RED GATE ASSET MANAGEMENT

FAQs

1. Can you give a brief introduction to Red Gate and what you do?

Red Gate is an independent investment manager with 20 years research and investment experience in the Greater China markets. We have always had the same goal: invest in high quality growth companies that will provide long-term, sustainable alpha for our clients.

We invest in wonderful companies based on a deep understanding their competitive moat and sustainability, future earnings growth potential, ROIC, free cash flow, the quality of the management team, strength of its balance sheet, and the ability to generate high rates of return through reinvestment of cash flows. We leverage our decades-long experience conducting on-the-ground, deep-dive due diligence to cross-check our desk research and drive stock selection and portfolio construction.

Our eight person investment team manages concentrated portfolios of 20-30 outstanding businesses which reduces the chance of owning mediocre names and increases the margin of safety for clients.

We are 100% employee owned with staff investing alongside clients to ensure the closest possible alignment with investors. These clients include leading sovereign wealth funds, pension funds, private banks and family offices

2. What are the important aspects of having an on-the-ground manager for investing in the China Markets?

There are over 6000 companies listed in the Greater China equity markets, forming a large opportunity set with significant structural inefficiencies. These inefficiencies stem from:

- *Inadequate and / or poor research;*
- *Retail investors / a lack of institutional participation;*
- *A general lack of patient capital;*

These market inefficiencies demand extensive local knowledge, something we believe can only be achieved by having an on-the-ground team. This helps form the basis for the idea generation stage of the investment process through to the on-the-ground due diligence and on-going monitoring of portfolio holdings.

3. How would you describe Red Gate's team culture?

Our people are our greatest asset and the driving force behind our success. Our senior management team have been working together for over a decade and are supported by a stable staff of similarly entrepreneurial spirited and talented team members. We encourage an open team environment for discussion, debate and diverse thinking styles, a key reason for this stability. With a shared vision and strong belief in our investment philosophy, every member of the team has invested alongside our investors.

4. What is Red Gate's competitive position within the China marketplace?

- *20 years of China investment experience, including deep-dive research on hundreds of companies provides us an information advantage and gives us a unique view and understanding of the markets and opportunity set.*

- *We have a tried and tested investment process that we are always looking to enhance to better identify and invest in quality growth companies, whilst maintaining a margin of safety for our clients.*

- *The majority of team members' liquid capital is invested alongside our clients. We manage client's capital as if it were our own and only profit if our clients profit.*

- *We have a stable, experienced on-the-ground team who have worked together for many years and complement each other's investment styles.*

- *We are one of only a few China-focused investment managers to be a PRI signatory and we employ strict ESG criteria that is incorporated into our investment process. To date, we have never invested in a fraudulent or delisted company.*

5. What is your investment philosophy and what types of companies do you look to invest in?

Our primary objective is to invest in high quality growth companies that will provide long-term, sustainable alpha for our clients through successive market cycles. Our philosophy can be summarized as:

- ***Invest in Quality Growth** – Excellent future earnings growth, ample cash flow, strong moat, high ROIC, quality management, innovative business models, resilient to change, do not require leverage to drive returns, excellent management team, and ability to generate high rates of return through reinvestment of cash flows.*

- ***Invest with Conviction** – We buy what we know and know why we own them, running a concentrated portfolio of 20- 30 names to reduce the chance of owning low quality and mediocre companies.*

- ***Invest at Reasonable Price** – We do not want to overpay and always want to ensure a margin* *of safety when investing in a portfolio company.*

6. Can you describe your investment process?

We have a simple and repeatable investment process that is centered around our investment philosophy. This can be broken down into three key stages:

I. *We determine our investable universe by quantitatively screening Chinese companies in our favoured sectors listed based on 8 key indicators (ROIC, Gross Margin, Operating Margin, Cash Conversion, Current Ratio, Interest Coverage, Free Cash Flow Yield and PE). We then conduct research on company specifics, including analysis of a company's annual financial reports and any other information that gives us a better understanding of the companies' moat, long-term drivers and the quality of its management team.*

II. *Next comes our deep-dive on-the-ground due diligence. Based in Shanghai we have cost effective and efficient access to a company's staff, customer base and competitors, as well as former employees. We typically look to speak with several primary sources of information to help us understand a company's corporate culture and business model, as well as ensure we avoid poorly-governed and managed businesses. For example: In 1Q 2019 we visited 3rd and 4th tier city hospitals as part of our research on a medical device producer. We were able to talk to end users to see how the quality of the company's products and after-sales support compared to overseas competitors. The feedback from the end-users was very positive with them telling us domestic provider offered the same quality product but with 24 hour service support. This supported our replacement thesis and gave us more confidence in the target company.*

III. *Following our on-the-ground due diligence our target list is narrowed down from around 120 to 40 names. Based on the quality of the business and its valuation, we come up with a final portfolio. We are a long-term and patient investor, preferring to wait for the market to provide us entry points that give significant margin of safety on target names. Once invested we also have a strict sell decision mechanism for exiting positions.*

7. What information advantages you have as an on-the-ground manager?

Aside from having excellent access to companies, their management teams and other primary sources on information in China, being an on-the-ground manager gives us significant information advantages when thinking about sectors, industries and companies to invest in:

- *It gives us a first-hand view of trends, consumer habits and the developments of the market in general. It provides us a first mover advantage over those looking at China from a distance. With many new sectors emerging at an ever increasing rate, being here helps us make* *informed decisions of where research and analysis should be focused.*

- *We are better positioned to look for risk. For example: in early 2015 the government unveiled a series of stimulus packages. The unintended consequence was a surge in the stock market driven by margin financing for retail investors. When the financing tap was turned off, the markets saw significant sell-offs from June to October of that year. Having closely followed the margin lending and developments on-the-ground in the first half of the year, we were able to better navigate these periods of extreme market volatility. We are not here to minimize the short term volatility, but to maximize the long term returns for our clients.*

8. Do you incorporate ESG factors into your investment process?

ESG forms and important part of our investment process. Management quality, shareholder rights, corporate governance and social and environmental responsibility are among the many key factors we consider when evaluating investment opportunities

We believe that Chinese companies that perform well in ESG will also have long-term competitive advantages, for example: good corporate governance can help companies increase profits, reduce expenses and encourage innovation. Companies with high environmental and social standards are more likely to establish a positive brand image by providing high-quality products and services, while also improving customer loyalty and employee enthusiasm.

We are a team of rational people. We conduct our research in a transparent, ethical and sustainable way and expect to find similar values in the companies we invest. There are fewer and fewer fraudulent companies in the China markets but we remain vigilant – just because one of the big four is an auditor it does not mean the company in question is not fraudulent. We do not rely on the research of others and spend anywhere between 4-12 weeks researching a target company, including on-the-ground due diligence and the thorough analysis of financial statements, and key 'quality growth indicators' such as cash flow generation and other hard-to-manipulate data points. We actively avoid companies that have large amounts of debt and/or rely on leverage to drive growth. Red flags will also be raised if there have been major changes in a company's senior management team and/or auditors. Put simply, we only buy what we know and if something limits our access to knowing a company then we will pass. We have never invested in a fraudulent company or in a company that has been delisted.

As an ESG conscious investment manager, we are also one of very few China focused managers signed on to the Principles for Responsible Investing (PRI).

9. How do you manage Risk?

We define risk as permanent capital loss. Our philosophy of investing in handful of quality growth companies with wide moats and margin of safety greatly diminishes the chances of taking *unrewarding bets and losing capital permanently. We also reduce the chances of owning low quality or mediocre companies by:*

- *Having a portfolio that is diversified across sectors, with a 10% single stock limit*
- *Regularly stress-testing holdings on the quality of companies' balance sheets, ability to generate free cash flow, their cash reserves and debt and interest bearing liabilities*
- *Ensuring all existing holdings provide a reasonable margin of safety to have good downside protection*

10. Overseas' investors sometimes question the transparency and reporting standards in China, what red flags do you look for if avoiding a prospective investment?

As a China manager for the past 20 years, we have always avoided companies that:

- *Raise debt and equity frequently;*
- *Their cash flow is inconsistent;*
- *They have much higher gross margin than their competitors with little/no evidence to support why;*
- *They like to change CFOs and auditors more often;*
- *They have very complicated corporate structures with insiders trading in and out the stocks;*
- *High related party transactions;*
- *Questionable management teams who are hard to access and not transparent on their activities;*
- *Unsound business model and illogical diversification and expansion strategy.*

The above are key indicators that a company is not fit to be included in any of our portfolios.

11. Can you provide some insight into the characteristics of the portfolios you manage and what returns you expect to achieve?

The portfolios under management are:

- *Highly concentrated, consisting of 20-30 conviction growth names.*
- *Diversified across sectors, with a 10% single stock limit*
- *Current favorable sectors include: TMT, Healthcare and Consumption sectors, particularly in the high growth areas such as 5G, Online Education, Innovative Drugs and Medical Devices that have low penetration rates and significant earnings growth visibilities for years to come.*
- *Long-term investment horizon of 3-5 years, with a low turnover rate of 25-50% (depending on market volatility and share price).*
- *The portfolio will typically exhibit more than 20% top-line and bottom-line growth*

We aim to achieve 8%-12% annualized net returns over a3-5 year period.