EMERGING MARKET EQUITIES – A HORIZON OF OPPORTUNITY

Key takeouts:

- The investment universe in emerging markets has expanded rapidly
- Investment opportunities are created when economies modernise, grow and become financially sophisticated
- Investors in global indices are generally missing out on the long-term opportunities offered by emerging markets
- Emerging markets are growing faster than developed markets owing to a loosening of regulation and an opening up of domestic markets to capital investment
- China is the most dramatic example of what compounded high growth can do for countries

Around 80% of the world's population live in the developing world, with close to half this populace from China and India alone. In terms of land mass, similar statistics prevail, with the bulk of global land located in countries yet to reach economic maturity. As a general principle, developing countries started on the path to industrialisation decades after their developed peers and, remain far poorer overall. For this reason, their contribution to global economic output, at between 40% and 50% - depending on whether market or purchasing power party (PPP) exchange rates are used - is substantially below their population share.

Financial markets in developing regions also developed much later than those in the developed world, rendering their current share of global market capitalisation at only around 25%. Once free-float adjustments are taken into account, their share of benchmark global indices reduces to below 20%. While many large developed markets boast market capitalisation rates greater than 100% of GDP, very few emerging markets are anywhere near this level. The exception to this rule is South Africa (SA), where financial markets developed far earlier and where many global multinationals have listings on the Johannesburg Stock Exchange (JSE), artificially boosting the market capitalization ratio to 200% of GDP.

Although I have spoken about developing markets more generally, this piece will concentrate on emerging markets, as they make up the bulk of the investable equity universe outside developed markets. Within the broader MSCI ACWI index, emerging markets have a 12% weight and frontier markets have no representation at all. Given that emerging markets are between 40% and 50% of global output and are growing between 1.5x and 2x faster than the developed world (in aggregate), investors in ACWI (or any other global index) are structurally underweight emerging markets and are generally missing out on the long-term opportunities they offer.

The tortoise and the hare

Emerging markets are growing faster than developed markets as a result of several drivers. The simplest explanation is that when installed capital and productivity levels are low - which was the case in most emerging markets 30 years ago – a dollar of capital invested yields higher incremental returns than in a country with a high base of installed capital and an already productive workforce.

China and India were both very poorly managed by their respective governments until the early 1980s and 1990s and it is no coincidence that a loosening of regulation and an opening up of domestic markets to capital investment and competitive forces coincided with a significant increase in growth rates in these countries.

China's transformation, in particular, could rank as humanity's greatest ever poverty upliftment project. In 1980, China's GDP per capita was similar to that of Zambia and more than 85% of the population lived in extreme poverty. Since then, the country has averaged real GDP growth of close to 10% per annum, raising GDP per capita from under $200 at the time to $9,000 today - a fifty-fold increase in the space of one generation. Today, less than 10% of Chinese live in extreme poverty.

The relatively low increase in population - cumulatively only 40% over 29 years – has certainly helped to ensure that high aggregate growth translated into high per capita growth; but, even if China's population had doubled over the period, abject poverty would still have largely been eliminated. The one-child policy certainly played a role in reducing population growth, but its role should not be overstated – the birth rate was already in steep decline when the population curbs were introduced and examples elsewhere in Asia suggest that the rising wealth levels would have seen it naturally decline even further. In the process, China's share of global output has moved from 2% to close to 20%, as the chart below illustrates.

China is not alone in having raised living standards materially, although it is probably the most dramatic example of what compounded high growth can do for countries. India, the world's only other billion-person country, has also come a long way since it started opening up in the early 1990s. Despite being a democracy (with the occasional emergency rule) since independence from Britain, India traditionally had a very protected and state-dominated economy with many key sectors (notably banking) nationalized in the years after independence from Britain, foreign investment severely curtailed and price controls distorting economic incentives.

The result was close to 50 years of economic stagnation, made worse by a fairly high birth rate that saw the population increase by 2.5 times in the 44 years after independence and until reforms were introduced in 1991 by then Finance Minister Manmohan Singh (who would subsequently serve as Prime Minister for ten years from 2004). India's GDP per capita in 1991 was $300 (at market prices) and, by the end of 2018, was estimated to have grown to $2,000: a compound growth rate of 7.3% delivered despite a 50% increase in population over the 27-year period.

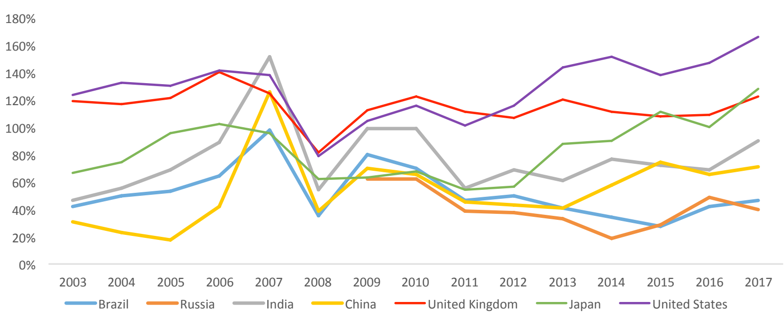
The opportunities in the step-change

Why is the above context important when considering opportunities available to equity investors? The answer stems from the investment opportunities created when economies modernise, increase in size and see a step change in financial sophistication. Shanghai's stock exchange, for example, was re-established in late 1990 after a 41-year closure. From having no listed companies at all 30 years ago, the market capitalisation of Chinese stocks today exceeds $10 tn.

India's market capitalisation has increased from $280 bn in 2003 to $2.5 tn in 2018; a nine-fold increase in fifteen years. The table below, drawn from the World Federation of Exchanges Database, shows how the market capitalisation (in current US dollars) has changed for the listed universe of several countries over the latest 14 years for which data is available for all the selected countries.

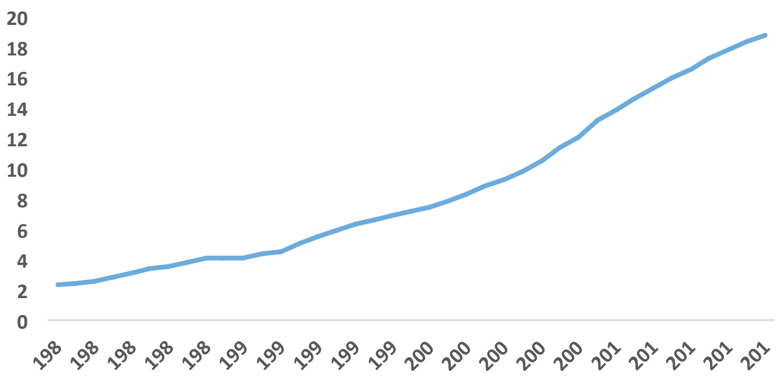
The results above speak volumes, although I would caution that they are not directly translatable into equity returns as, at the very least, they include new listings over the period, follow-up equity offerings on already-listed

Market Cap to GDP (%) BRIC and selected Developed Markets



Source: World Bank estimates

China share of world GDP at PPP (%)



Source: International Monetary Fund estimates stocks and they ignore dividends that have been paid. Nonetheless, the figures do highlight that the investment universe in emerging markets has expanded rapidly and therefore should be given serious consideration by investors. As markets develop, and as liquidity and trading continuously improve as they have done over the last two decades, we would expect that the weight of emerging markets within global indices will increase significantly from the 12% to 13% mentioned earlier.

It is important to highlight that emerging markets are not one homogenous asset class where equity values in the various countries move in tandem. The returns in the various individual emerging markets can and do diverge materially, as their drivers are very different. As an example, China's market has grown with the rapid industrialisation that the country has undergone. Its market is comprised of oil, property, banking, industrials, consumer and internet stocks and there remains heavy influence from the state through direct and indirect ownership and regulation of the listed universe. No one individual industry or sector dominates and, with a quasi-fixed currency, the influence of exchange rate movements for dollar-based investors is also more muted than, for example, South Africa, which has a freely floating exchange rate (the rand) with substantial volatility.

Brazil, on the other hand, has a higher equity weighting toward oil, iron ore, agricultural commodities and regulated utilities. The Brazilian currency, like the rand and Russian ruble, is volatile and heavily influenced by commodity prices. At times when commodity prices are high and terms of trade are in Brazil's favour, Brazil's equities tend to increase substantially in value and the currency strength that accompanies this amplifies the movement.

The broader emerging market classification includes countries that are growing fast but are relatively poor in absolute terms, such as India, and those that are relatively wealthy and growing at rates similar to those of developed markets such as South Korea and Taiwan. The investment opportunities between these countries therefore differ materially, since industry structures are quite divergent. Less developed countries tend to have more fragmented industries with substantial scope for consolidation, whereas wealthier emerging markets tend to have a greater degree of consolidation.

Some of the best returns available in emerging markets will be available where companies increase their market share at the expense of weaker players, growing revenue at a rate substantially above nominal GDP growth. In the process, these companies will be able to raise margins as their scale relative to competitors increases and barriers to entry for new entrants rise. A good example of this is the Russian food retail sector, where the top two players have barely 10% market share each and the formal players, as a whole, around 65%. In developed markets, it is not uncommon for the top players in food retail to have market shares above 20% and for formal retail to command 75% to 80% of total sales. The only natural limitation to market share in Russia is a 25% single-metro market share limit in terms of Russia's food retail law, and both the market leaders are some way from running into this ceiling.

Financial services is another sector in which substantial opportunities exist due to fairly low credit penetration. In most emerging markets, access to financial services is far from universal, and penetration of products such as bank accounts, credit card and mortgages are a fraction of development peers. As an example, in the middle of 2018, the Bank for International Settlements notes that the Credit-to-GDP ratio (total credit to the private non-financial sector divided by GDP) of India stood at 56%. Brazil was not much higher at 67%. In comparison, the UK's ratio was 170% and the United States 150%. Some emerging markets do have developed-level credit penetration, but this is restricted to wealthier emerging markets such as Korea, with 194%.

Stock market size

Country Name	2004 US$ Market Cap	2017 US$ Market Cap	%Chg CAGR	Classification
China	448	8,711	25.6%	Emerging
Indonesia	73	521	16.3%	Emerging
Thailand	115	549	12.7%	Emerging
Korea, Rep.	428	1,772	11.5%	Emerging
Brazil	330	955	8.5%	Emerging
South Africa	443	1,231	8.2%	Emerging
Argentina	41	109	7.9%	Frontier*
Mexico	171	417	7.1%	Emerging
Nigeria	16	37	6.8%	Frontier
Turkey	98	228	6.7%	Emerging
Netherlands	539	1,100	5.6%	Developed
Switzerland	829	1,686	5.6%	Developed
United States	16,324	32,121	5.3%	Developed
Australia	776	1,508	5.2%	Developed
Germany	1,195	2,262	5.0%	Developed
France	1,559	2,749	4.5%	Developed
Portugal	70	76	0.6%	Developed
Spain	941	889	-0.4%	Developed

Source: World Federation of Exchanges. * to join EM index in May

Taking action

Some examples will naturally answer the question most asked by investors with respect to their potential emerging markets exposure – should the investment be passive or active? Coronation has been an active manager in emerging markets for more than a quarter of a century and we believe it is the most suited option to investors looking for long term value uplift in returns. As a starter, a large percent of the indices in emerging markets are dominated by many mediocre businesses that often serve as state champions. Examples of these include the Chinese state-owned banks, whose credit allocation is very opaque, and national oil companies such as Petrobras and Gazprom. This is clearly different to some developed market countries like the US, where the index is dominated by some of the best businesses in the world run primarily for the benefit of shareholders. Examples include technology stocks such as Apple, Amazon, Alphabet and Facebook.

While the index quality has improved over the last decade, we still don't believe it represents access to the most compelling businesses and investments in emerging markets.

We believe that some of the best opportunities are in private sector run businesses such as the Russian food retailers mentioned earlier. Another very compelling example are Indian banks. Some 70% of the market here is still run by the state-owned banks, whose operations have underperformed their private sector peers since their monopoly ended as part of the economic reform process. As recently as 15 years ago, the private sector market share was 10%. It has since tripled in a banking market (as measured by total assets) that has also grown by 15% per annum in nominal terms over the period. The private sector banks have better balance sheets, which allows them to grow their books faster than the public sector banks. They also have better credit granting processes, so the bad debts of the well-run private sector banks are substantially lower than public sector banks that often have a dual agenda of furthering development regardless of credit risk.

The combination of high growth, robust credit processes and long-term thinking from management will yield higher returns for investors over the long term. An index-tracking investor would have a larger allocation to public sector banks and would also have significant exposure to overvalued consumer stocks in the FMCG sector. Here, a scarcity premium means that Hindustan Unilever (Unilever PLC's listed subsidiary) trades on more than 50x earnings, despite delivering earnings growth below that of HDFC Bank, the leading private sector bank that trades on 20x earnings.

To conclude, in our view emerging markets offer a compelling long-term opportunity for investors. The most important consideration, however, is time horizon. As countries and economies are still decades behind their developed market peers on most metrics, the duration of the investment opportunity is also long dated. A focus on the long term (five years or longer) rather than shorter term will, in our view, deliver compelling returns for investors even if shorter-term volatility may be higher than in developed markets.

Suhail Suleman
Portfolio Manager,
Emerging Markets,
Coronation Fund Managers