ASH PARK

Compounding through Consumer Staples

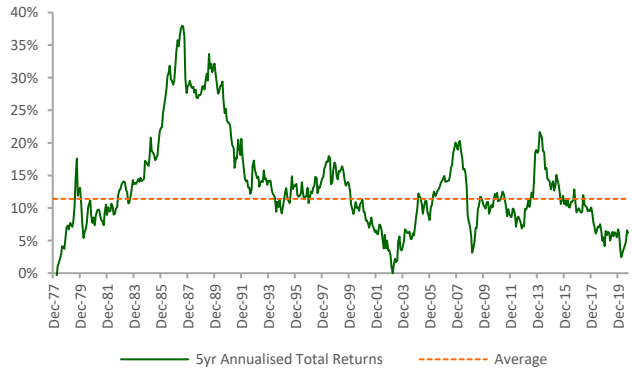
Ash Park on Asian Beauty

Our long-term 'buy-and-hold' approach to owning the world's best consumer franchises, which history has shown produce superior long-term returns, predisposes us to trade infrequently. But the global disruption caused by Covid-19 has created an unusually large number of opportunities for our strategy to buy in to some strong businesses at very attractive valuations. Our previous scepticism over direct investments in Chinese consumer stocks has only been reinforced by the collapse in Luckin Coffee and ongoing corruption chatter surrounding the baijiu stocks. But our increased exposure to Asian Beauty – now lifted to 14%, having previously been limited to a position in Estée Lauder – should enable us to access the Chinese consumer growth opportunity across a number of different markets and channels and in a much more attractive way. Low levels of per-capita beauty consumption in China should support this superior growth outlook for several decades to come. Adding our Beauty exposure to positions in some smaller companies, and taking into account the valuations of our Tobacco holdings, we now think two thirds of the portfolio is capable of delivering mid-term returns of ~15% pa, well above our longer-term expectations.

The Ash Park Global Consumer Franchise Strategy

- Concentrated portfolio of high-quality businesses . . .
- . . . seeking to sustain high returns on capital, underpinned by much-loved everyday consumer brands
- A smart way to access the EM consumer growth opportunity
- No benchmark constraint, significant liquidity
- Low turnover, minimising frictional costs
- Removes reinvestment risk and the need to find the 'hot new' investment theme
- Managed by experts in the Consumer Staples industry and backed by a global network of contacts
- Principals have at least 75% of their investible assets in the Strategy

Global Staples have never lost money in any 5yr period



Returns in US$ for Ash Park Global Consumer Staples index, since 1977
Source: Ash Park, Refinitiv Datastream

Ash Park Global Consumer Franchise UCITS Fund Returns (EUR, net of all fees and expenses)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2020	0.1%	-9.2%	-6.2%	8.5%	0.9%	0.0%	-2.1%	1.2%	2.5%				-5.2%
2019	3.5%	5.5%	6.4%	-0.4%	-3.0%	0.7%	2.2%	0.9%	0.3%	-2.6%	4.6%	1.2%	20.6%
2018	-2.1%	-6.5%	0.6%	-1.0%	0.8%	2.5%	3.4%	-1.4%	-0.2%	-1.6%	-1.4%	-7.7%	-14.1%
2017	-0.2%	8.4%	1.8%	0.0%	4.4%	-3.6%	-3.5%	-1.2%	-0.2%	1.6%	0.0%	2.7%	10.1%
2016	-0.4%	-1.2%	1.4%	0.2%	2.6%	2.6%	-0.9%	-0.7%	-0.9%	-2.2%	-3.6%	2.3%	-1.2%
2015	9.7%	5.3%	-0.1%	-1.9%	3.1%	-4.3%	6.0%	-7.9%	2.0%	8.8%	3.0%	-3.3%	20.5%

				Cumulative			Annualised	
2020 to 30th Sep	**CY 2019**	**CY 2018**	**CY 2017**	**12m to 30th Sep**	**3 yrs to 30th Sep**	**Since Inception**	**3 yrs to 30th Sep**	**Since Inception**
-5.2%	20.6%	-14.1%	10.1%	-2.3%	2.5%	37.9%	0.8%	5.5%

The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not a guide to future performance.

Source: Ash Park. This table illustrates the returns of the Ash Park Global Consumer Franchise UCITS fund which launched on 14 October 2014. The Ash Park Fund returns illustrated above are the net asset value per share of GBP Class A shares of the Ash Park Global Consumer Franchise UCITS Fund translated into EUR at the relevant daily exchange rate (net of all fees and expenses, all dividends reinvested) up to 24th November 2015, and thereafter reflect the net asset value per share of EUR Class A shares. Past performance is not an indicator or guarantee of future results. The UCITS fund is not available to US investors.

Ash Park on Asian Beauty

Holding up half the sky

"To understand my mother — and not just my mother, but many women of her background and age — you have to go back to the Cultural Revolution of China, and possibly a generation before that, too. My mother was born right when the movement started in 1966, when Chairman Mao Zedong mandated the purging of anything that appeared capitalist or traditional in Chinese society. Mao believed that paying attention to feminine beauty was considered both petit bourgeois and an outcome of gender oppression. Mao wasn't just against Western forms of femininity — he was radically opposed to traditional Chinese norms of beauty, too."[1]

Figure 1: Scene from *The Red Detachment of Women, 1972*[2]

Source: US National Archives

Interviewed by *China Daily* in 2005, Wang Ping – author of *Aching for Beauty*, a history of footbinding in China – told the paper *"the aesthetic taste during the Cultural Revolution advocated for a 'revolutionary beauty' style like the gray Mao suit, army uniform and short hair, a unisex style which went hand in hand with Mao's advocating for women as the other half of the sky. . . I genuinely believed these were the only measurement for beauty and the uniform was the most beautiful thing on earth, that make-up and permed hair were a horror."*[3]

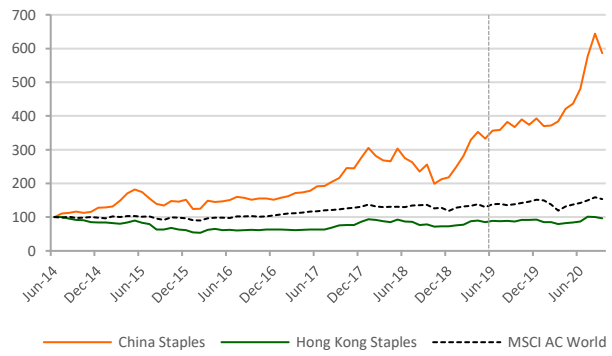
It might seem a little clichéd to begin a letter on China with a story about Chairman Mao, but in seeking to understand what is happening in the beauty industry today it really does seem important to recognise the impact the Cultural Revolution had. During this period cosmetics production and use was supressed[4], and the subsequent ending of that repression, and China's ongoing economic liberalisation, have produced what we think is a really exciting growth story. The Covid-related disruption to retail trends – and stock prices – has given us an excellent chance to increase our exposure to the China beauty theme.

We're still wary of Chinese listed businesses

We wrote our Q2 2019 letter[5] about what we saw as the perils of making investments directly in listed Chinese companies. This is a market that fascinates us, but we are also determined not to get involved in situations we don't fully understand, or which are dependent on more-or-less corrupt distribution networks. Most importantly, we are determined not to be pushed into making bad investments in an exciting market purely because of FOMO and a scarcity of viable stocks to choose from.

Last summer China Staples had already enjoyed a remarkably strong run, producing US$ total returns of 256% in the five years to June 2019 – a 29% CAGR. But the performance of the sector in China has accelerated markedly since then, leading to a 65% total return over the 15 months to the end of this September. Covid barely made a dent in returns, and the subsequent recovery looks to have been rocket-powered.

Figure 2: China Staples' strong performance has continued



Total returns in US$, gross dividends reinvested. 30th June 2014 = 100
Source: Ash Park and Refinitiv DataStream

That archetypal Chinese spirit drink, baijiu, has once again been the driving force. Last time we looked we thought it remarkable that the largest and most prestigious of the Chinese baijiu businesses, Kweichow Moutai, had added $151bn of market cap over the five years to June 2019, but it turns out it was just getting started: its market cap has since risen another $128bn (to put it another way, more than one and a half Diageos). With a current market cap totalling $308bn it is now running very close to P&G and Nestlé for the title of the world's largest Staples company. We estimate that Moutai and its giant baijiu peer Wuliangye ($125bn market cap)

[1] Beauty Shopping With My Mother, a Former Cultural Revolution Red Guard – *Racked*, 19th January 2017

[2] This ballet was performed for President Nixon when he visited China in 1972, and is one of the eight 'revolutionary operas' produced during the Cultural Revolution with the close involvement of Jiang Qing, the wife of Chairman Mao.

[3] Chinese women go 'crazy' for cosmetics – *China Daily*, 7th June 2005

[4] Although judging by Figure 1, make-up was OK for the theatre. As the author of the *Racked* article notes: *"That's not to say that beautiful, adorned women weren't used as political devices in the Communist Party . . . As with all movements led by mostly men, beautiful women were used to glorify and distract."*

[5] *Ash Park on China*, July 2019

generated well over half of the Chinese Staples returns shown in Figure 2 over the last 15 months.

Yet the arrest and prosecution of former Moutai managers and distributors on bribery charges has continued[6], as have the bail-outs of local infrastructure projects[7], and just in the last few months Chinese authorities have stepped-up their rhetoric against corruption in the company and the pricing of its *Fetien* brand[8]. Is it always wrong not to have owned stocks which have gone up a lot? Painful, perhaps, but we are convinced our investors' long-term interests are best served by our maintaining our discipline. We are also mindful that during the last major Chinese anti-corruption campaign in 2013, Moutai's earnings didn't grow for four years and its forward P/E collapsed from the 20-30x range to a low of under 7x. The consensus forward P/E today is 38x.

In a pre-Covid time which seems like another age, but was in fact only late January, we were pitched an exciting Luckin Coffee story on the fringes of a big investor gathering. Just a couple of days later an anonymous investor released a detailed dossier alleging that much of Luckin's activity was fraudulent. By this summer the company had admitted to faking a substantial portion of its revenues, and much of the top management was fired.[9] A stock which reached a peak market cap of $4.9bn and counted some large, sophisticated investors amongst its shareholders has collapsed to a market cap of $285m. That's a bit more excitement than we can comfortably handle.

Figure 3: Nongfu Spring: turning water (and PET) into billions

Source: Nongfu Spring

We've followed the dynamics of the bottled water industry for a long time and have found it to be a reasonably attractive business at the premium end for brands with a provenance (like Nestlé's *San Pellegrino*) or added consumer benefits (eg Coca-Cola's *smartwater*). Mass-market water is tougher because it tends to be a more commoditised business, with margins to match, not to mention ever-increasing pressures from environmental concerns.

A few years ago, Coca-Cola decided to deemphasise low-margin water in China (and elsewhere), ceding volume in the process. And a month ago Nestlé announced that it was selling its mass-market Chinese water business to Tsingtao.[10] Our view on water looks positively jaundiced compared to the exuberance greeting last month's IPO of Nongfu Spring.[11]

Nongfu Spring's market cap is now $50bn, valuing it at 61x forward earnings and at almost 15x last year's revenues. Nestlé looks to have got not much more than 1x sales for its own Chinese water business, and even the mighty Coca-Cola trades on only 40% of Nongfu's sales multiple. Nongfu makes remarkably good margins and has plenty of growth avenues (tea, juices and functional beverages account for approaching 40% of revenues), but we think we ought to be able to find more attractive investment opportunities than this.

Smoore International Holdings is one of the world's leading manufacturers of vaping and tobacco heating devices, with clients such as international tobacco giants BAT (which brands its vaping devices *Vuse*) and Japan Tobacco, and large independent vaping businesses such as RELX and NJOY. Smoore has grown rapidly alongside the overall vaping market and, assuming that the industry can navigate the regulatory squalls that threaten in the near term, should have an exciting long-term future.

Figure 4: A *Vuse Alto* vaping device, manufactured by Smoore

Source: BAT

But here again we wonder about the valuation. Smoore's 2019 revenues were $1.1bn, and its $26bn market cap puts it on around 24x trailing revenues, or around 44x consensus 12m forward earnings. BAT, one of Smoore's largest customers, generated $1.6bn in revenues from next-generation products (NGPs)[12] out of a total of $33bn in sales. But BAT is valued at just 4x trailing revenues and 8x forward earnings. If BAT's NGP business traded on the same revenue multiple as Smoore's, it would account for close to half of BAT's total market cap, and BAT's legacy combustible business would be trading on around 4.5x forward earnings.

Is the long-term value in the future of the nicotine industry going to come from technology, or from the brands selected by consumers? Smoore is a pure play on NGP growth, but only a small proportion of its sales come from its own brands: its future success is heavily linked to the success of its largest clients, and in staying close to the technological leading edge. Smoore might well turn out to be a

[6] Former Kweichow Moutai vice-chairman jailed for taking bribes – *China Daily*, 24th August 2020; Ex-general manager of Moutai e-commerce gets 1 year for bribery – *China Daily*, 31st March 2020

[7] Why China's prized booze company is helping bail out a highway builder – *Quartz*, 18th September 2020

[8] Chinese liquor group Kweichow Moutai tumbles after graft news report – *Financial Times*, 16th July 2020; Regulators warn of rising prices for famed liquor brands ahead of holiday – *Global Times*, 23rd September 2020

[9] Luckin Scandal Is Bad Timing for U.S.-Listed Chinese Companies – *Bloomberg*, 29th July 2020

[10] Nestle sells China water business to Tsingtao – *China Daily*, 28th August 2020

[11] Bottled water IPO makes founder China's third richest person – *Financial Times*, 8th September 2020

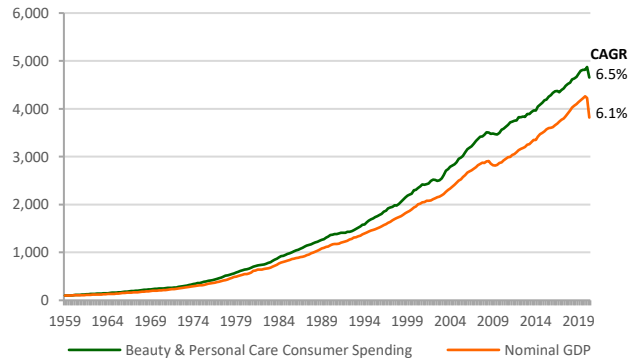
[12] NGPs including vaping and tobacco heating products, and oral nicotine pouches.

great long-term investment, but a stock like BAT seems to be a much better one at this price.

Beauty versus the beasts

We are left struggling to find direct China exposure that we are prepared to own, due to a combination of company-specific factors, valuation, and the broader Chinese governance issues which still concern us. We prefer to get our Chinese exposure through other international companies that happen to have a large presence in the Chinese market. In the beauty industry we have found some stocks that we think we can get behind properly.

Figure 5: US beauty spending consistently outstrips GDP



Current US$, Q1 1959 = 100
Source: Bureau of Economic Analysis, Ash Park

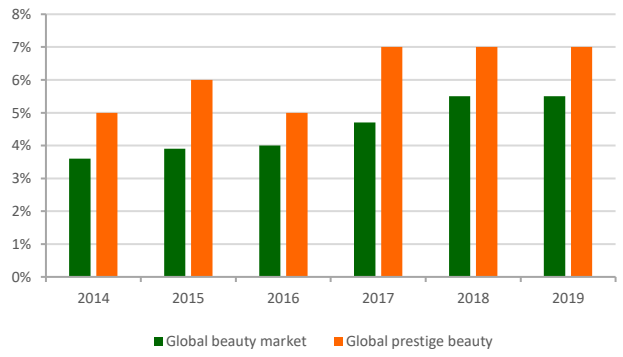
Typically, we avoid selecting investments based on their category exposure, because we've found that a company's own behaviour, rather than the Staples business in which it operates, has tended to be the bigger determinant of returns. Nevertheless, it has always struck us as notable that Beauty and Personal Care is the one Staples sector for which consumer spending has outpaced GDP: it appears there are natural constraints to the quantity of food, drink or tobacco that people can ingest, but fewer limits to how much people can spend looking after their body or appearance.[13]

Beauty is a business with highly attractive gross margins – typically 70-80% for the larger international companies, compared to 35-40% for a good packaged food company – which gives companies a lot of resource to invest behind their brands. There is a natural trend towards premiumisation, so that in many markets the luxury end of the beauty category is the fastest growing part (Figure 6).

Putting a lipstick (back) in the hands of every woman

The consequence of the Cultural Revolution for cosmetics in China was that when a Shiseido executive, Hisako Nagashima, travelled to China in the early 1980s, he saw little make-up and people also seemed to be wearing the same clothes: *"People were clad in the same uniforms and it was hard to tell the difference between men and women. Clothes were being rationed, so they were wearing the same red army uniforms."*[14]

Figure 6: The global beauty market is premiumising

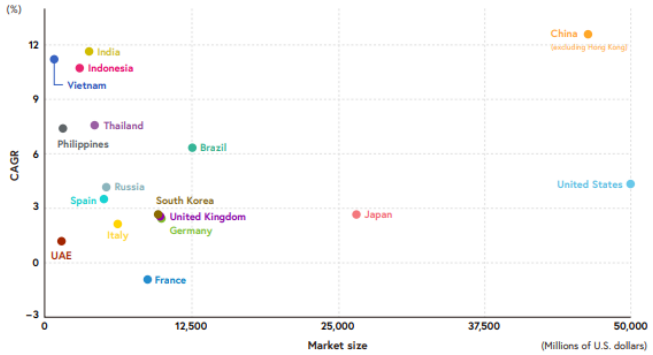


Source: Estée Lauder, L'Oréal, Ash Park

The European, American and Asian companies that entered China in the 1980s and 1990s built on past heritage to revive cosmetics use, exemplified by the mission of storied former L'Oréal CEO Sir Lindsay Owen-Jones to *"put a lipstick in the hands of every Chinese woman."*

China is already the second largest beauty market in the world, and it's the fastest growing (Figure 7), yet there seems a very long way to go. Per-capita beauty consumption is still not much more than a quarter the level of developed markets, and also runs far below neighbouring countries. A recent broker report we saw put Chinese per-capita cosmetics spend at $31 in 2019, compared to Japan at $199 and Korea at $170.[15]

Figure 7: Size of cosmetics market and 2015-19 CAGR



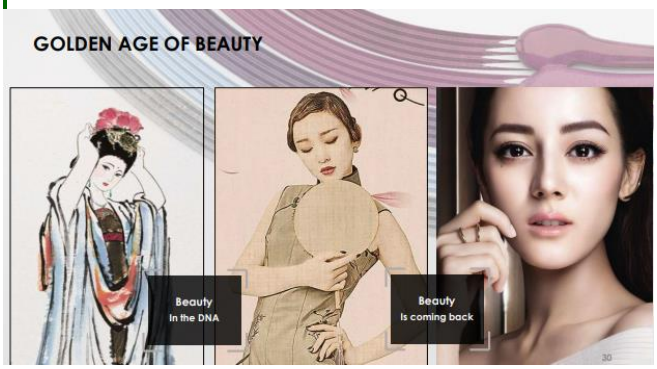
Source: Shiseido 2019 Annual Report

[13] US consumer spending on Food, Beverages and Tobacco has tended to decline modestly as a proportion of GDP. That doesn't make them bad investments: people still need to keep eating and drinking and their habits don't change very much, whereas the winners and losers in other categories of consumer spending – think household appliances, cars or clothing – can change very much more quickly.

[14] Making China Beautiful: Shiseido and the China Market – *Harvard Business Review*, July 2008

[15] Asia Consumer: The next big thing – *CLSA*, 23rd September 2020

Figure 8: A new golden age of beauty in China



Source: L'Oréal Capital Markets Days in Shanghai, November 2018

If the exciting Chinese consumer growth theme is already well-known in the investment world, the beauty category seems to be a supercharged way to access those trends. There are three factors specific to beauty that support attractive levels of long-term sustainable growth:

Reach

Beauty is becoming more accessible. There are thousands of department stores across China, most of which have upgraded from mass beauty portfolios towards prestige offerings, but the combined effects of travel and e-commerce have significantly increased the reach and ability of consumers to spend. Around 10% of Chinese citizens hold a passport, and traveller growth has been running at just over 10% pa, with spending of $2,335 per trip / head. Social media and e-commerce have significantly expanded reach too. Although most prestige brands often reach a few hundred cities, e-commerce platforms like Alibaba have expanded that reach to 30,000 cities, opening up the potential consumer base from 100m to closer to 600m, with plans to extend that further to 800m consumers.

Digital

This isn't just about reach, but also about teaching a large consumer pool, coming out of a 30-year blackout, how best to use beauty products, especially make-up. The digital revolution and shift to online has worked very well for global companies because for consumers it's more about education and product research – upgrading and premiumising demand – and less about price comparison and the downwards pricing pressure that can sometimes accompany online retail growth in other markets.

Competitive landscape

There are no significant local Chinese players in prestige skincare[16], only Western and other Asian players. This won't last forever[17], but in the medium term the international beauty companies are regularly taking share from the mass-market players which are dominated by Chinese companies.

Figure 9: Mark & Harold at Shiseido's new R&D centre, May '19

Source: Ash Park

Covid's impact on beauty sales channels

We have held a position in Estée Lauder, the world's largest pure luxury cosmetics company, since our launch; it has been an excellent stock for us. We estimate that Estée has doubled its sales in China in the last three years, and that this market now accounts for around a quarter of the group's sales. But we have been interested for a while in increasing and diversifying our exposure to the Asian beauty category, taking regular field trips (Figure 9) and digging further into the Japanese and Korean listed beauty businesses.

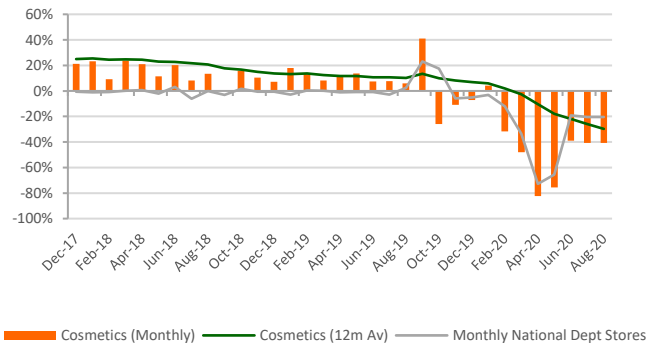
Over the last five years the Japanese Cosmetics companies have been very strong performers, underpinned by rapidly-growing earnings. Much of the earnings growth came from Chinese consumers, albeit in a variety of channels: the Japanese companies have seen strong growth in their Chinese subsidiaries, but the impact of Chinese tourists buying in the large travel retail segment, and in Japan itself, has also been significant. Taking each of these channels into account, we estimate that the largest Japanese Cosmetics player, Shiseido, effectively generated around a third of its sales from Chinese consumers in 2019, which makes it at almost the same size as its underlying Japanese business.

The Japanese consumption tax increase in October 2019 caused a little short-term upheaval to sales trends but, not surprisingly, the impact from Covid has been much greater. Department store traffic in Japan has weakened substantially, partly because of the impact of the state of emergency on domestic shoppers, but also reflecting an almost total halt to inbound tourist visits. Cosmetics sales, which had been trending well above the national department store average, have trended below average in the Covid period, reflecting the strong weighting of tourists in cosmetics purchases (Figure 10).

[16] Skincare accounted for 73% of the value of the Chinese beauty market in 2019, compared to 20% for make-up and 7% for fragrances (similar to the split in Japan). The markets of Europe and North America are weighted much more equally to fragrances and make-up, with skincare accounting for about one third of sales value in each region. *Source*: *Shiseido 2019 annual report*

[17] And in cosmetics we are paying close attention to the impressive rise of *Perfect Diary*: China's Perfect Diary gives cosmetics world a makeover – *The Business Times*, 27th August 2020

Figure 10: Cosmetics sales in Japanese department stores

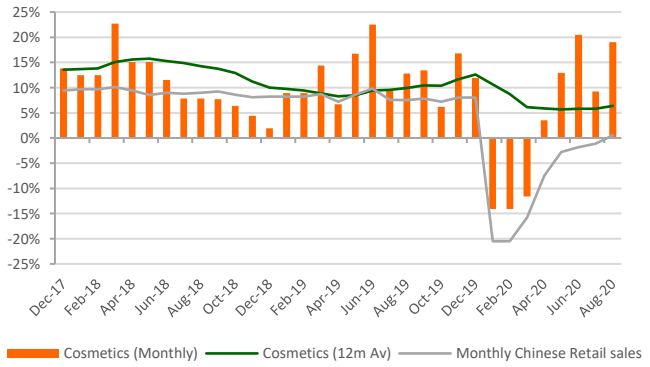


Cosmetics sales represent the average of figures from two large Japanese department store chains, Takashimaya and J Front Retailing
Source: Ash Park, company data

On the other hand, cosmetics retail sales in China have bounced back very rapidly after the initial hit from Covid-related lockdowns (Figure 11). Online sales have grown particularly strongly – for instance, Groupe L'Occitane's grew over 90% in Q2 and Estée Lauder's Chinese e-commerce sales more than doubled – so that China now has the highest online sales penetration amongst the world's largest beauty markets.

The current picture is further complicated by the travel retail segment, which typically accounts for an important and very profitable portion of sales (around one fifth of the Chinese beauty business). You might expect that an almost total halt to international travel would mean nearly zero sales in this channel, but in fact it's been quite resilient. Estée Lauder's travel retail sales fell only 30% in Q2, and Shiseido's performance was broadly similar. The latter's travel retail sales to consumers in Asia actually *grew* in the low teens in Asia for the same quarter.

Figure 11: Retail Cosmetics sales in China



Source: National Bureau of Statistics of China, Ash Park

Figure 12: A busy *Shiseido* store in Hainan Island

Source: Shiseido H1 2020 results presentation

Chinese travellers might temporarily have stopped visiting Japan[18], but it seems that domestic travel has held up well, with internal flights this August reportedly running at almost the same level as last year. The popular tourist destination of Hainan island has seen a particular boom in cosmetics sales, having increased the annual allowance for duty-free shopping from 30,000 to 100,000 yuan (~US$ 4,400 to 14,700) per person from 1st July this year. Total duty-free spending in Hainan increased 228% to RMB 8.61bn (~US$ 1.25bn) in the three months to September.[19]

We've seen similar resilience in Korea, where the travel retail channel isn't just about tourists going through airports, but also organised trips of professional 'daigou' shoppers, large downtown duty-free stores, and online sales, all of which have dampened the impact of reduced tourist travel.

Figure 13: Quick rebounds after previous crises

Source: L'Oréal presentation at Kepler Chevreux Conference, Sep 2020

[18] Chinese visitors accounted for 51% of overall visits to Japan in 2019, and in the three months to July 2020 these visits fell 100%. In the three years to December 2019, the number of Chinese visitors to Japan grew by around 11% a year.

[19] Booming domestic travel demand during summer holidays proves to be a bright ray of sunshine for China's aviation sector – *South China Morning Post*, 3rd September 2020; China's changing duty-free strategy – *CGTN*, 4th October 2020

Figure 14: Harold product testing in Shanghai, November 2018

Source: Ash Park

From the 'lipstick index' to the 'moisturizer index'

About 20 year ago Leonard Lauder, then chairman of Estée Lauder, conceived the 'lipstick index' to express the idea that sales of affordable indulgences remained robust in tough economic times. He hadn't reckoned with face masks. Speaking on a recent investor call Estée's current CEO, Fabrizio Freda, explained:

"Lipstick is not selling, but the index is still valid. It's just been substituted by moisturizers. And that's why I called the new moisturizer index, meaning the concept is still the same. Beauty is a very resilient category, and people don't give up their basic beauty habits so easily. This time, they didn't give up their moisturizers. Historically, they were not giving up their lipsticks."[20]

In watching the Asian Beauty companies we've been mindful that from time to time there are upsets – eg the SARS and MERS episodes, or the THAAD crisis that hit Korean stocks in particular – which have presented good entry points. Covid is another of those episodes.

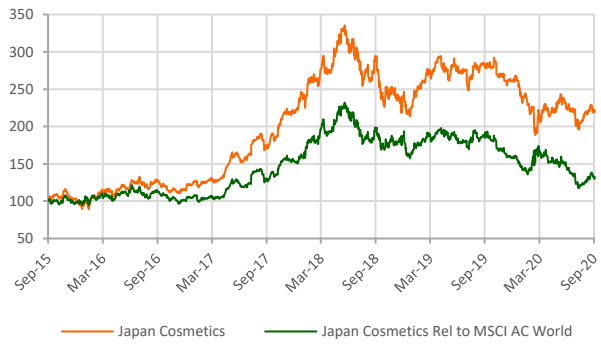
As L'Oréal points out, the beauty market has always rebounded – and quickly – after previous crises (Figure 13). Even with masks, make-up consumption is recovering month by month and perhaps, in CEO Jean-Paul Agon's words, when Covid is just a bad memory *"there will be a firework of make-up consumption, to celebrate".*

There are lots of reasons to be optimistic for the future of the beauty industry, beyond the strong historic growth trend we showed earlier in Figure 5. Economic and demographic factors support Asian growth, but there are also new market opportunities amongst ageing populations, from consumers' desire for more healthy, natural and sustainable products, and from the still nascent male consumption of beauty products (Figure 14). The shift of sales to e-commerce channels is also increasing access to beauty and allowing more engaged and personalised relationships with customers.

That said, Covid's short-term impact on sales has been significant, and will cause substantial declines in profits at some beauty companies this year, as they are squeezed by a combination of the temporary sales drop and the decision to continue investing so that they emerge as winners when the world normalises. That is the kind of behaviour we like, even if it can scare some investors and bring down stock prices in the short term. The Japanese cosmetics stocks, for example, hit two-year absolute and relative lows over the spring / summer (Figure 15).

We have used that opportunity to increase our exposure to the beauty category, specifically to Asia as well, by adding three new stocks which have sold off considerably since the start of the year. We are confident that when we look back in a few years' time this will prove to have been a great entry point.

Figure 15: Japan Cosmetics sector total return index



Gross dividends reinvested, US$. September 2015 = 100
Source: Refinitiv DataStream, Ash Park

Our new Asia beauty positions

We have decided to spread our exposure to Asian beauty across five stocks with different nationalities and listings in order to mitigate risk that can come with tariff impositions or political contretemps. In addition to our positions in Estée Lauder (US) and L'Occitane (Hong Kong listing, European business headquarters – initiated in May last year but also boosted this spring) we have bought Shiseido and Kosé (both Japanese) as well as Amorepacific (Korean).

Aside from their significant position in the Chinese beauty market, these new stocks share another attribute that we find attractive. Like Estée Lauder, three of them retain a strong influence from their founding family (Kosé, Amorepacific) or another large shareholder (L'Occitane).[21]

And though this isn't the primary reason to own them, we consider that there are valuation anomalies with two of the stocks. Despite being a strong global brand, L'Occitane seems to be a poorly-

[20] *Estée Lauder investor webcast, 27th August 2020*

[21] Shiseido's culture also still has close links to its founding family, though no family shareholder block. Yoshiharu Fukuhara, grandson of founder Arinobu Fukuhara, became President & CEO of the company in 1987 and is today its Honorary Chairman.

followed company, which may be down to a combination of its relatively small size (~$2.5bn market cap) and the fact that it's a European-headquartered business with its primary listing in Hong Kong. And for Amorepacific we've been able to buy the Corporation's preference shares, which come without votes but trade at a discount of around 65% to the ordinary shares, with essentially identical economics.

It's not easy benchmarking valuations when this year's financial performance is so heavily impacted by Covid factors. But looking out to 2022, by which time we expect sales trends to have normalised, we think our aggregate Beauty positions give us very attractive market exposures. We've mentioned L'Oréal a lot in this letter (and we actually have a small exposure to it via our investment in Nestlé) and it's a great business with impressive leadership. But our aggregate position gives us the same online presence, 50% more China exposure and a higher gross margin / lower EBIT margin (and therefore more upside potential in our view) on an appreciably lower valuation (Figure 16).

Figure 16: EV / Sales multiples of our Asian Beauty exposure

	Ash Park Beauty	L'Oréal
China exposure %	32%	23%
Online exposure %	32%	32%
Gross margin %	76.7%	73.0%
2022 EBIT margin %	11.5%	18.6%
2022 FCF yield %	4.3%	3.2%
2022 EV/Sales	2.4	4.3

Source: Ash Park estimates

Shiseido

Shiseido was founded in 1872 and is one of the oldest and most global Japanese beauty companies. It has always had a reputation for its R&D capabilities and high-quality products, but the 2014 arrival of an external CEO, Masahiko Uotani, has given the company a new transformational energy: in the five years since his arrival sales have grown 50% and the margin nearly doubled (albeit still only just over 10% in 2019).

Figure 17: Shiseido's diverse top management team

Source: Shiseido

Under Mr Uotani's stewardship Shiseido has completely revamped its product portfolio to focus on fewer, prestige skin-focused ranges, made major investments into R&D, IT and manufacturing capabilities and, most importantly, significantly increased the marketing budget. The company has also sought to stimulate cultural change by hiring other external talent, with the result that it now has a management board which looks significantly more diverse than that of many Japanese (or indeed US or European) companies (Figure 17).

Kosé

Kosé was founded in 1946 by Kosaburo Kobayashi, the grandfather of the current CEO Kazutoshi Kobayashi. The company has always focused on prestige brands – such as *Decorté* (Figure 18), *Albion* and *Sekkisei* – and R&D, and for nearly 40 years had a technical cooperation agreement with L'Oréal. Although the company's international expansion, in Hong Kong and Singapore, started in the late 1960s, it remained focused on the domestic Japanese market until relatively late: Japan represented 84% of revenues as recently as 2015. An international push has now started in earnest; group revenues have increased by nearly 60% since 2015, and at the most recent set of results Japan represented only 58% of sales.

Figure 18: Kate Moss advert for Kosé's *Decorté* brand

Source: katemossagency

It acquired a majority stake in *tarte*, a US vegan and cruelty-free make-up brand, in 2014 for US$135m and the business has since grown very substantially. The push into China has come relatively late, but that has allowed Kosé to put e-commerce at the vanguard of its initiatives, rather than having to start out building a deep and expensive network of stores. That has allowed its Chinese business to keep growing strongly through the Covid crisis: in Q2, 80% of its Chinese sales were online, growing 59% and allowing Kosé's overall Chinese sales to grow 17% despite a halving of sales through physical stores.

L'Occitane

The *L'Occitane en Provence* brand was founded in 1976, selling natural personal care products with a clear French regional provenance. The present Chairman and controlling shareholder, Reinold Geiger, acquired a majority shareholding in 1996 and began the group's internationalisation; the stock was listed in Hong Kong in March 2010. When we first invested in May 2019, we felt that the company was coming towards the end of a near decade-long store roll-out program and a heavy upweighting of marketing spend (up >400bp as a % of sales), which was just starting to pay off in

terms of top and bottom-line growth. With approximately one quarter of sales in Greater China and a strong online capability, the company had started to deliver mid to high single-digit organic sales growth pre-Covid – impressive off a €1bn+ sales base.

Figure 19: L'Occitane's Tmall store with Single's Day campaign

Source: Tmall

Despite the significant Covid-19 impact and the closure of most of its store base for a period of time, the business is bouncing back quickly. Online sales grew 96% and accounted for 53% of sales in the quarter ending 30th June, and the geographic highlight was China, where total sales grew 25% year-on-year. Since then, the recently acquired, high-margin *Elemis* brand has launched in China via 100+ Sephora outlets and online via T-Mall, which should further accelerate sales growth and increase group exposure to the attractive Chinese skincare market.

Amorepacific

Amorepacific was founded in 1945 by Suh Sung-whan, whose mother sold camellia oil as a hair treatment; his son, Suh Kyung-bae, is its Chairman and CEO today. The company's first product was *Melody Cream* moisturizer, and it has maintained its focus on skincare, with brands such as *Sulwhasoo*, *Laneige* and *Innisfree*. Amorepacific has long been recognised for its R&D and new product launch capabilities: for instance, it was the first to properly understand the consumer benefits of retinol in anti-aging products, creating a beauty boom that went global.

Like many of the Asian players, Amore's expansion into China came relatively early as it benefited from the rise of Korean popular culture, and it has also been adept at capturing the rapid growth of travelling Chinese through the booming Korean duty-free channel; Chinese consumers now account for over 50% of Amorepacific's sales. More recently, having experienced a period of turbulence during the 2016 THAAD crisis[22], Amorepacific has doubled-down on investing behind its most premium products and in the rapidly growing e-commerce channels. Having doubled sales in the seven years to 2019, we believe that it carries the right heritage to bounce back strongly from the Covid crisis.

Figure 20: First Care Activating Serum from *Sulwhasoo*

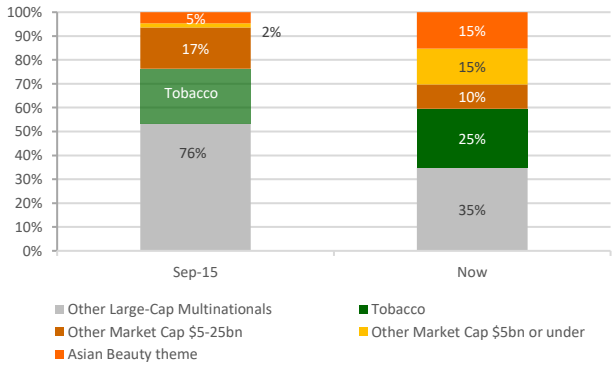
Source: sulwhasoo.official

Continuing the evolution of our portfolio

In previous letters we described how we've added more companies lower down the market cap scale over the last couple of years. Having added more exposure to Beauty over the last six months we thought it would be interesting to see how the portfolio had changed over the last five years.

We now have two thirds of the fund in either an identified theme (Beauty) special situation (Tobacco) or small (Fever-Tree, Nomad) or focused mid-cap stocks (eg Lindt, Campari and Brown-Forman). Large-cap multinationals now account for 35% of the fund, compared to 76% five years ago. That 76% included 23% in Tobacco stocks, which then traded in essentially the same manner as other international FMCG businesses. Our Tobacco exposure now carries a prospective dividend yield of 8.2% (4.1% in September 2015) and comes on a forward P/E of just 8.5x (v 14.7x).

Figure 21: How our portfolio has evolved



Source: Ash Park

We are still very enthusiastic about the high-quality large-cap branded Staples companies we own, which have an excellent

[22] The decision by Korea to deploy the US Terminal High Altitude Area Defense (THAAD) anti-ballistic missile system caused a wave of Chinese boycotts of Korean products and a temporary big drop in tourist visits.

record of long-term value creation. But we are increasingly excited about the other 65% of the fund: offering similar high-quality and broad geographic exposure but likely to offer superior returns.

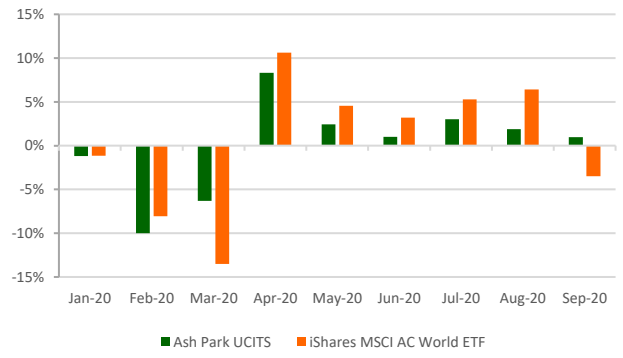
We expect our Beauty businesses to grow faster than our portfolio average, supported in particular by the heavy weighting towards China. We also know that the smaller stocks can grow somewhat faster than the portfolio because they typically operate in categories – such as premium chocolate or niche spirits or mixers – with a longer runway for growth from the ability to increase household penetration of their products. And Tobacco's prospective returns have been pushed up significantly by the market seemingly writing them off as no-growth value stocks: in fact, their earnings growth has been beaten the global market, as well as the global Consumer Staples average, since our launch, even before Covid effects kicked in.

Q3 portfolio review

Over the quarter, and as discussed, we initiated positions in Kosé and Amorepacific Corporation, and added more to Shiseido. We didn't make any outright sales, but funded these additions by reducing our weightings in some of our more defensive holdings which have been beneficiaries of the Covid crisis.

Despite that shift in our portfolio towards slightly more economically-exposed stocks, we think the strategy remains nicely defensive overall. Indeed, it is notable that the Fund has materially outperformed the market in aggregate in its down months so far this year (Figure 22). Although the market rebound has been driven by the excitement of growth (seemingly at any price, supported by the magic maths of near-zero interest rates), especially in the Technology sector, we remain focused on delivering steady long-term compounding of sustainable earnings growth whilst minimising downside risk for investors.

Figure 22: 2020 monthly performance



Source: Ash Park, Refinitiv Datastream

Thank you for your support and your interest in Ash Park.

The Ash Park team
8th October 2020

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All data sourced from Ash Park unless otherwise stated.

Performance for other share classes of the Fund may differ. Please refer to your individual statements or contact Ash Park for further information.

Note: Throughout this newsletter 'Consumer Staples' or 'Staples', where the term is capitalised, refers to the Ash Park definition or proprietary indices of the consumer staples sector, which include Food, Beverage, Tobacco and Household & Personal Care companies; the S&P Global Consumer Staples index also includes the Food Retail sector.