BAILLIE GIFFORD | Emerging Markets

April 2022

"Bad news is a headline, and gradual improvement is not."
Bill Gates

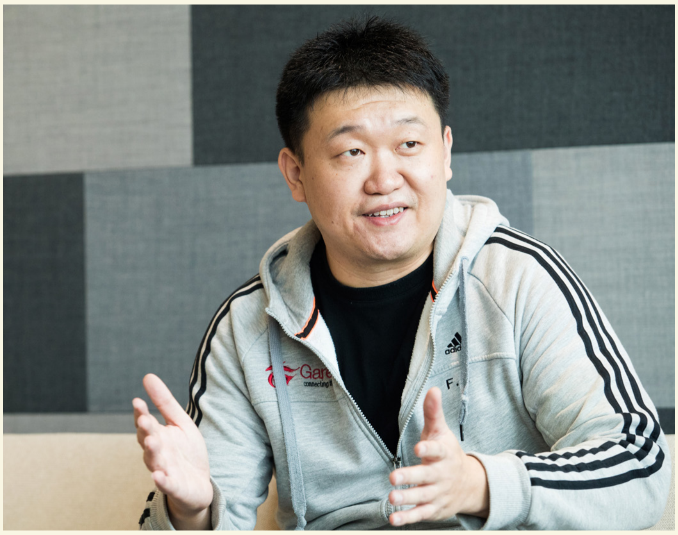
Removing oneself from the headlines has been particularly challenging in recent months, but we must remain focused on our goal: generating long term outperformance for our clients.

The recent market rotation has hurt the valuations of unprofitable early-stage businesses and the portfolio has not been immune to this. For reference, less than 6 per cent of the portfolio is invested in unprofitable companies. What is key for us, however, is ensuring we capture the highest growth businesses available to EM investors, and where we can see a clear path to profitable growth, history has shown that investing at an early stage helps our clients' returns. So long as we can understand the route to strong profit growth, it pays to support aggressive reinvestment.

One such investment opportunity is Sea Ltd, the ecommerce, fintech and gaming company that started life in South East Asia, as the name suggests. Sea's share price has more than halved in the last year, despite revenue more than doubling in the same period. The company has been recycling the cash flows from its successful gaming business to fund the exciting ecommerce and finance opportunities. The ecommerce business is extremely capital intensive, given it is in the early stages of its roll out. Amidst inflation worries and slowing gaming user growth, the market has become increasingly concerned that Sea's aggressive expansion plans are not sustainable.

There will no doubt be many twists and turns ahead for Sea Ltd. That said, we have spent a lot of time with its founder, Forrest Li, over many years, understanding his vision and watching his progress. It is a unique company with a unique opportunity, and in this note we'll lay out one of many scenarios in which it could be worth much more.

Sea's initial business was distributing games for Tencent to the ASEAN region. The company has since progressed to developing its own games, that crucially run on lower spec devices. This opens a huge addressable market. Sea's smash hit game is called Free Fire, which has around 300 million monthly users. For context, the well-known popular game Fortnite has 80 million monthly users.



Forrest Li, founder of Sea Ltd.

A few years ago, Sea began employing this same tactic of 'serving the underserved' by aggressively expanding into ecommerce (Shopee) and digital payments/financial services (SeaMoney). At the group level, the company generated $3.2bn of revenue in Q4, up over 100 per cent on the previous year. But this figure masks the dispersion at the segment level. The gaming segment of the business generated $1.4bn of that revenue, with EBITDA of $0.6bn. The ecommerce segment of the business is at a much earlier stage, so while it posted $1.6bn of revenue, this translated to EBITDA of -$0.9bn. SeaMoney is at even earlier stages yet, with revenues of just $0.2bn (up over 700 per cent) and EBITDA of -$0.15bn.

So, where does our view differ from the market? Firstly, 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 userbase and the longevity of the cashflows that the gaming business can continue to produce. It 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 is still generating more than $1bn of revenue a year. Alternatively, 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.

Secondly, Sea tapped the markets near the peak of its share price last September, allowing it to raise over $6bn. The company has over $10bn of cash on their balance sheet (15 per cent of their 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.

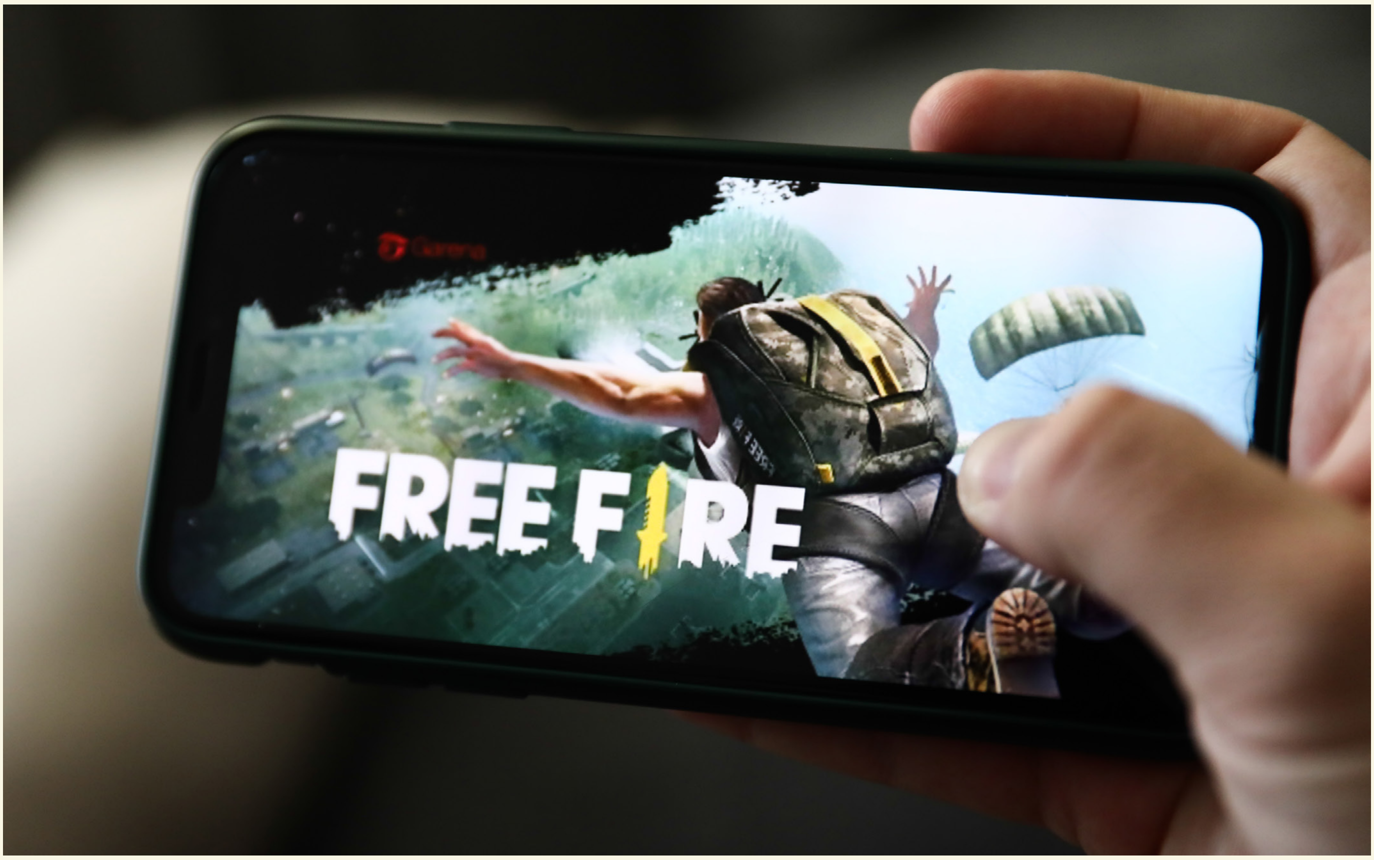
Thirdly, it appears the market is overlooking the potential of SeaMoney, which the founder, Forrest Li, believes could be an even larger opportunity than ecommerce. SeaMoney now has 46 million people using its mobile wallet, payment processing and credit services. With 74 per cent of those in their addressable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

Finally, we have become increasingly impressed by Shopee's experimental gaming-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 their expansion, receding from markets where the route to profitability is too challenging, most recently India.

If we make the pessimistic assumption that Shopee isn't successful in adding new markets, we can still envisage a doubling: Shopee GMV is currently more than $60bn, having grown 75 per cent in the last year. While we can't expect these blockbusting growth figures outside of Covid, it is worth remembering that ecommerce penetration is still only 12 per cent in ASEAN, and expected to grow to over 20 per cent by 2024. If GMV growth settles at 20 per cent CAGR for the next 5 years and take rates conservatively continue to improve from 6.6 per cent to 12 per cent, this would generate $18bn of revenue. At typical operating margins of 30 per cent and taxed at 25 per cent, this would equate to earnings of $4bn.

Global gaming is predicted to grow from a $175bn market to $300bn by 2025. Sea currently has a 1.8 per cent share of the global market. The fact that Garena's (Sea's gaming arm) ability has been to bring modern gaming to underserved regions suggests Sea's share of the global market could grow faster, but if we modestly cap it to 2.2 per cent, that's $6.6bn revenues. If the operating margins of 55 per cent today reduce to 45 per cent as competition increases, then this results in $2.5bn of earnings after tax to add to the pile.

If we ascribe no value to the finance opportunity or the 10 new games in development, then this would result in a business generating $6.5bn of earnings. For a company that has a track record of rapid expansion and execution, and an income stream that could last for well over a decade, a doubling certainly seems achievable at the current valuation.



Annual Past Performance to 31 March Each Year (Net %)

	2018	2019	2020	2021	2022
Emerging Markets Composite	33.0	-3.3	-17.7	77.3	-20.5
MSCI Emerging Markets	25.4	-7.1	-17.4	58.9	-11.1

Annualised returns to 31 March 2022 (Net %)

	1 Year	5 Years	10 Years
Emerging Markets Composite	-20.5	8.3	5.1
MSCI Emerging Markets	-11.1	6.4	3.7

Source: Baillie Gifford & Co and MSCI. US Dollars.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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