Long Term Global Growth

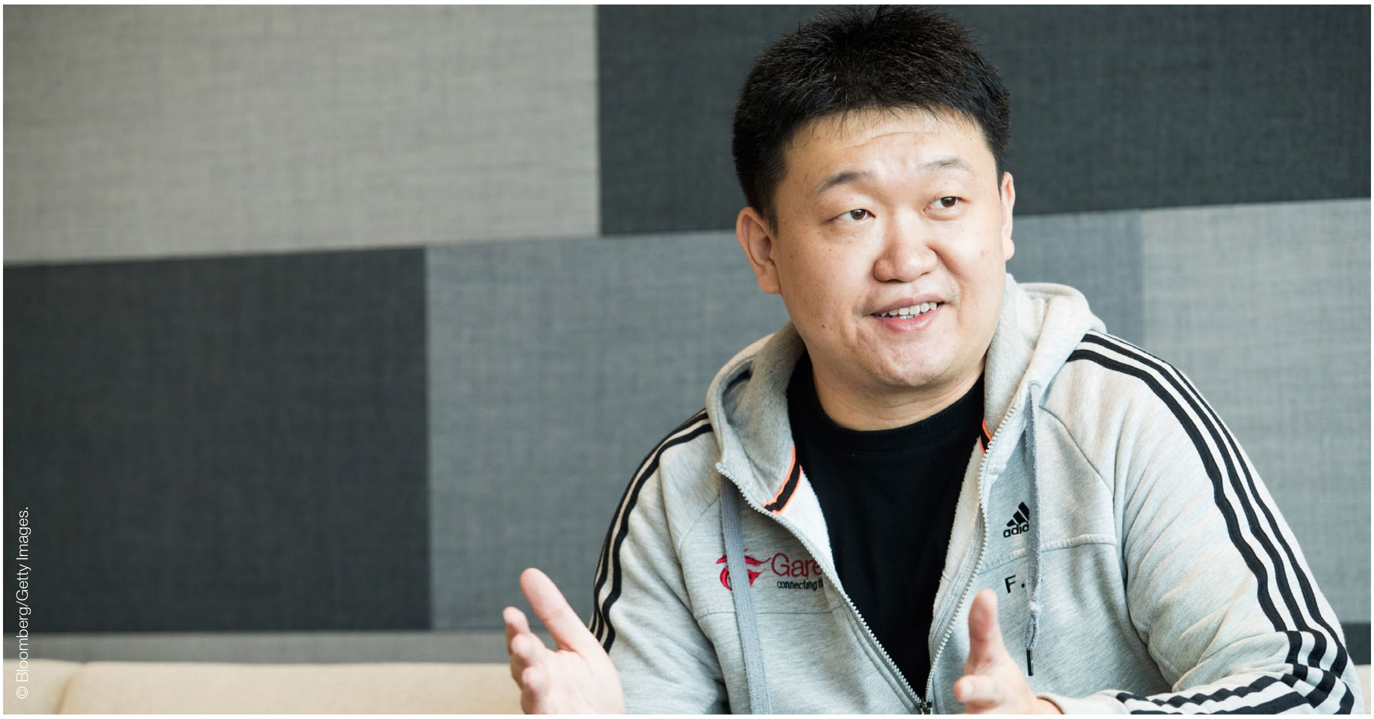
Reflections

June 2022

The LTGG research process is long and thoughtful, in line with our investment time horizon. By way of example, we recently added Sea Ltd, the South-East Asian ecommerce, fintech and gaming company, to the portfolio. We first met with the business in 2019 and produced a 10 question research paper the following year. After 10 meetings with management, including the company founder, we took a position in February this year. During this period, we built conviction in the company's long-term investment case as well as its innovative founder, Forrest Li. We were thus fortunate to be able to take advantage of Sea's recent share price weakness and add this business with compelling long-term prospects to our portfolio.

Sea's initial business was distributing games for Tencent throughout the ASEAN region. The company has since progressed into developing its own games. Crucially, these run on lower specification devices as well as high-end smartphones. This opens up a huge addressable market. Sea's smash hit gaming title is called Free Fire, which has around 300 million monthly users. For context, the popular game Fortnite has 80 million monthly users.

A few years ago, Sea began employing the tactic of 'serving the underserved' by aggressively expanding into ecommerce (Shopee) and digital payment/financial services (SeaMoney). At the group level, the company generated $2.9bn of revenue in Q1, up over 60 per cent on the previous year. The majority of revenue comes from the gaming and ecommerce segments and although revenue from digital finance is much smaller, it is growing at more than 300 per cent per year. Currently it is only the gaming segment which is profitable, and the company has been recycling the cash flows from this success to fund its exciting ecommerce and finance opportunities. The ecommerce business is extremely capital intensive, given it is in the early stages of its rollout. Amid inflation worries and slowing game user growth, the market has become increasingly concerned that Sea's aggressive expansion plans are not sustainable.



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So, where does our view differ from the market? First, after a year of supernormal growth driven by worldwide lockdowns, we think it's entirely expected that near-term growth slows as Free Fire users make the most of their post-Covid freedom. We do, however, think the market is underestimating the stickiness of the user base and the longevity of the cashflows that the gaming business can produce. Free Fire keeps players interested with refreshed content while incorporating social aspects, the key to a long-lasting franchise. For example, Tencent's 'League of Legends' is a decade old and still generating more than $1bn of revenue a year. Meanwhile, the three highest grossing games in the US on iOS are Roblox, Candy Crush and Clash of Clans, all of which have been around for about a decade.

Second, Sea tapped the markets near the peak of its share price last September, allowing it to raise over $6bn. The company has about $9bn of cash on its balance sheet (nearly 23 per cent of its market cap). Even if Free Fire did not continue to generate cash to fund the expansion efforts, the business could sustain Shopee's expansion for over a decade.

Third, it appears the market is overlooking the potential of SeaMoney, which Forrest Li believes could be an even larger opportunity than ecommerce. SeaMoney now has 46 million people using its mobile wallet, payment processing and credit services. With 74 per cent of those in their addressable markets either unbanked or underbanked, the opportunity is significant.

Finally, we have become increasingly impressed by Shopee's experimental game-like approach to new markets, but it requires patience. This approach has been particularly successful in their primary market (ASEAN+Taiwan) and has put Shopee on the path to cash generation rather than burn. Sea has also shown good judgement in its expansion, receding from markets where the route to profitability is too challenging, most recently India.

As I write, Sea's market cap is marginally over $40bn, so how do we achieve a five times return from here? Global gaming is predicted to grow from a $175bn market to $300bn by 2025 and Sea currently has a 2 per cent share of the global market. The LTGG blue sky case would see users reach upwards of 1.2 billion and each spend roughly $10 a year on a 33 per cent net margin that contributes about $4bn of free cash flow, resulting in the gaming business alone being worth $80bn. Add in ecommerce, where there is some of the fastest GDP growth in the world, increasing online penetration, and new geographies, and Shopee's gross merchandise value should have ample support for growth. We could imagine $625bn in 10 years at 25 per cent p.a. growth over that period. At 10 per cent take rates and 30 per cent margins for a capital-light model, that's about an $18bn annualised cash flow. Applying a conservative 10 times multiple to the combined $22bn in free cash flow achieves five times return without adding in any potential growth in finance or additional verticals. For a company that has a track record of rapid expansion and an income stream that could last for well over a decade, based on today's market cap, Sea represents a very exciting growth opportunity.

We continue to build and deepen our relationship with Forrest Li and were pleased to have him visit our office in Edinburgh recently. During the meeting we asked if the share price weakness affected management's strategy and long-term thinking, but Forrest was keen to emphasise that it encourages Sea to focus on its priorities more than ever. The meeting also reinforced the relentless culture of experimentation that he instils in the company and the focus on customer centricity. We look forward to seeing how Sea develops over the coming years.

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