Ren Tang**, many iconic brands which are also listed in China's top 100 time-honoured brands by the Ministry of Commerce.

In the last decade, China has also created several of the world's best technology companies that have wide moats comparable to world class companies like Google, Apple, Facebook and Microsoft. In her widely followed Internet Trends report, Mary Meeker highlights that China accounts for 21% of world-wide internet users and seven out of the top thirty largest internet companies. Two of these companies with wide moats are:

Tencent (700 HK) is a \$430 billion company which has consecutively grown revenue and EPS for 17 years, and despite its size is impressively still growing double digits with high returns on equity. The moat is very wide because it is integral in the daily life and habits of a 1 billion Chinese consumers -

this is incredibly difficult (and perhaps impossible) to copy due to high switching costs, strong network effect and dependence on the apps in day-to-day life. Nearly 50% of Chinese mobile user time is spent on several of the company's online platforms including its super app, WeChat. Additionally, Tencent and Alibaba are VC investors together owning stakes by some accounts in over half of China's internet companies, which gives them huge access to data about the Chinese consumer. Knowing your customer is important in the age of data as the new oil, and no one knows has more data about their customer better than Tencent and Alibaba in China.

Netease (NTES) is a \$30 billion market cap company in a largely duopolistic market and has grown revenue double digits for the last 17 years and is still growing over 30% with high returns on equity. The founder, William Ding, owns 45% (amongst the highest insider ownership for Chinese internet) and is one of the best capital allocators in China returning over \$3.5 billion to shareholders over the past 15 years and repurchasing shares at good prices. Netease reputedly has the best product development culture among Chinese internet companies. The company has large reinvestment opportunities in new growth areas like music and education in the hands of a great capital allocator.

The next Asian market is India, which offers an incredibly rich place to hunt for wide-moat companies with thousands of listed companies to fish from. It is also the Asian market with the most multi-baggers, which means that Indian markets tend to be expensive relative to other Asian markets, so patience is a virtue. In investing in India and China, it is paramount to bet on the quality of management – as this can make or break an investment.

Outside of the financials sector in India, like HDFC Bank, Gruh Finance and Bajaj Finance that have consistently grown earnings for 15 years and still growing, some examples of wide-moat companies in India are:

Pidilite (500331) is India's largest manufacturer and distributor of adhesives, with a significant 70% of the adhesive market, and had 17/17 years of revenue and 15/17 years of EPS growth. With their strategy to spot under-served and under-penetrated segments, Pidilite was the pioneer in white-resin glue in 1963 through the iconic Fevicol brand. Over generations, they gradually built on their core competency and added brands like Fevistik, Fevikwik, M-Seal, Fevicryl and Dr Fixit that have come to become how users define the product. Furthermore, instead of selling through stores, they embarked on a bold marketing plan and approached the main consumers (carpenters and contractors) directly. These attributes allowed them to grow sales and EPS at 15.5% and 17.8% CAGR for 18 years. As a testament to their moat, they are able to sell their products at a premium to their competitors and generate 25%+ ROE for the last 15 years.

Marico (531642) is India's leading producer of coconut oils and hair oils founded in 1988 with 46% market share in Indian hair oil and 1 in 3 Indians using their products. The company sells primarily in India (~80% of sales) but also has strong presence in other South Asian countries (e.g. 80% market share in Bangladesh) and Middle East. Hair oil and coconut oil are staple products unique to Indian consumers who use it daily, but almost unheard of for multi-national FMCG companies so competition was limited in the early phases. Marico cemented their dominance in the hair oil category by releasing new brands into adjacent categories like hair nourishment and male grooming as well as building one of the most extensive distribution networks in India with 4.9 million retail outlets today. Marico's brand and pricing power is reflected in its consistent 30-40% ROE. Furthermore, Marico has managed to grow consistently in 19 out of the last 20 years compounding revenue at 11% CAGR and net profits at 19% CAGR.

Nesco (505355) is a \$600 million mid cap company that has a strong moat as it owns a 70-acre parcel of land which the founder bought for only \$1 million in 1950s. The company operates Mumbai's largest private exhibition business, Bombay Exhibition Center (BEC) that is a cash cow business and a

near monopoly of large-scale exhibitions in the city. The other half of its business comes from leasing out 4 buildings on the land they own to prime tenants. Today the land parcel is worth hundreds of millions of dollars creating barriers to entry for new entrants. Importantly, the reinvestment opportunity remains large to take advantage of this asset. As land prices in Mumbai have soared since, this moat grows with time as land becomes more scarce and prices continue to climb, giving them a lower cost base than any new entrant. Revenues and EPS have grown 13/15 years and EBIT margins have been 50%+ since 2008 with a net cash balance sheet.

Vinati Organics (524200) is an Indian speciality chemical manufacturer founded in 1989. Vinati dominates a few niche segments, with 65% global market share of IBB (20% of sales, a raw material for Ibuprofen) and 55% global market share of ATBS (55% of revenue, used in various applications such as detergents, coatings, water treatment, oil field, etc.). They became the global market leader in these segments due to their deep focus on developing the most specialized and efficient production process in relatively niche chemicals. These processes are highly complex and patented. In fact, within the ATBS segment, Vinati is so dominant that Lubrizol, the original inventor of the chemical, recently gave up and sold their business to Vinati. Vinati's competitive moats is reflected in its EBIT margins of 25-35% and ROE of 20-30%. In the last 20 years Vinati grew revenue 18 years and compounded revenue at 18% CAGR.

There are several other examples of wide-moat Indian companies with dominant market positions, high returns on equity and reinvestment opportunity which include the likes of Titan, Schaeffler India, Zydus Wellness, Indian Energy Exchange, and Garware Technical Fibers.

Japan is home to many wide-moat businesses which have high returns on unlevered equity and strong free cash flow. Considering Japan's GDP growth has been stagnant, future growth and reinvestment opportunity to create long-term shareholder value is crucial. Therefore, I look for Japanese companies that are also successful in selling their high-quality products to consumers in other large Asian markets like China and India.

Some examples of wide-moat companies in Japan are listed below:

Pigeon (7956 JP) is a \$4.9 billion, 60 year old Japanese brand, specializing in breastfeeding and child-rearing products with high market shares ranging from 30-70%. Pigeon's product designs are based on six decades of breastfeeding research and infant behavioural observation, inspired by its founder, Yuichi Nakata who tried milk from over 1,000 mothers in the 1940s to develop the best baby bottles. Today, Pigeon has over 3,000 niche products such as a special bottle for babies with cleft lip (a rare birth defect) and baby shoes that were developed by studying walking motions of toddlers. Pigeon has significant pricing power as mothers trust the brand, resulting in 40-50% ROE ex-cash. This wide moat has led Pigeon to successfully generate 34% of their revenues in China, which is the highest amongst all Japanese companies selling in China ahead of other good Japanese businesses like KOSE, Yakult and Lion Corp. This is a testament to the competitive advantage of Pigeon. Due to its growth in China and India, Pigeon has had 15 consecutive years of revenue and operating income growth and consistently increased gross margins. The company rewards shareholders as it has paid out nearly 60% of its free cash flow over the last 15 years in dividends.

Kobayashi (4967 JP) is a \$5.8 billion, 125 year old Japanese "big fish in a small pond" wide-moat business with a culture of generating hit niche products that are difficult to copy leading to its 40%+ return on equity. Kobayashi sells simple, predictable products including heat pads, toilet bowl cleaners, eye-wash, and oral hygiene and skin care products with over 155 brands that consumers have to keep buying. I believe Kobayashi fits Mr. Buffett's quote, "Our approach is very much profiting from lack of change rather than from change. With Wrigley chewing gum it's the lack of change that appeals to me. That's the kind of business I like." Excluding non-core divestments, Kobayashi has

grown revenue consistently every year. The company has had 20 straight years of profit growth and dividend increases and consistently free cash positive. Kobayashi achieves 20% of its revenue from “new” products – which is a reflection on its unique culture of innovation and R&D. I presented the company in November 2013 at MOI Global’s Japan Investing Summit.

Other examples of wide-moat Japanese companies with dominant franchises, high returns on tangible equity and meaningful reinvestment opportunity include the likes of **Shiseido**, **Unicharm**, **Nintendo**, **Kao** and **Rohto Pharmaceutical**.

Despite the above list, Japan to foreign investors may conjure up the notion of “value trap” cigar butts with inefficient balance sheets, low returns on equity and run by management whose incentives are not aligned with those of minority shareholders. However, change is on the horizon as private equity investors and activist hedge funds are prioritizing Japan. For instance, KKR declared Japan as their “highest priority” in the world outside the US, Carlyle launched a new Fund calling it a “tremendous” opportunity. And recently activist hedge fund Third Point (Dan Loeb) went to the lengths of publishing a hundred-page report to realize the significant value in Sony.

In South East Asian markets, Vietnam is an exciting ASEAN market with long-term potential with a big population (90 million), GDP growth of 7%+, an English speaking, young country with median age below 30 and a huge beneficiary as an alternative manufacturing hub to China due to the US-China trade war.

Examples of wide-moat companies in Vietnam are **FPT** (#1 IT services company in Vietnam) and **Saigon Cargo Service** (leading cargo operator in one of the fastest growing aviation markets). In certain sectors (e.g. telecom, financials, retail, utilities, infrastructure related etc.) there are foreign ownership limits (FOL) that can range from 30-49%. We expect eventually these to narrow, as Vietnam markets open up and therefore provide opportunity.

Indonesia provides good consumer businesses to invest in given the tailwind of its large demographic (260 million population). One of my favorite wide-moat companies is **Sido Muncul** (#1 market share, 60% share for herbal cold remedy and energy drinks with 60% and 50% market share respectively, high brand recognition).

In Singapore, holding company **Haw Par**, the maker of the iconic Tiger Balm which is over hundred years old has a wide moat with its mind share and distinctive brand. The company also has stakes in Singapore’s UOB Bank which generates significant dividend income. In Philippines (105 million population), **San Miguel F&B** dominates the beer industry with 90%+ share because of its wide moat from distribution and being the first brewery in Philippines, allowing the company to create a bond through generations.

Finally, in the frontier markets in Bangladesh and Pakistan, examples of wide-moat companies are: **Square Pharmaceutical**, **Olympic Industries**, and **Muree Brewery** which have consistently increased revenue and EPS for more than a decade at high returns on unlevered equity.

Access the [related presentation](#) from Wide-Moat Investing Summit 2019.