The VIEW *from* BURGUNDY

WINNING BY NOT LOSING

Anne Mette de Place Filippini, Senior Vice President and Portfolio Manager for Emerging Markets equities, delivered the following presentation at the London Value Investor Conference on May 26, 2016.

Before I became an investor, I was a tennis player. I played competitively as a junior and became pretty good at the game. It took me a long time to learn the lesson that, many more times than not, winning is the result of not losing. Neither striking great shots nor having a better game is a prerequisite to winning; making your opponent hit another shot is what really matters!

Wimbledon is the most prestigious Grand Slam tournament in tennis. I thought it would be fitting to illustrate this point by looking at what became known as one of the best matches ever played: the 2008 Wimbledon final between Roger Federer and Rafael Nadal.

Federer had already won the Wimbledon title five consecutive times, from 2003 to 2007, and was a favourite going into the match. In both 2006 and 2007, the two had played epic finals at Wimbledon and their rivalry had become legendary.

After the winner lifted the trophy at 9:20 p.m., there was a 1,400 megawatt spike in the U.K. national power grid, equivalent to half a million tea kettles being boiled at the same time. Fans had been glued to their seats and caused an enormous surge when they all got up after the game to turn on the lights. John McEnroe put it best when he said, "Well, there's nothing left to say here... Simply the greatest match I ever saw in my lifetime."[i]

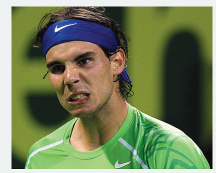
Looking at the match statistics (see Figure 1 on the following page) can help us understand why this was such an epic match.

Roger Federer played a terrific match. He served more aces, hit a faster serve, played more aggressively by going to the net more often and hit 50 per cent more winners than his opponent. On most metrics, he did better or at least as well as his opponent. A +37 differential between winners and unforced errors is rare and spectacular, not something you see often.

So why did Federer **lose**? Rafael Nadal played better on one key metric: **unforced errors**. An unforced error is when you lose a point by hitting the ball into the net or hitting it out of bounds without being under duress from your opponent. In other words, you missed a ball you shouldn't have missed. Nadal hit only 27 unforced errors against Federer's 52. Even though he was outplayed on winners, Nadal won because he played more within himself, within his comfort zone. He didn't play as aggressively and didn't hit as hard, but won by making fewer errors. On a subtler metric, break point conversions, we can also see that his mental energy was well directed, winning the right points and converting more opportunities into games.

WIMBLEDON FINAL 2008

Roger Federer



Rafael Nadal

Roger Federer		Rafael Nadal
65%	1st Serve %	73%
25	Aces	6
2	Double Faults	3
89	Winners	60
52	**Unforced Errors**	**27**
+37	Winner – UFE	+33
73%	Winning % on 1st Serve	69%
57%	Winning % on 2nd Serve	59%
33%	Receiving Points Won	33%
1/13 (7%)	Break Point Conversions	4/13 (30%)
42/75 (56%)	Net Approaches Won	22/31 (71%)
129 mph	Fastest Serve	126 mph
117 mph	Avg. 1st Serve Speed	112 mph
100 mph	Avg. 2nd Serve Speed	93 mph

FIGURE 1

Image source: Vinod Divakaran
Data source: Wikipedia "2008 Wimbledon Championships – Men's singles final"

Now the catch is that "winning by not losing" is not nearly as appealing to our psyche as a "winning by winning" strategy. It just feels a lot better to win by hitting great shots, or in investing terms, to pick stocks that turn into multi-baggers. Telling the story, "I won because I played some amazing shots, hitting my favourite forehand winner," is much more appealing than the alternative, "I won because I played with a margin of safety that allowed me to make few mistakes." But if we go with the appealing strategy, we may find ourselves, as Federer did, making more unforced errors.

2

China's torrid growth requires ever larger tonnage of raw materials from Brazil. Massive new oil discoveries will permanently alter the country's terms of trade. This will spur an investment boom and require substantial new infrastructure to be built. Oil sector privatizations will open the gates for private capital and entrepreneurs to prosper.

UNFORCED ERRORS IN INVESTING

So what are the common unforced errors in investing?

Unforced Error #1: Chasing Winners

It is much more exciting to tell a story about hitting great winners than simply getting the ball back in the court, and nowhere in investing is storytelling more prevalent than in emerging markets. Great narratives get spun that capture the imagination of emerging market investors. Rewind a few years and the story on Brazil went something like this:

At the height of the stronger-for-longer commodity boom, it was standing-room-only when the CEO of the Brazilian mining giant Vale hosted an investor luncheon in Toronto. The Global Financial Crisis inflicted severe pain in 2008-09, but the market recovered swiftly on "decoupling" and stimulus, and in late 2010 hit new highs (see Figure 2). At an event hosted by *The Economist* in Mexico around this time, the audience was asked to cast a vote on, "Is God Brazilian?"

CHASING WINNERS

Brazil's Bovespa Index

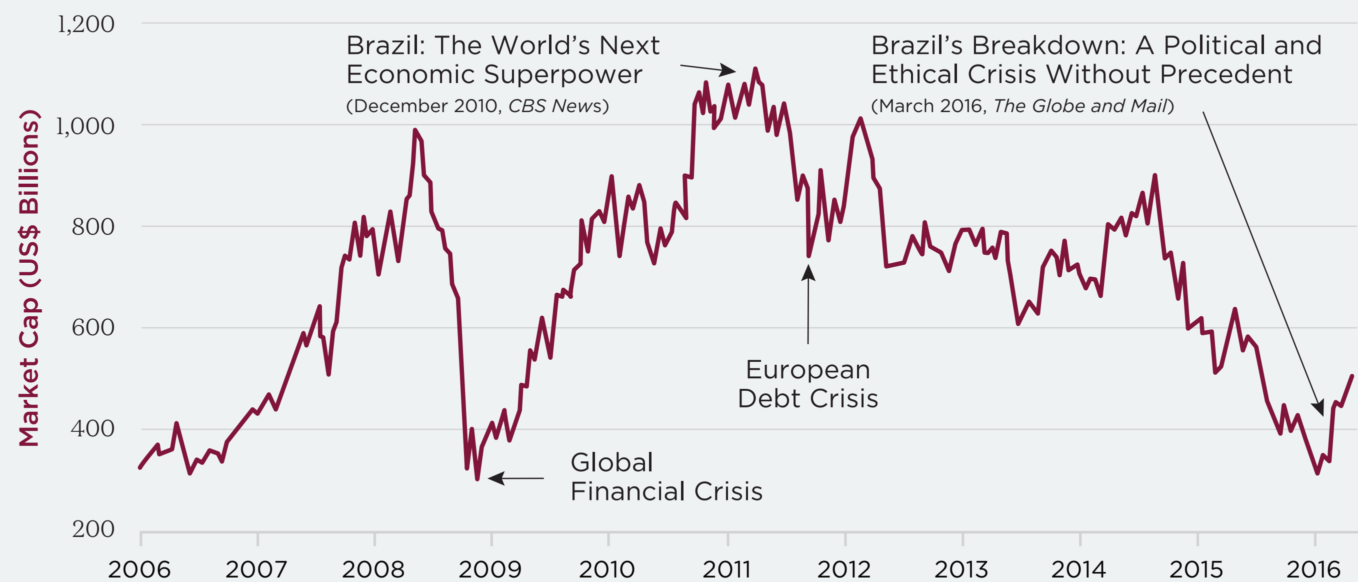


FIGURE 2

Source: Bloomberg

Inevitably the boom turned to bust. Growth faltered and went into reverse on exceptionally poor policies, and the economy slid into the worst rot in living memory. The unveiling of staggering corruption took the country from an economic to a political crisis, which is where we are today. In January 2016, the market revisited 2008 lows, valuing Brazil's Bovespa Index at only a little more than US$300 billion, 70% below its highs. In other words, the entire Brazilian market was being valued at just over half of Apple's total market capitalization.

The perceived biggest winner, the oil industry, ended up being the biggest unforced error (see Figure 3). From the peak in 2010, investors lost 90% of their money in Petrobras stock when measured in U.S. dollars. From peak to

BRAZIL OIL BOOM & BUST

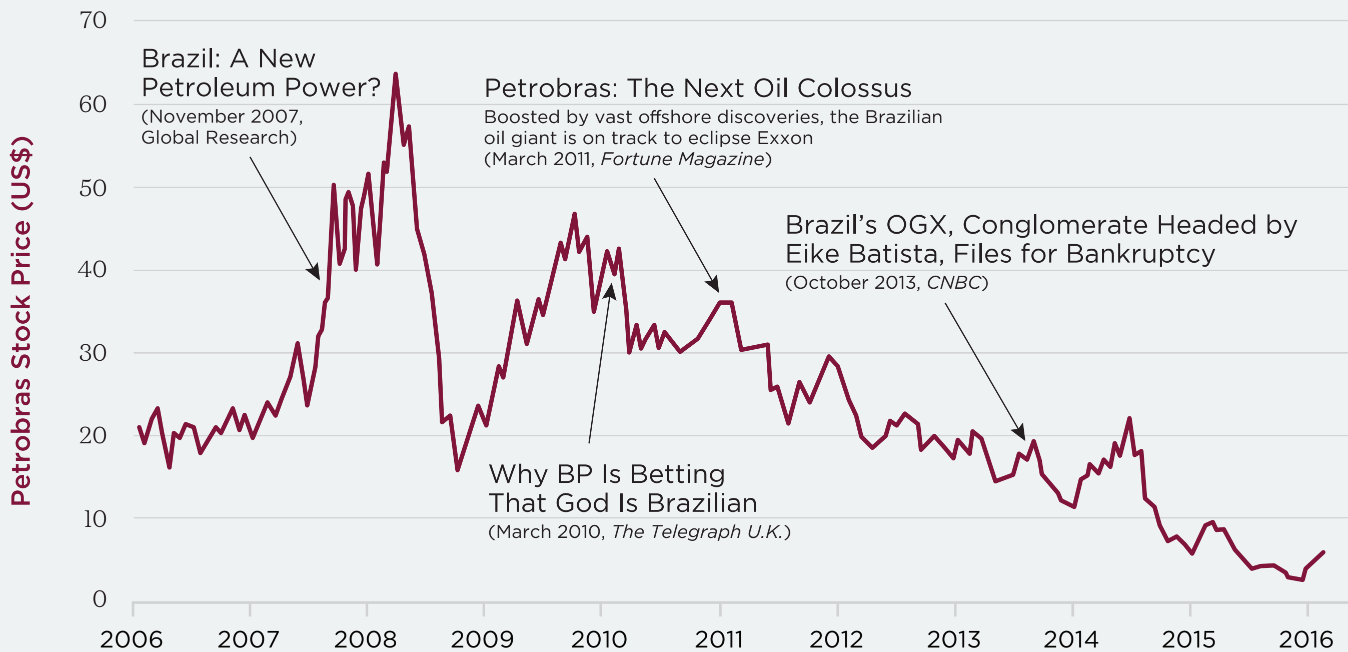


FIGURE 3

Source: Bloomberg

trough, US$220 billion dollars vanished in Petrobras stock and another US$80 billion dollars in Eike Batista's oil and gas business, OGX. Not to mention the US$330 billion dollars spent in Petrobras' capital budget over the past 10 years – it is difficult to determine future returns on those capital expenditure dollars.

In May 2016, Petrobras named Pedro Parente as the company's new CEO; he is an experienced leader dating back to the Cardoso administration and I suspect his reign will bring important improvements to the company.

Nevertheless, Petrobras remains a government-run and -controlled company, and serves as a stark reminder of the perils of investing alongside government. Governments are not attractive business partners for minority investors. There are many government businesses listed on emerging markets exchanges. We find them especially in sectors considered strategic by the state: oil and gas, and financials. The problem for minority investors, like us, is that they are managed to achieve a broad array of priorities. They serve many objectives: social, political, power and security. They are run for the good of the state and rarely on sound business principles.

Unforced Error #2: Not Knowing What You Are Doing

If hitting winners is hard, a tennis player might revert to a strategy of trying to do everything well by covering lots of ground. In investing, this would be equivalent to diversifying and, at its extreme, indexing or buying the market as a whole. In emerging markets, we believe that is a particularly bad idea because it exposes your investments to risks you did not intend to assume.

Figure 4 on the following page shows the top 30 constituents in the MSCI Emerging Markets Index. Three-quarters of the companies here are either global in nature, government-controlled or in anomalous structures, such as Variable Interest Entities (VIEs), to get around foreign ownership restrictions. This is not an exciting list for quality investors looking to invest in emerging markets.

Unforced Error #3: Overpaying

In tennis, this would mean hitting too close to the net or picking a target on the line – two strategies that leave no margin of safety. At Burgundy, we are value investors with a bent for quality, and the challenge we face today is that obvious quality is very expensive. Here are some of the highest-quality companies that we have found in Southeast Asia.

GREAT COMPANIES DON'T ALWAYS MAKE GREAT INVESTMENTS

	Trailing P/E Multiple	Forward P/E Multiple
Hindustan Unilever	44x	38x
Unilever Indonesia	58x	54x
HM Sampoerna	43x	39x
Asian Paints	56x	46x
Nestlé India	50x	45x
Bumrungrad Hospital	43x	38x
Average	**49x**	**43x**

Source: Bloomberg

Investors are paying, on average, 49 times trailing earnings and 43 times the current year's forecasted earnings. A lot of growth is built into those valuations. They trade at a large valuation differential to their developed market peers.

As you can see in the table on page 6, we would need 14% to 20% compound earnings growth over the next five years to close this gap. If we add a hurdle rate for deploying capital of 10% per year, then the required earnings growth goes up by that amount. We would be paying up front for significant growth.

DOWNSIDE TO BEING EVERYWHERE

MSCI Emerging Markets Index – Top 30 Index Members

Samsung Electronics	3.83%	Bank of China	0.89%	**CNOOC**	0.61%
Taiwan Semiconductor Manufacturing	3.14%	**Gazprom**	0.84%	**Lukoil Holdings**	0.59%
Tencent Holdings	2.90%	Itau Unibanco Holding	0.79%	Sberbank Russia	0.57%
China Mobile	1.93%	Banco Bradesco	0.76%	**Hyundai Motor**	0.53%
Naspers	1.51%	Ambev	0.73%	**Reliance Industries**	0.53%
China Construction Bank	1.48%	*Baidu*	0.72%	**China Petroleum & Chemical**	0.50%
Ind. & Commercial Bank of China	1.10%	Ping An Insurance	0.68%	**Sasol**	0.50%
Alibaba Group Holding	1.04%	Housing Development Finance	0.67%	**Steinhoff International Holdings**	0.50%
Hon Hai Precision Industry	0.94%	Petroleo Brasileiro	0.63%	**Tata Consultancy Services**	0.50%
Infosys	0.92%	America Movil	0.61%	MTN Group	0.48%

Company is: **BOLD** = Global; UNDERLINE = Government Controlled; *ITALICS* = Variable Interest Entity (VIE)

As at April 30, 2016.
Source: MSCI

FIGURE 4

COMPANIES MUST COMPOUND EARNINGS SIGNIFICANTLY TO MEET THEIR PEERS

	Trailing P/E Multiple	Required Earnings Growth Per Year (5 Years)
Hindustan Unilever (India)	**44x**	14%
Unilever Indonesia Unilever (U.K.)	**58x** 23x	20%
HM Sampoerna (Indonesia) Philip Morris Intl. (U.S.)	**43x** 22x	14%
Asian Paints (India) Sherwin-Williams (U.S.)	**56x** 23x	19%
Nestlé India Nestlé (CH)	**50x** 23x	17%
Bumrungrad Hospital (Thailand) Universal Health Services (U.S.)	**43x** 20x	17%

Source: Bloomberg

THE "WINNING BY NOT LOSING" STRATEGY

So what does a "winning by not losing" strategy look like for investors?

- **Employ independent thinking and research** – rather than chasing winners or following the crowd. As Ben Graham said, "The stock investor is neither right or wrong because others agreed or disagreed with him; he is right because his facts and analysis are right."
- **Follow a business approach to ownership (bottom-up)** – Since risk comes from not knowing what you are doing, we can minimize mistakes by understanding what we own and staying within our circle of competence.
- **Choose business partners carefully** – Typically in emerging markets investing, when you pick a stock you also pick a partner.
- **Focus on quality** – Select businesses that are resilient, that sell everyday products and services, and that can survive and pull ahead in tough environments.
- **Invest with a margin of safety** – Hit well above the net to give yourself a margin of safety and pick a target inside the line, not on the line.

"WINNING BY NOT LOSING" IN PRACTICE

Let's explore how we apply the "winning by not losing" strategy to our investment approach. It seems appropriate to go back to Brazil, a market in which macroeconomic uncertainty did not provide investors with any comfort. But to quote Warren Buffett:

> "Imagine the cost to us, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak."

At Burgundy, we have made investments in Brazil since 2009. While our investments cover a diverse range of businesses, we will illustrate the point with reference to a case study of the Brazilian payments industry. We have owned two businesses in this sector: Redecard (until it was taken private) and now Cielo.

Focus on Quality

The payments industry in Brazil boasts a number of very attractive characteristics.

- It takes a fee on a growing industry. A small toll is exacted on the billions of transactions that flow through millions of merchants every year. Card payments as a percentage of total consumption in Brazil remain well below half the level of the U.S. As consumption grows and more spending gets done on plastic, the payment industry benefits.

- Three merchant acquirers – Cielo, Itau Unibanco's Redecard and Santander's Getnet – represent more than 90% of the industry. While the industry is competitive, it operates as a rational oligopoly. A merchant acquirer is a company that processes credit and debit card payments on behalf of merchants. Along with the credit card brand owners, such as Visa and MasterCard, and the credit card issuing banks themselves, merchant acquirers represent a critical component of an economy's credit/debit card infrastructure. With market share exceeding 50%, Cielo is Brazil's largest merchant acquirer.
- Competitive advantages of scale and distribution favour the largest players. Cielo's controlling shareholders – two of Brazil's largest banks, Bradesco and Banco do Brasil – represent 45% of the country's bank branches. This is important because bank branches serve as a low-cost acquisition channel for new merchants.
- In countries prone to inflation and a high cost of capital, the best types of companies to own are those that have an inflation-protected revenue model and little need for ongoing capital reinvestment. A fee on nominal spend indexes us to inflation. Capital requirements are mainly to buy point-of-sale equipment, which is then leased to the merchants.

The high-quality nature of these businesses can be exemplified by Cielo's financial characteristics. Since its public listing in 2009, the company has compounded its top and bottom line by strong double-digit growth rates. The business does not require much capital; and hence, the return ratios are very high. Cielo has used its balance sheet prudently during the current crisis to expand its business and moat – firstly into prepayments and more importantly through mergers and acquisitions. Current debt ratios remain reasonable and management is focused on paying down debt. The company is thus positioned well for an eventual recovery.

Invest with a Margin of Safety

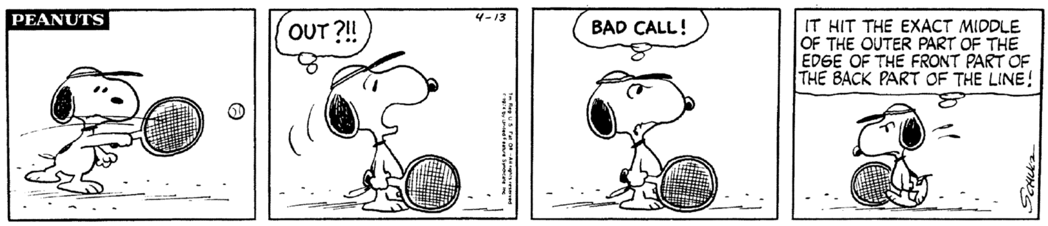
It was macro apprehensions that gave us our initial entry point in 2009 as shares traded down below their IPO level. Regulatory uncertainty in 2010 gave us an opportunity to add to our position weight. Regulators wanted more competition, clearly a negative, but we also understood that the strong moats in the business were built on scale and distribution, two factors that were not going to change. Again in 2013 and early-2016, the market served up opportunities, largely on poor Brazil sentiment.

The point being that, while the stock market has been tumultuous throughout our holding period, these businesses have continued to grow their earnings base. Apprehensions about macro events, in fact, were what gave us opportunities to buy or add at attractive margins of safety.

Today, Cielo's valuation is in line with where we see the Burgundy portfolio trading as a whole. The discount to intrinsic value, or margin of safety, should allow us to modestly exceed our long-term return hurdle rate. At current prices, we will continue to own the stock unless we uncover better opportunities elsewhere – but these seem hard to come by today.

Choose Business Partners Carefully

Valuation estimates are just estimates, and our intrinsic values do not explicitly give value to the ability of a business to adapt or to be opportunistic – those are free options. "Never let a good crisis go to waste," Winston Churchill said. Likewise, we find that great businesses led by capable managers find ways to turn crisis to opportunity.



To prop up economic growth, President Dilma's administration pushed public sector banks to lend more than they should have. This led to capital shortage in the sector and, with the equity markets unco-operative, allowed Cielo to strike a deal with Banco do Brasil on very favourable terms. In the joint venture, Cielo shares in the interchange fees from the bank's credit card division in exchange for performing card-related back-office operations for the bank. As earnings here are tied to a more resilient revenue stream, and again avoid any credit risk for Cielo, we see this as a highly constructive strategic move. Expanding when others are forced to retreat makes perfect sense to us.

CONCLUSION

Investing is a game of patience. In times of full valuations, which we think these are, it is tempting to "go for a little more" by hitting for the lines – or in this case, hitting for the "exact middle of the outer part of the edge of the front part of the back part of the line"!

Knowing what you own, avoiding unforced errors and hitting with a margin of safety are all key to staying power. These are the times of "winning by not losing."

This issue of The View from Burgundy *was written by Anne Mette de Place Filippini, Senior Vice President and Portfolio Manager for Emerging Markets equities.*

ENDNOTES

i. http://www.tenniscanada.com/11-things-you-might-not-know-about-the-08-wimbledon-final/

Original publication date October 2016.

DISCLAIMER

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We strive to achieve strong, long-term absolute results, while providing outstanding client service.

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