QUARTERLY SHAREHOLDER LETTER

Topic: On-demand Grocery Disruption

31 March 2021

Dear Shareholder,

Until the great Covid boost of 2020, grocery shopping was slower to move online than many categories. Demand was muted for a few reasons: groceries have lowish ticket sizes – lower, at least, than consumer electronics or high fashion – and low margins; people tend to buy food from companies they trust (particularly fresh food); shopping behaviour is sticky due to the relatively habitual, high frequency nature of grocery shopping, and barriers such as delivery fees were off-putting. On the other hand, the supply side struggled with complicated supply chains and difficult-to-crack economics. However, the lengthy Covid pandemic has encouraged people to experiment at a time when the level of digital adoption has made it a whole lot easier for suppliers to reach scale. Unsurprisingly, recent surveys indicate that most people who tried online grocery shopping during the pandemic will continue to do it post Covid.

We therefore expect continued growth in online grocery penetration, and within online grocery, on-demand services that deliver in a hurry are likely to keep growing faster, from less than 10% of the total online grocery bill in most markets today.

Ready when you are

This letter focuses on the threats and opportunities facing companies from the growth in on-demand grocery shopping. We look at on-demand specifically as we think it will be the most relevant channel for online groceries in EM, and could be the most disruptive.

The Fund is exposed to the trend in several ways. Delivery Hero, currently 1.2% of the portfolio, is not only a leading food delivery platform in over 40 countries from South Korea to Peru, but is also developing an EM-wide instant grocery business. In Russia, Yandex (1.7% of the Fund) grew gross merchandise value (GMV) from groceries by 366% in 2020. Meanwhile in China, where rapid development was afoot even before Covid, 15-20% of Alibaba's (4.3% of the Fund) GMV comes from groceries and on-demand is driving growth. Besides digital-native platforms tapping into the on-demand grocery business, the portfolio also has a combined 2% in regular grocers that are operating diverse offline formats across EM, including CP ALL in Thailand, Walmex in Mexico and Central America, Puregold in the Philippines, and Magnit in Russia. And while some may be more exposed than others, all face the inevitable challenge of adapting to the new environment. Finally, other on-demand companies may yet turn up in the portfolio, including Meituan on our Focus List and the giant unicorns like Grab, Gojek, and Rappi, which are expected to go public before long.

How it works

An online order is "on-demand" when it is delivered within 10 minutes to a couple of hours. We observe two distinct on-demand grocery models in most markets. The first is an *instant convenience* model, usually delivering in 10-45 minutes. This has generally emerged from food delivery platforms with their own delivery capabilities like Delivery Hero and Meituan in EM (DoorDash and Deliveroo in DM). These platforms fulfil orders by relying on the inventory of third-party offline stores (3P) or by operating dark stores or micro fulfilment centres to sell their own inventory (1P), or a combination of the two. A second model is a *bigger basket concierge* model, usually involving 1-2 hours' delivery time and operated by 3P platforms such as Cornershop (Mexico and Chile) or Instacart (US and Canada), and incumbent retailers like Walmart, which have developed their own on-demand platforms. This model is more service-intensive as it includes both in-store picking and delivery.

The key element in these on-demand models is that the picking is done close to the consumer, so the order arrives on your doorstep in hours or minutes rather than overnight.

We ask several questions about this new shopping habit. How big an opportunity might it be for the digital-native platforms, and will it be profitable? Is this an opportunity or a threat to incumbent offline retailers, and does it depend on whether they are operating a big box format, convenience stores, or other proximity formats? Naspers is a leading investor in food delivery, and knows a lot about it, so it was sobering to hear them say it was *"very hard to tell public investors we are going to go into a deep investment cycle, putting hundreds of millions of dollars into something where the end is unknown"*.

How we think about it

We are optimists for "instant" convenience

It is early days, but we think instant convenience grocery is a large and profitable opportunity and will change the way we all shop.

In most markets the restaurant delivery platforms have a head start if they control the delivery process. These platforms can structurally create very wide, competitive moats because they not only provide the most efficient instant delivery logistics but also own the customer relationship. In China, Meituan has consistently reduced delivery costs and has shown how it can be profitable with own delivery.

The on-demand food delivery platforms morphed out of the online restaurant trade but are now rapidly evolving into separate businesses. The first generation, effectively a bunch of restaurant marketplaces, grew organically by consolidating local restaurants which had their own delivery capabilities and replacing the telephone with online ordering. Some groceries found their way onto the bike but the basic business was selling meals. The second-generation players developed own delivery (OD) logistics and tech capabilities, which expanded the total addressable market (TAM) to include traditionally dine-in only restaurants. There have been few OD companies in the public domain until recently, but with more disclosure by the likes of Meituan, Delivery Hero and DoorDash it has become clearer that OD runs well at scale and can be profitable. This has led to the emergence of third generation models, which deliver anything on-demand. The Colombian company Rappi is a good example in Latam. They can deliver almost anything, but the largest incremental TAM for these third-generation companies, by a wide margin, is grocery.

It was not always obvious that this would be a viable business, but it seems even customers on lower incomes are willing to pay delivery fees for convenience. Customer acquisition costs tend to be very low because the traffic comes from food delivery, and it helps that the most popular ordering times in the day, for example when you get home from work, are often complementary to ordering a takeaway later in the evening, so the driver's time is used efficiently. It seems possible that the economics may work particularly well in some EM countries where inequality is high (delivery is cheap but the demand for convenience is well supported), cities are densely populated (more fulfilled orders per driver per hour), and margins in grocery are high.

We can't get very far in any supply chain analysis without celebrating technology. One of the beauties of technology is that costs can be scaled, which means larger players have an advantage – Delivery Hero has a head start here with its single "Dmart" technology that it rolls out globally. Smart IT investment like this can aggregate demand, give better forecasting and dramatically cut wastage in fresh. Technology can also reduce delivery costs through optimising routes and stacking the orders – the technological apotheosis of an Indian dabbawalla delivering tiffin.

Delivery Hero is one of the earliest entrants into instant groceries. When a customer clicks on shopping, Delivery Hero's own grocery "store" Dmart (local names vary) is displayed as the top option, followed by 3P alternatives. Orders are managed by the system, picking and packing takes place in dark stores close to the consumer, and finally orders are delivered, usually within 20-30 minutes, by Delivery Hero's own drivers. A couple of the company's key markets illustrate the dynamics in instant convenience:

Case study #1: Turkey 1P

Delivery Hero's Turkish food delivery business, Yemeksepeti, is hugely dominant, with almost 100% share. In 2019 it launched what is today their most advanced 1P instant grocery platform, Banabi, with over 80 dark stores. Banabi's GMV has already reached an estimated US$280m, equivalent to 1% of modern trade in Turkey. The typical customer comes home from work and realises they don't have certain grocery items to make dinner. Initially, people bought only 1-2 items per order, but the average basket has now reached 10+ items and is worth slightly more than an average meal order, while the average customer is ordering once a week. Unit economics are ahead of the business plan; we figure it already makes a positive contribution.

At your service in Turkey

It is too early to estimate the implications for offline incumbents. The most relevant retail competitors in Turkey are discounters (Şok, BIM), whose main customers want something different from on-demand groceries. However, there is a risk that higher margin perishables move to more convenient on-demand platforms as customers begin to trust their quality. Banabi also offers more SKUs than discounters, so it ticks the boxes of both selection and convenience, but matching discounter pricing will be a lot more challenging.

Case study #2: Foodpanda in Asia 1P + 3P

Delivery Hero also operates Foodpanda, one of the largest on-demand food delivery platforms in Asia outside China. It launched the 1P grocery platform Pandamart in early 2020, offering around 3,000 SKUs and aiming to deliver in under 30 minutes. It has also developed an array of 3P stores under the "grocery" tab, curated by category and individualised according to user behaviour. Foodpanda has partnered with Marks & Spencer and Carrefour in supermarkets, 7-11 and Shell in convenience, and directly with FMCG brand owners like Unilever and Heineken, which have their own virtual stores on the platform. Management says initial results are above expectations. As investors in Delivery Hero we are in a strong position: our base case of intrinsic value does not include grocery. However, we think it is one of the most interesting areas of upside and could add over 40% to the company's TAM.

All yours at the click of a mouse

The offline retail landscape in many Asian countries tends to favour convenience stores (CVS) due to the population density and long working hours. We think these Asian CVS incumbents are more likely to be impacted by on-demand delivery than the discounters in Turkey because of the large overlap between what a CVS customer wants and what instant delivery can supply. It is not surprising that the CVS response is to partner with on-demand platforms and launch their own initiatives. A longer-term question is whether governments may intervene to protect the many thousands of mom-and-pop CVS franchisees if on-demand starts to threaten their existence.

China, perhaps unsurprisingly given its size, has its own dynamics. It is the most advanced instant grocery market in the world, with a load of different business models optimised for the multiple grocery landscapes to be found in the country. Alibaba led the way with Hema, the first big instant grocery platform in China, offering high-end groceries in tier one cities supported by neighbourhood stores that did a good job in delivery. This was rapidly followed by dark store models in tier one cities that focused on fresh, and delivery from formal retailers in tier one cities (JD is the leader here). Lower tier cities saw the rise of community group buying, leveraging WeChat to acquire customers, and delivering from mom-and-pop stores. The rise of instant grocery in China is fast because most groceries are bought in small mom-and-pops, which don't have so much choice and aren't cheap. So, in a sense, the digital platforms are driving the efficiencies that in most other places have been realised by modern retail.

Impact on incumbents will be a function of geographic footprint, format, and corporate culture

The resounding message from the digital platforms has been that 1P, i.e. selling the company's own inventory, will only work in higher income, high density areas, so it will only apply to specific segments of our markets. So we don't need to worry about offline retailers losing business because they can become 3P suppliers and fill the gap, right? Not so fast.

In fact, 3P on-demand platforms can be a pain in the neck to offline retail. First, the platforms charge a fee to carry the goods, which either eats into profits or forces the retailers to mark up prices and risk being less competitive. Worse, the platform could use 3P as a Trojan horse to understand the customer and ultimately cut out their 3P partners with a more profitable 1P offer. Ultimately, platforms can end up owning the customer relationship and capturing most of the value, including all the lucrative advertising and fintech opportunities that underpin all those fabulous tech company valuations. Ouch.

But all is not lost for the incumbent retailers, and in many EMs they are well positioned to take advantage of the trend for instant gratification. Supply chains are extremely important in grocery, and retailers that have developed supply chain scale advantages have a huge advantage. The spectrum is wide in EM, from Mexico (highly developed supply chains) to India and China (less developed). In addition, there is nothing stopping offline retailers from leveraging their store network and high customer frequency to cheaply onboard customers into their own digital platforms, becoming decent omni-channel players.

The rise of on-demand may alter the landscape in other ways. As online shopping grows, it may accelerate consolidation among retailers, particularly given scale advantages are augmented online. Early movers should have an advantage, but not all offline retailers will be able to successfully develop their own on-demand or omni-channel solutions. Great retailers that develop strong online capabilities should benefit from the extra sales of their 3P partners, while smaller retailers may have no choice but to join the 3P platforms, typically on inferior terms – but hey, better an online sale on someone else's platform than miss out altogether.

Walmex is a good example of successful migration. It is the offline market leader, with 50% of Mexico's modern grocery market – the company says there is a Walmex store 10 minutes from 90% of the metropolitan population. The massive scale and store presence allows Walmex to negotiate decent terms with 3P platforms while also investing in its own online platforms. We see a precedent in the US, where unlike smaller grocers, Walmart pays only a flat fee to Instacart, and no revenue share. In addition, Instacart shares customer data with Walmart, a key benefit only a few retailers can get. This negotiating power adds to the scale advantages Walmart already enjoys in purchasing and logistics, making it more competitive than other 3P retailers on the platform. And store location, which in the offline world still differentiates smaller retailers, is of course irrelevant online.

Empirically, online grocery tends to be more concentrated than offline. Even in a highly developed place like the UK, where the four largest offline grocers have 60% market share, they have 80% online. And the more fragmented the market, the bigger the opportunity to consolidate.

Teddy with your carrots?

When we assess potential threats and opportunities for incumbents, it is clear that culture is a significant factor. How well retailers embrace the online world, and to what extent they can adapt their culture, will be key to how their businesses cope as online grocery continues to take share. We often see incumbents' cost-based mentality as a barrier for management to invest decisively in grocery delivery. To succeed long-term in a digital, omni-channel world, retailers need to shift their focus from store-level unit economics to customer economics and be willing to invest early. We see Walmex as particularly well positioned among old economy retailers, and we are measuring our other retailers against their success.

In conclusion

The grocery sector is evolving rapidly and seems to be snowballing towards on-demand. We see a significant opportunity for instant delivery platforms like Delivery Hero, and are cautious about the impact these platforms can have particularly for convenience store operators like 7-11. In parallel, we think dominant offline retailers that can shift their culture and build solid online capabilities will have a great opportunity to consolidate the market. We are watching the space closely and anticipate with mixed feelings a future when our groceries arrive in 10 minutes – from just a small handful of super-powerful retailers.

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Genesis Investment Management, LLP
21 Grosvenor Place
London SW1X 7HU
United Kingdom
Telephone: +44 (0) 20 7201 7200