Sturgeon Insights
Laying the groundwork for investing in frontier markets

Frontier market strategies often promise strong returns on the back of strong demographics; a growing middle class; rising consumption; and highly attractive valuations. Achieving consistently strong returns in these markets is not easy and requires far more than a high-level narrative. It requires a rigorous and multi-faceted investment framework which demands company resiliency in the face of the economic volatility inherent to frontier markets.

Here we outline six core components of our investment approach which draws on our 15 years of experience investing in Central Asia.

1. Develop an appropriate return target

Establishing an appropriate financial return target is a critical first step that precedes the launch of any Sturgeon Fund. We will only launch a Fund when our team has secured a sufficient number of actionable investment opportunities offering returns that meet this return target.

At Sturgeon, our financial return target is built up in the following way:

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\text{Opportunity cost} \quad (30\%) \quad + \quad \text{Risk premium} \quad (10\%) \quad = \quad \text{Sturgeon return target} \quad (40\%)
\]

**Opportunity cost:** Based on trailing 10-year internal rate of return (IRR) data from Pitchbook\(^1\), developed market PE growth strategies have on average generated 15% IRRs, with upper quartile managers realising 29.7%. We take the upper quartile developed market IRR as the opportunity cost for investors not investing in a top-performing developed market PE fund.

**Risk premium:** We then add an appropriate risk premium based on the 7-year asset class forecasts produced by GMO (see appendix). We take the difference between GMO’s forecast for ‘emerging value’ (11.8%), which we use as a proxy for frontier markets, and ‘international large-cap’ (1.9%) which equates to 9.9%.

2. Establish sources of quality deal flow

To put it simply, without access to trusted sources of deal flow, there is no investment strategy. At Sturgeon, we secure a consistent flow of deals by establishing an extensive local presence over multiple years. In the case of Uzbekistan, this process began 8 years prior to launching our dedicated Fund.

Although gaining access to leading figures across the private and public sphere is often easier in frontier markets, these relationships can be superficial and significant time is required to build deep mutual trust. Dedicating time to this process has resulted in Sturgeon establishing an unparalleled network of individuals who act as our eyes and ears on the ground, not only providing deal flow but also providing real-time news on local developments and valuable reputational feedback on prospective investee companies.

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\(^1\) Source: Pitchbook.com Internal Rate of Return (IRR) realised data - as at 31 March 2020.
2. Establish sources of quality deal flow (continued)

We also hire a local Sturgeon team to source investment opportunities and act as a touchpoint for local companies. In addition, our local team is tasked with undertaking key operational processes - legal work, local filings, etc. which would be challenging to complete from a distance. It is common in frontier markets for potential investee companies to have insufficient experience to prepare materials of required depth for our appraisal. As a result, our local team is crucial for supporting the preparation of company data and documentation.

Having invested in Central Asia for over fifteen years, the Sturgeon brand is recognised locally as a leading provider of institutional capital. Our strong reputation has resulted in a substantial amount of quality inbound deal flow with a comprehensive local feedback system and operational support.

3. Focus on risk management

When looking at investment opportunities, our team must overcome substantial information asymmetry. Our job as an investment manager is to ensure we continually question every aspect of a given investment opportunity to minimise the potential variation around our initial investment thesis and modelling.

Frontier market returns are characterised by a wide spread of potential outcomes. By employing a bottom-up approach to risk management which values company resilience, we can significantly reduce tail risk. Our experience informs us that adding a margin-of-safety of 10% to our 40% return target is prudent. This results in a 50% discount rate which is used in all our modelling:

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\text{Sturgeon return target (40\%)} + \text{Margin-of-safety (10\%)} = \text{Sturgeon discount rate (50\%)}
\]

When conducting our initial company due diligence and building an investment pipeline, we question and cross-check every aspect of the investment case to maximise the probability that our models will match reality. We debate opportunities fiercely internally and open every business to our trusted network for feedback.

Our questioning begins at a high level with the probing of the market context, potential and competition. A common question we ask ourselves is whether a frontier market is truly ready for a given product/service - it is possible to be too early as well as too late. The line of questioning then focuses on the intricacies of the product and business idea: how will it work; who are the customers; which input factors are required; and how price, volume and cost have been calculated? There are also many other factors to consider, such as the required funding over our investment horizon and the team’s track record of execution. The company’s various exit options are also scrutinised long before investing.

4. Build a data infrastructure

To reduce information asymmetry and monitor potential investment targets, we go beyond the financial reports and management projections. Following our initial rounds of questioning, we establish all the key variables that drive a given business and map them to trackable data points.
4. Build a data infrastructure (continued)
We then work with individual companies to develop an infrastructure which allows us to monitor verifiable data points in real-time. This system provides us with reliable data to monitor the business and guide our discussions with management. The more granular the data, the easier it is to understand what is and isn’t working, and importantly, how to address it. This data infrastructure is kept in place throughout our investment holding period and forms a key component of our strategy.

5. Identify and monitor environmental, social and governance (ESG) risks
Alongside our financial analysis and due diligence, we look to identify and monitor risks that may not already have been captured in our financial modelling.

We develop a stakeholder map to establish if there are any conflicts of interests driving inefficient business decisions. The map would capture information on a supplier that may have been awarded a contract based on being a friend/relative of a senior manager. We compile these maps using information gathered from employees, clients, lawyers, suppliers and external due diligence providers as well as our local network and team.

Sturgeon has also developed a system of quantitative and qualitative key performance indicators (KPIs) to monitor risks following industry-leading ESG guidelines. These KPIs are complementary and inseparable from our core investment process as well as being vital for ensuring the resiliency of our financial returns. Our list of KPIs is extensive and includes items such as supplier churn, employee turnover, board composition, cybersecurity, media representation and customer fraud.

6. Set deal terms which provide sufficient downside protection
We formalise our deal teams once we have sufficient confidence in an investment’s ability to meet our forecasts. First and foremost, the implied valuation must meet our target return with a sufficient margin-of-safety to provide a buffer in the circumstance that the business performs at the lower end of our expectations.

Beyond negotiating hard on price, our secondary goal is to further protect ourselves by locking-in operational transparency and control of capital allocation. To achieve this, we always obtain at least one board seat, appoint a CFO to oversee accounts and veto-privileges over significant capital allocation decisions. Deal terms also ensure management compensation is linked to appropriate performance targets.

For a full breakdown of Sturgeon’s investment process please contact the team:

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**Appendix**

**7-YEAR ASSET CLASS REAL RETURN FORECASTS***

*Source: GMO*

The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

*Source: GMO*

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