Sturgeon Insights
A 'new economy' approach to frontier market investing

Frontier markets have for a long time offered the promise of high returns driven by structural dynamics such as: strong demographics; a growing middle class; rising consumption; and highly attractive valuations. However, investor returns have historically failed to match this structurally higher GDP growth, due to the elevated macro volatility associated with these markets. Sturgeon believes that resilient businesses driven by secular trends can deliver superior returns in line with high GDP growth irrespective of any economic volatility.

The level of risk in frontier markets - the spread between potential outcomes - is generally higher than more developed markets. The distribution of returns is characterised by fat tails, with events such as a crash in commodity prices quickly leading to currency devaluations and a fall in asset values. By employing a bottom-up approach to risk management which values company resilience, we can maximise our understanding of the left tail risk and improve the probability of enjoying the greater rewards that frontier markets offer.

At Sturgeon, we employ a framework for reviewing business models in frontier markets which stresses the importance of a business's flexibility and resilience to succeed irrespective of macro headwinds. In pursuit of this, we always seek the following characteristics from our businesses:

- **Significant intangible value**: Sectors with high intangible value are far more resilient, unlike traditional industries whose value is primarily 'tangible' and consequently easily bought, replicated and expropriated. For example, digital 'new economy' businesses rarely face threats of expropriation, with the worst-case scenario being a data-sharing agreement with government officials. For companies with true intangible value, the government is aware they cannot simply replace management as they might do with traditional industries.

- **Unique structural growth dynamics**: Rather than looking for businesses which are reliant on growing demand as a result of macro tailwinds, we look for businesses which benefit from a long runway of growth built on a secular trend which is not directly correlated to the macro story.

The new economy

Over recent years, the emergence of cheaper forms of technology and increased levels of connectivity in frontier countries have opened new types of opportunities. In parallel, the capital needed to fund such companies has been absent, which presents us with a unique ability to capture the outsized returns these opportunities present. Although not our exclusive focus, we find technology-driven businesses are most capable of meeting our high return threshold (40% hard currency internal rate of return). We strongly disagree with the notion that investments in digital businesses in frontier markets have similar traits to their developed market peers but with an additional layer of risk. Our 15 years of experience has taught us that frontier markets are often structurally superior markets for digital offerings.

[1] Source: Pitchbook.com Internal Rate of Return (IRR) realised data - as at 31 March 2020.

The new economy (continued)

When we look at the venture capital deals in developed markets, a combination of historically low interest rates; extremely high competition for deals; a low hit rate; and a tendency for the best deals to go to a small number of large VC firms, has resulted in the prevalence of unsustainable business models with minimal prospects of achieving a profit.

To date, 70% of IPOs this year in the US were of lossmaking companies. Many other companies also display no path to profitability, for example, Uber and WeWork. Intense competition and high customer acquisition costs result in investors subsidising business losses for many years in the hope that many internal/external factors come together perfectly to achieve profitability. It is also incredibly challenging to draw business away from incumbents operating in core functions such as banking and insurance. For example, there is still no proven FinTech alternative to high street retail banks that has proven itself to be consistently profitable.

In frontier markets, the situation is entirely different. After nearly a decade of record growth, our strategy still represents the only private Fund investing in Uzbek venture capital deals. In contrast to developed markets, there is less need to persuade the population to switch from deeply embedded institutions. For example, retail and MSME lending is still nascent in Uzbekistan, with less than 5% of the population borrowing from a financial institution in 2019. As a result of the under-penetration of the market by incumbents, customer acquisition costs remain extremely low.

Technological leapfrogging

Uzbekistan has effectively skipped the offline era we experienced in the West – with the associated baggage and infrastructure – starting instead from the digital age. The country has high smartphone penetration (>76% of population) and a young tech-savvy population without preconceived ideas of how things ‘should be’. This allows for the adoption of new services that are far more efficient and profitable. Many frontier and emerging markets have some of the most advanced banks in the world (e.g. Kaspi in Kazakhstan and Tinkoff in Russia), which generate ROEs in excess of 40% with a low cost base. These companies were able to take the opportunity of technological leapfrogging while unencumbered by legacy issues such as an extensive branch network and bloated workforce. In sharp contrast to investing in traditional industries, which often requires a painful streamlining of the workforce, digital businesses create high productivity jobs and are often praised and encouraged by governments.

Sourcing

Although sourcing quality online/digital businesses in frontier markets is demanding, we do come across a sufficient number of talented entrepreneurs who have an economically interesting business, an experienced management team and a track record of success, but who lack the capital to truly scale their businesses. This allows us to secure attractive valuations with businesses that are receptive to a collaborative working relationship.

The online/digital businesses we consider always have business models with high normalised operating margins; for example, SaaS businesses can generate >50% operating margins. They also have large addressable markets and management with a track record of strong execution. These companies must also show themselves to be a beneficiary of a country’s technological upgrading as opposed to simply enjoying demand-growth based on broad economic growth. Even in a severe economic contraction, the sheer size of the nascent addressable market, and the promise of cost-reducing efficiency for businesses, embeds a margin-of-safety for investors.

Building an ecosystem

Due to the value proposition these businesses represent, the pooling of resources needed to make businesses successful is also more easily realised. For example, a logistics business will go out of their way to collaborate with an e-commerce business, so that both can meaningfully grow revenue. At Sturgeon we are cultivating an ecosystem for consumers, incorporating financials, eCommerce and technology-enabled businesses. This system expands demand for offline/online and mobile financial services for households and MSMEs. Our introduction of international fintech experts, and general advocacy for data collection and analysis, allows for the development of smarter financial solutions to keep up with local demand from a fast-growing, digitalising economy.

Digital businesses are frequently complementary to one another; for example, a fintech bank can distribute financing solutions through an ERP SaaS platform, enhancing the functionality of both businesses. Another example is the integration of our eCommerce business with our ERP SaaS platform to onboard the inventory of over 250 offline shops, representing 18,000 SKU via a simple API. These SKUs can now be sold online, increasing revenues for all stakeholders.

Exit

Finally, these businesses are often easier to exit in a timely manner, and upon sale have a greater chance of achieving a premium. If a business has already displayed positive unit economics and a continued runway of growth, an international IPO also becomes an option. International investors, particularly those focused on frontier and emerging markets, will pay a premium for resilient companies that differentiate themselves from an investment universe dominated by traditional businesses: 75% of MSCI Frontier index is comprised of traditional industries such as banking, telecoms and real estate.

Covid-19: the ultimate stress test

At the date of this report, COVID-19 continues to cause havoc across the world. Uzbekistan has implemented a full lockdown, and according to the IMF, the economy is now set to grow at +1.8% in 2020, rather than the expected +6%. In many ways, the situation is a worst-case scenario which has caused a simultaneous shock to both supply and demand. The Uzbek government and the central bank have responded by expanding monetary and fiscal policies to support the economy.

Although some of our online/digital businesses have seen a temporary fall in demand, the crisis has accelerated the countries technological transition. Given the lockdown, one of our core portfolios positions, an eCommerce platform, has seen an uptick in offline stores signing up to sell their products online. We have also seen the cost of acquiring customers collapse as the general population moves online. Our businesses are capturing a sticky customer-base at a fraction of the pre-crisis marketing spend, with higher average order values.

For a full breakdown of Sturgeon's 'new economy' approach please contact the team:

Contact

Alex Branton

Investment Director

ab@sturgeoncapital.com

DISCLAIMER

This presentation is not an advertisement or a prospectus and is not intended for public use or distribution. It has been prepared by Sturgeon Capital Limited ("Sturgeon Capital") for information and discussion purposes only with prospective eligible investors and should not be considered to be an offer or solicitation of an offer to buy or sell shares in the capital of the Fund. In particular, this document does not constitute an offer to sell, or the solicitation of an offer to acquire or subscribe for shares in the capital of the Company in any jurisdiction where to do so would be unlawful. This document, any presentation made in connection herewith and any accompanying materials do not purport to contain all information that may be required to evaluate the Company and/or its financial position and do not, and are not intended to, constitute either advice or a recommendation regarding shares of the Company. This document is not intended to provide, and should not be relied upon for, accounting, legal or tax advice and each prospective investor should consult its own legal, business, tax and other advisers in evaluating any potential investment opportunity.

The information in this presentation has not been fully verified and is subject to material revision and further amendment without notice. This presentation has not been approved by an authorised person in accordance with section 21 of the Financial Services and Markets Act 2000. As such this document is being made available only to and is directed only at: (a) persons outside the United Kingdom; (b) persons having professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth bodies corporate, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) (A) to (C) of the Order, and other persons to whom it may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). Any failure to comply with these restrictions constitutes a violation of the laws of the United Kingdom.

The distribution of this presentation in, or to persons subject to the laws of, other jurisdictions may be restricted by law and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. Any failure to comply with these restrictions may constitute a violation of the laws of the relevant jurisdiction. This presentation may not be copied, circulated or published, in whole or in part, without the prior written consent of Sturgeon Capital.

None of the Company or Sturgeon Capital or any other person makes any guarantee, representation or warranty, express or implied, as to the accuracy, completeness or fairness of the information and opinions contained in this document, and none of the Company or Sturgeon Capital or any other person accepts any responsibility or liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

In preparing this presentation, Sturgeon Capital has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which Sturgeon Capital otherwise reviewed. The information presented in this document may be based upon the subjective views of Sturgeon Capital or upon third party sources subjectively selected by Sturgeon Capital. Sturgeon Capital believes that such third party sources are reliable, however no assurances can be made in this regard.

Neither this presentation nor its contents may be distributed, published or reproduced, in whole or in part, by you or any other person for any purpose. In particular, neither this presentation nor any copy of it may be: (i) taken or transmitted into the United States of America; (ii) distributed, directly or indirectly, in the United States of America or to any US person (within the meaning of regulations made under the US Securities Act 1933, as amended); (iii) subject to certain exceptions, taken or transmitted into Canada, Australia, New Zealand or the Republic of South Africa or to any resident thereof; or (iv) taken or transmitted into or distributed in Japan or to any resident thereof. Any failure to comply with these restrictions may constitute a violation of the securities laws or the laws of any such jurisdiction. The distribution of this document in other jurisdictions may be restricted by law and the persons into whose possession this document comes should inform themselves about, and observe, any such restrictions.

The value of investments and the income from them can fall as well as rise. An investor may not get the amount of money he/she invests.

This document may include statements that are, or may be deemed to be, forward-looking statements. The words "target", "expect", "anticipate", "believe", "intend", "plan", "estimate", "aim", "forecast", "project", "indicate", "should", "may", "will" and similar expressions may identify forward-looking statements. Any statements in this document regarding the Company's current intentions, beliefs or expectations concerning, among other things, the Company's operating performance, financial condition, prospects, growth, strategies, general economic conditions and the industry in which the Company operates, are forward-looking statements and are based on numerous assumptions regarding the Company's present and future business strategies and the environment in which the Company will operate in the future. Forward-looking statements involve inherent known and unknown risks, uncertainties and contingencies because they relate to events and depend on circumstances that may or may not occur in the future and that may cause the actual results, performance or achievements of the Company to differ significantly, positively or negatively, from those expressed or implied by such forward-looking statements. No representation or warranty, express or implied, is made regarding future performance or the achievement or reasonableness of any forward-looking statements. As a result, recipients of this document should not rely on forward-looking statements due to the inherent uncertainty. Save as required by applicable law or regulation, the Company undertakes no obligation to publicly release the results of any revisions to any forward-looking statements in this document that may occur due to any change in its expectations or to reflect events or circumstances after the date of this document. No statement in this document is intended to be, nor should be construed as, a profit forecast.

This document includes certain track record information regarding Sturgeon Capital. Such information is not necessarily comprehensive and potential investors should not consider such information to be indicative of the possible future performance of the Company or any investment opportunity to which this document relates. The past performance of Sturgeon Capital is not a reliable indicator of, and cannot be relied upon as a guide to, the future performance of Sturgeon Capital or the Company.
By accepting this document or by attending any presentation to which this document relates you will be taken to have represented, warranted and undertaken that: (i) you are a relevant person; (ii) you have read and agree to comply with the contents of this disclaimer; and (iii) you will treat and safeguard as strictly private and confidential all the information contained herein and take all reasonable steps to preserve such confidentiality.