GLOBAL ALPHA

QUARTERLY COMMENTARY

September 30, 2022

Fed hikes and dollar strength continued to affect Emerging Markets. China did not contribute much by maintaining its zero Covid policy. Despite the general backdrop we do identify some strong companies and particular markets that do perform well in this scenario.

In first place, India highlights very clearly. MSCI India Small Cap outperformed MSCI India Large Cap by almost 17% in Q3. This is driven by good bottom-up companies, but also driven by sound demographics, secular themes and public and private investments accelerating in the country. We recently published a weekly note explaining in detail our India added value and why we continue to like the market for the mid-long term despite high valuations.[1] During Q1 2022 we visited, in person, many of our holdings in the country reaffirming our good impressions. We continue to add value in this market.

We also highlight Latin America, in particular Brazil and Mexico. MSCI Latin America Small Cap outperformed MSCI Emerging Markets Small Cap by almost 5% in Q3. The latter was due to some effects such as i) markets non reliant on tech companies; ii) strong bottom-up stories, especially financials, benefited by rate hikes; iii) extremely discounted valuations in relation to Asian companies; iv) a stable commodity scenario. We continue to outperform in this region. Global Alpha has continued in person meetings, where we've met 100+ companies. We had the opportunity for face-to-face meetings with most of our Latin American Holdings, where we maintained our positive stance for many bottom-up stories and we also explored some interesting new ideas.

After a Q2 of outperformance, China has disappointed us and the market in general. Our main preferences in Chinese companies came from consumer and manufacturing sectors. Our thesis was driven mainly by the Chinese increasing the emerging middle class and local manufacturing such as Robotics in order to foster local companies. Nevertheless, the country has insisted on its Zero Covid Policy, even after the party congress held in October, and there are no clear signs of where Xi's third administration is intending to guide the country.

Finally, we highlight some "nonconventional" Small Cap Emerging Markets that have outperformed YTD. We recently visited 27 companies in Turkey and 12 in Greece. All in all, despite strong inflationary pressures we found some good ideas in Turkey. Although we are not invested, we feel that there are ways to play hyperinflationary countries, especially in companies with strong pricing power who are good exporters who can benefit by the expected weakness of the currency

BACK TO EMERGING MARKETS SMALL CAP

During the third quarter, the MSCI Emerging Markets Small Cap Index outperformed the MSCI Emerging Markets Index and the MSCI World Index.

[1] Please see our weekly note: India: Our EM Queen, published on October 13th.

Within the MSCI Emerging Small Cap Index, Energy, which represents 2.4% of the index, was the strongest performing sector, delivering a return of 11.4%. At the opposite end of the spectrum, Information Technology was the worst performing sector, returning -5.3% for the quarter, with an index weight of 16.1%.

PERFORMANCE HIGHLIGHTS

For the third quarter, our Emerging Markets Small Cap composite delivered a return of -1.3% gross, underperforming the MSCI Emerging Markets Small Cap Index by 2.2% gross.

Our top contributor was City Union Bank (CUBK IN) a privately owned bank in India that lends to small and medium sized enterprises (SME). The bank is conservatively managed with a granular balance sheet and a long track record of focused and profitable lending to the SME sector.

Reasons the stock outperformed

After taking a conservative stance on lending to ride out Covid related stress and maintain asset quality, CUBK's management indicated that it is now ready to push the accelerator on lending. With customers looking to resume capital expenditure on the back of India's economy reopening, management raised guidance on their loan growth outlook for the year. Also, improvement in asset quality and control over credit costs helped maintain their sector leading profitability and return ratios. We expect CUBK to benefit from the start of a new credit cycle as the banking sector emerges from the turbulence of the last three years with a clean balance sheet.

Outperformer

Another top contributor was ABC Bank (ABC4 BZ) Banco ABC, a commercial bank in Brazil focused on large middle and corporates. Banco ABC has roughly 3,000 clients and has commercial footprints in 31 different cities in, nine different states. The bank is a niche, focused bank with high quality management.

Reasons the stock outperformed

ABC bank's outperformance has been driven by strong delivery, achieving a level of 15-17% ROE in a consistent way, while the stock is still trading below book value. The bank has been favoured by an increase in SELIC rates and is nurturing several fee enhancing initiatives that are likely to sustain and increase current profitability levels. Management continues to be focused on enhancing returns for shareholders.

Our top detractor was Jiumaojiu International Holdings (9922 HK), a Chinese multi-brand and multi-concept restaurant chain operator, with a highly standardized, scalable, and replicable business model, with superior store unit economics, facing a long runway for restaurant fleet expansion underpinned by strong brand equity.

Reasons the stock underperformed

As China continued to follow its zero covid policy, JMJ's same store growth and table turnover continued to face headwinds from lockdowns and movement restrictions. In spite of a tough operating environment, the company was able to expand margins and maintain its guidance for new store openings. Jiumaojiu also announced an ill-timed acquisition of property rights for a mall development which was also intended to serve as its future headquarters. They however terminated this transaction in the face of an adverse reaction from the market, to the relief of the investor community, which saw this rightly as a poor capital allocation decision.

Reasons we still own the stock

Despite the operating deleverage caused by social restriction measures and its recent about turn with the property transaction, we expect Jiumaojiu to continue to deliver on profitability due to its robust supply chain, vertical integration, and operating efficiencies.

We believe these factors also will allow the company to weather the inflationary environment better than its peers. Covid-19 and the Chinese government's containment measures represent the main headwinds for Jiumaojiu's growth trajectory in the near future. Despite the uncertainty, we remain confident in the investment thesis and believe that Jiumaojiu is a high-quality business operator enjoying a long and visible growth runway, a company we typically favour.

NEW POSITION

During the quarter we initiated a new position in Grupo Aeroportuario Del Centro Norte (OMA MM) The group holds a 50-year concession to operate, maintain and develop 13 airports in Mexico, most of them located in the northern and central region of the country. OMA served 18 million passengers in 2021.

OMA benefits from the increasing travel in Mexico with the company already surpassing its pre-pandemic levels and maintaining high profitability numbers (ROE 40%+ EBITDA Margin 60%+). Furthermore, the company offers an opportunity for companies looking to move routes away from the congested Mexico City airport and development of airports closer to the US border, conveying some of the nearshoring themes. OMA has close to 80% of its costs fixed, enjoying strong operating leverage. We also highlight the experience of Vinci, as a new shareholder, in building airports around the world which can create relevant further room for expansions.

OTHER NEW BUYS AND SELLS

During the quarter we exited some companies such as Ambipar (AMBP3 BZ) due to high leverage and losing confidence on management strategy. We also exited, among others, Manapurram Finance (MGFL IN) because we wanted to replace it with the dominant and better managed player in the industry, Muthoot Finance (MUTH IN), which came under our market cap range. We also added three financials, TISCO TB, ABCB4 BZ and Banco Inter, considering positive expected delivery and good risk management, together with Supreme Industries in India, a direct beneficiary of ongoing Capex cycle in the country.

WHAT IS OUR EAR-TO-THE-GROUND APPROACH TELLING US?

The Global Alpha Emerging Markets Team has returned to conferences and in person meetings. As explained during Q1 and Q3, we visited many holdings and companies from different latitudes. This is just starting. We are travelling to Taiwan and Vietnam during November and to Korea and Mumbai in February. For us, being close to our holdings, with boots on the ground is a clear competitive advantage in adding value to our clients.

We will be closely monitoring China's environment. Congress outcome (with current information) was bad in our view, leaving the door open for Xi to do anything he desires. We just don't know where he intends to drive the country. We also have to factor in new US sanctions, which probably have not ended. We've lowered our positions in China and become market neutral amid increasing uncertainty. It is totally probable that pragmatism will prevail, and the country will gradually end its Zero Covid Policy during 2023. If that is the case, we are very well prepared to reposition ourselves in China, expecting earnings upgrades. But as for now we prefer to be cautious. We thought history could give us a guideline but it hasn't been the case[2]

We assisted in a conference in Dubai with many Egyptian companies. We are currently invested in two holdings in the country, and we find there are very interesting bottom-up stories. For sure we must control risk and the Macro environment continues to be cloudy, but there are some interesting events happening as the devaluation of EGP which prevails the imminent agreement with the IMF. This is a situation we are closely monitoring; it reminds us of November 3, 2016, when a significant rally started after devaluation and the subsequent IMF agreement. Nevertheless, the optimism started fading away due to long term lack of investments and catalysts. In this cycle we have reasons to be more positive for a more structural pick up of the country although we will not hurry digesting the ongoing developments step by step.

The Global Alpha team

[2] Please see our weekly note: China History doesn't repeat itself but it often rhymes, published on March 10th.

About Global Alpha Capital Management Ltd.

Global Alpha Capital Management Ltd. (Global Alpha) is an independent and privately owned investment management firm focused exclusively on global and International small cap portfolio management. The team believes that portfolios built from the bottom up using a global thematic perspective and a risk-controlled, low turnover approach are key to generating consistent added value for clients over time.

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Performance figures are stated in Canadian dollars. Performance figures are stated after trading fees and before management fees and operating expenses. Operating expenses include items such as custodial fees for segregated accounts and for pooled vehicles would include charges for valuation, audit, tax and legal expenses. Such additional operating expenses would reduce the actual returns experienced by investors in segregated accounts and pooled vehicles. Further information about the Global Small Cap Composite is available by contacting the firm.