

August 28th, 2023

Dear Partners,

Our sweet spot for ideas is in companies where:

- 1) The product is great (our key focus), but the company or investment case has negative marks against it in other areas, which serve as a distraction for other investors; and
- 2) Liquidity is lower than \$30 million per day, which makes it uninvestable for medium-to-large funds.

The second aspect isn't required, and since launch we've made plenty of money in liquid companies. But for less liquid companies the barrier to entry in making the investment is real, and as one element in building conviction it helps to have a reason why something that seems obvious to us isn't being snatched up by others.

Regarding the first aspect, we are looking for "buts" – situations where people say "the product is great, *but...*" As strong believers in product and customer obsession as the key driver of business value, versus other investors we place more weight on the "great product" than the "but", which can lead to some different conclusions and get us into some very interesting, underappreciated ideas. (Oftentimes, of course, the "but" is indeed disqualifying – it is our job to be discerning, consider the risks fully, and pick the right ones.)

One such interesting idea that meets both of the "sweet spot" criteria above is Bank of Georgia, the #1 bank in the country of Georgia. Bank of Georgia is a very profitable bank that offers a great product for its customers, *but...* it's located in Georgia, which causes most potential investors to discard it from the consideration set immediately. Furthermore, Bank of Georgia (a \$2 billion market cap company listed in London and part of the FTSE 250) only trades \$3 million per day, which makes it uninvestable for even the subset of funds that might otherwise consider it.

Our research, in addition to showing that Bank of Georgia is very well-run and shareholder-focused, leads us to be excited about Georgia as a country – a country that, after the Rose Revolution in 2003, is a pro-Western democracy with low levels of corruption, high economic freedom, low inflation, a stable exchange rate, and high GDP growth that seems poised to continue for years to come.

Bank of Georgia

Georgia is a small country with only 3.7 million people. Partially as a result, the banking sector is very consolidated, with the top two banks (Bank of Georgia and TBC Bank) having a combined 80% market share, split almost evenly between them – one of the best banking market structures in the world. The dominance of these two banks and the small size of the market makes it unattractive for foreign competitors to enter, a different situation than in some neighboring countries like Uzbekistan.

Furthermore, the small size and relative immaturity of the market has prevented a meaningful non-bank capital market from developing, which leaves Bank of Georgia and TBC Bank as the only games in town for financing and deposits. Fintechs are not really present either; these banks *are* the fintechs, with instant payments between customers, unsecured consumer loans via app, and dominance of the card payment ecosystems (Bank of Georgia has 54% acquiring market share in the country, up from 38% in 2020). As a result, these two banks seem poised to capture much of the value created by the financial sector in Georgia, with little leakage to competitors or alternatives.

Combined, these attributes (very consolidated market, limited non-bank competition) have led to strong and enduring NIMs and ROEs for the top two banks. Over the past 10 years, through a variety of

environments, ROE has averaged 24% for Bank of Georgia and 22% for TBC Bank. This average period also includes numerous years prior to a shift to digitalization, which drove substantial operating efficiency improvement for both banks; Bank of Georgia's cost-to-income ratio, a measure of operating efficiency, has dropped by 12 points since 2014, meaning it can sustainably generate higher ROEs for the same NIM. This year, Bank of Georgia is poised to generate a ~29% ROE.

Unlike in some other oligopolistic sectors, these high ROEs have not come from exploiting or underserving customers. In terms of pricing, we hear Bank of Georgia and TBC Bank compete aggressively for customers, though not to the point of irrationality. In terms of service, both banks are rated highly, and in particular their digital offerings are world-class – we've heard from former executives who've worked in both Georgia and the UK that the Georgian bank mobile apps offer a much superior customer experience, "21st century vs. 20th," with the UK gradually catching up via digital banks like Revolut and Monzo. Out of the 3.7 million total population of Georgia, 1.2 million use Bank of Georgia's mobile app monthly, of whom 48% use it daily, a high DAU/MAU ratio that reflects its ease of use and pervasiveness in day-to-day payments (as one reference point, the Facebook app's global DAU/MAU ratio is 68%). Bank of Georgia has a retail customer NPS of 61, which is unheard of amongst universal banks globally; this is up from 27 in 2017, a reflection of the substantial work new management has done since 2019 to re-focus on customers and improve on that metric.

Bank of Georgia's management team is excellent. Over the past two decades, the bank has had three strong, Western-educated CEOs: Lado Gurgenidze (2004-2006), who turned around a previously mismanaged bank, grew the loan book from \$66 million to \$399 million, listed the company in London, then later became Prime Minister of Georgia; Irakli Gilauri (2006-2018), who further grew the loan book 9x to \$3.5 billion; and the current CEO Archil Gachechiladze (2019-present), who has now grown the bank's loans to \$7 billion. We have studied the tenures of all three leaders and traced the development of the bank over time, through various economic cycles. Our conversations with former employees indicate that these leaders have built a strong culture that makes the bank one of the top places to work in Georgia. The culture has a strong focus on risk management, with one aspect being a focus on maintaining conservative capital ratios; the current common equity tier 1 capital ratio (CET1) is 18.7%, 4 points above the regulatory minimum as set by its regulator (for reference, Bank of America's CET1 ratio is 11.6% and PNC Bank's is 9.5%, though there are differences in calculation, e.g., GAAP vs. IFRS). More than 80% of top management's compensation is paid in deferred shares, which vest in tranches over up to 8 years, a structure that helps align management's incentives with that of shareholders.

The investment case is simple: consistent with its history and boosted by tailwinds such as digitalization driving higher operating efficiency, Bank of Georgia should generate a normalized ROE of ~25% (vs. the current ~29%) for many years to come. Half of the ROE will be reinvested into loan growth, driving low teens growth; the other half, or close to half, will be paid out via dividends and share buybacks. How much should one be willing to pay for this type of unusually high return profile? If a bank with this normalized ROE were based in the US or Western Europe (clearly a big "if" – but just taking a hypothetical), we believe it would easily command a multiple of between 2-4x book value, which would represent ~8-16x normalized earnings; such a valuation may likely be an undervaluation of such a bank, as increased ROE points above the cost of capital drive compounding value creation and are increasingly rather than linearly more valuable.

Bank of Georgia currently trades at 1.1x book value, which represents 4x current earnings and <5x normalized earnings. And at the current price, we expect to receive a ~13% yield from 2024 dividends & buybacks. Given its market share dominance, management quality, and growth prospects, this is far too cheap of a valuation, even after considering its somewhat unusual home country. Factoring in low teens earnings growth, low teens capital return, ~3% annual currency depreciation via USD (which would be faster than historical trends), and a moderate increase in valuation (we assume we exit at 1.35x book,

reflecting how a Georgian bank may never get a full valuation it deserves), we anticipate receiving a 25% IRR in USD on our investment.

How could this go wrong? In local currency, it's hard to see how we lose a lot, given our entry price just above book and <5x normalized earnings (of course, normalized ROE and thus normalized earnings could go lower than we expect – but the low entry multiple partially compensates for this). The main area of risk that we see, common across these types of investments, is in the currency. The Georgian lari has been remarkably resilient over time, depreciating at an average annual CAGR of 1% vs. the USD over the past 20 years, though with volatility in the interim and perhaps a current end-point that has benefited from some unexpected tailwinds. However, a large sudden depreciation, while unlikely in our view given Georgia's strong economic governance and financial/debt metrics, cannot be ruled out, especially for such a small economy. Hedging the lari is expensive and, in our view, expected value negative. We plan to instead manage the risk via prudent sizing.

Could Russia invade again, as it did in 2008? While on the surface this may seem a relevant fear based on pattern recognition, to us it seems very unlikely. Russia goaded Georgia into attacking South Ossetia in 2008, to which it then responded by attacking Georgia and occupying the breakaway provinces of South Ossetia and Abkhazia, a situation that has persisted since then. However, South Ossetia and Abkhazia had long been ethnically distinct, self-governing territories with very contentious relationships with Georgia and who looked to Russia for protection. Russia seems to already have what it wants, has little natural interest in the remainder of Georgia, and Russian relations with Georgia are stable to slightly improving. Risk of further Russian invasion to us seems very low, and again we will manage this risk via sizing.

A few words on Georgia

Georgia has been the beneficiary of an enormous, mostly unheralded turnaround. In 2003, Georgia was on the precipice of becoming a failed state – with massive corruption (one of the worst among post-Soviet countries, to the extent where for example university admissions and grades were driven almost entirely by bribes), failing infrastructure, and an aged Soviet-era leader who had been in power for 30 years. Georgia's GDP had collapsed by more than 75% from peak in real terms by 1995, and by 2003 GDP per capita was still only \$1,000.

2003's Rose Revolution, a protest movement in response to rigged elections, swept a slate of reformers to power with a mandate to dramatically transform the country. The new 36-year old President Saakashvili, elected with 96% of the vote, immediately set out to tackle corruption (such as by firing 85% of the police force at once), arrest oligarchs who had dominated the economy, cut red tape, simplify taxes while at the same time increasing tax enforcement, reform the universities, invest in infrastructure, etc. The results have been shocking. As measured by international observers, Georgia has registered enormous gains in reducing corruption (now ranking similarly to Italy and Latvia), ease of doing business (now #7 in the world as measured by the World Bank, just behind the US), and economic freedom. GDP per capita in just 20 years has risen from \$1,000 to \$7,000. Due to low costs of living, GDP per capita on a PPP basis is \$20,000.

As a small country with few natural resources (except for agriculture), Georgia knows that it has to rely on attracting foreign capital for growth; as a result, both of Georgia's two main political parties are very pro-market, with little difference in economic policy. Georgia's 3.7 million population is enormously pro-West and anti-Russia, and Georgia aspires to EU and NATO membership. Georgia has free trade agreements with both the EU and China, and Georgians have visa-free travel to the EU. Georgia's national bank seems highly competent, maintaining relatively stable inflation (~4% in the 2010s) and exchange rate (only 1% average annual depreciation against the dollar since 2003, and flat versus the

dollar since 2016). Georgia has no exposure to Russian gas, and hydropower accounts for >80% of Georgia's electricity generation.

Russia's invasion of Ukraine, rather than being a detriment as initially feared, has proved to be a boon to Georgia's economy. There was a direct benefit, as some high-income Russian migrants, especially in the IT services sector, have moved to Georgia and laid down roots; as well as an ongoing indirect benefit, as the strategic value of Georgia's position has increased. Georgia lies at the heart of the so-called "Middle Corridor" (running from China to Kazakhstan and then through Azerbaijan, Georgia, and Turkey into Europe), the desirability of which has greatly increased as it strategically bypasses both Russia and Iran, leading to new infrastructure investment along this route. Georgia has also emerged as a new hub for some multinationals' Central Asian operations, replacing hubs in Russia and Belarus.

Real GDP growth in Georgia is expected to be 7% in 2023, after strong years in 2022 (+10%) and 2021 (+11%, recovering from 2020's -7%). In the pre-covid period from 2010 to 2019, real GDP growth averaged 5%. Given the favorable dynamics present in Georgia's economy, the government's pro-market and fiscally responsible policies (including <3% of GDP budget deficit, 38% government debt to GDP, and currently 3% core inflation), and an under-developed economy still at a low base (\$7,000 GDP per capita), these trends seem poised to continue.

Conclusion

We are currently operating with a higher-than-normal cash balance, as we stick to our framework of being highly sensitive to valuation and investing our capital only in exceptional IRRs. As stocks fell in August (a modest fall – but we don't need the entire market to be inexpensive to put significant money to work, just a limited number of great companies), we have been adding to existing positions such as Smartsheet and starting new ones.

We sold positions at good prices as IRRs fell below acceptable levels. Rather than lower our hurdle rate and invest as if we are back to normal times with few significant risks on the horizon, I prefer to keep our hurdle high and put the onus on myself to continue to find high-IRR places to put our capital. I am hard at work searching in sometimes-unusual areas for companies with amazing products and absurd valuations, our favorite combo (and, I should add, having a blast while doing so).

As always, I am immensely grateful for the opportunity to manage our capital and am hard at work trying to compound it at the highest rate that I can.

Yours,

Tim Liu

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