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Emerging Markets Equity: Evolving and Transforming

BARINGS INSIGHTS

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Technological innovation, an increasingly confident consumer and a growing focus on ESG are re-shaping the long-term growth opportunity in emerging market equities.

Emerging markets (EMs) have experienced a seismic shift over the past decade. While they have traditionally been perceived as dominated by 'old economy' industries like low-cost manufacturing and commodity production, many EM economies have transitioned from 'primary' and 'secondary' industries toward 'tertiary' or service-based industries.[1] This evolution is reflected in the makeup of the investible EM equities universe—new economy sectors, including consumer discretionary, information technology, communication services and health care, now account for roughly 55% of the EM benchmark index, nearly double the weighting of 10 years ago. At the same time, old economy industries like energy, materials, industrials and utilities have nearly halved in size to make up roughly 19% of the index today.[2] And the change is broad-based, occurring across countries from China to India to South Africa to Brazil.

While we continue to see value in select companies across more traditional sectors, we believe this widespread transition in the EM landscape, coupled with changing consumption patterns and an increased focus on sustainability, presents a compelling long-term opportunity in EM companies that are exposed to these trends—and/or that are enablers of the change.

EMs Dominating Fast-Growing Sectors

While the shift toward the new economy is indeed global, EM companies are at the forefront of many of these fast-growing but highly concentrated sectors.

EMs LEAD EV BATTERY INDUSTRY GROWTH

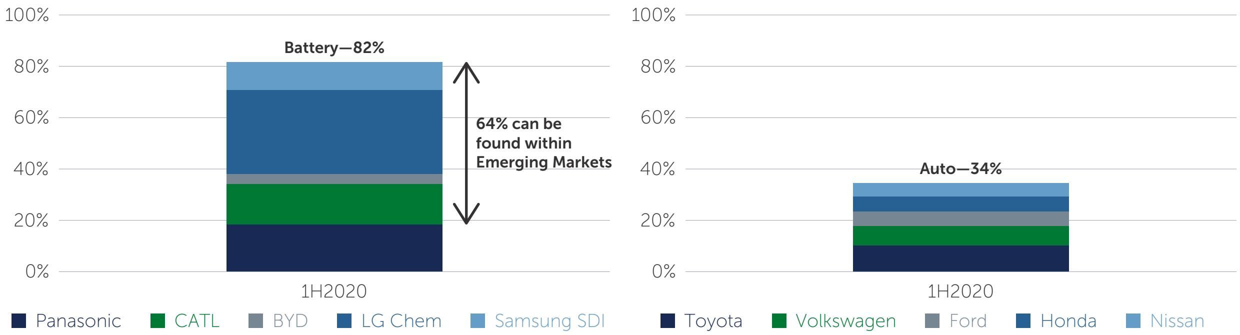
The electric vehicle (EV) battery industry is one example. Amid the push toward green investment globally, the EV battery sector has been one of the primary beneficiaries—thanks in large part to government subsidies for clean energy, which have helped narrow the price gap between EVs and traditional internal combustion vehicles. This in turn is increasing demand—which is forecast to grow 5.4x by 2025[3]—as well as resulting in higher production volumes, improved efficiency and lower costs of production. As these dynamics continue to play out, the price gap between EVs and traditional vehicles is forecast to narrow even further, and effectively close by 2025[4].

Mindful of the growing disruption to their traditional lines of business, auto companies across the world are also investing heavily in new EV designs, which should lead to a continued ramp-up in new model launches. Combined with the expected narrowing of the price gap, this is likely to drive EV unit sales and market penetration even higher over the next decade. In our view, this bodes well for key EV battery producers, many of which have already secured long-term supply contracts with major global auto companies.[5]

1. Primary industries involve acquiring raw materials, while secondary industries focus on manufacturing these raw materials into products. Tertiary industries refer to the commercial services that support the production and distribution process.
2. Source: Barings, Factset. As of September 30, 2020.
3. Source: HSBC. As of September 30, 2020.
4. Source: HSBC. As of September 30, 2020.
5. Source: McKinsey. As of 2020.

From an investment standpoint, the EV battery market is highly concentrated by the top five manufacturing companies, which make up 82% of the market—of these, four are based in EM and have a 64% market share **(FIGURE 1)**.

FIGURE 1: Global Market Share of Top Five Battery Manufacturers vs. Top Five Auto Manufacturers



SOURCES: HSBC; European Automobile Manufacturers Association (ECEA). As of September 30, 2020.

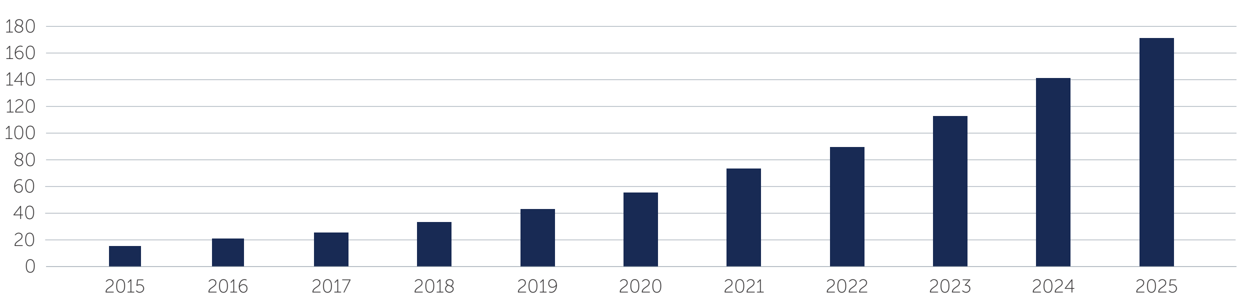
EMs AT THE FOREFRONT OF MEMORY AND FOUNDRY INDUSTRIES

Memory storage and foundry are further examples of new economy sectors dominated by EMs, which look well-positioned to benefit from the long-term growth in this space going forward. The memory storage industry has experienced steady consolidation over the last 20 years—in part due to rising technology barriers—which has caused the number of key players to decline from 24 to three. Of these, the two largest are EM companies that make up 71% of the market.[6] At the same time, the industry is undergoing robust growth, registering 28% compound annual growth over the last decade, thanks in part to rising smartphone penetration and increasing memory content per device.[7]

The foundry sector, which manufactures microprocessors that control electronic devices and enables them to perform various functions, has also undergone significant evolution. A decade ago, Silicon Valley-based Intel was the market leader, and fairly far ahead of businesses like Taiwan Semiconductor Manufacturing Company (TSMC) and Samsung. Today, the landscape looks much different, with TSMC and Samsung now at the forefront in terms of technological advancement. In fact, for the first time in its history, Intel is looking to outsource production to TSMC.

While both the EV and foundry sectors are well established, our outlook remains positive given the strong demand drivers at play, which we believe will provide support over the long term. For instance, governments, companies and individuals are generating an increasing amount of data every year, fueling demand for memory, storage and advanced microprocessors to analyze and process that data **(FIGURE 2)**. At the same time, Cloud data center CAPEX continues to grow strongly, while the introduction of artificial intelligence (AI) capable servers will also likely contribute to stronger demand going forward.

FIGURE 2: Data Growth (Zettabytes)

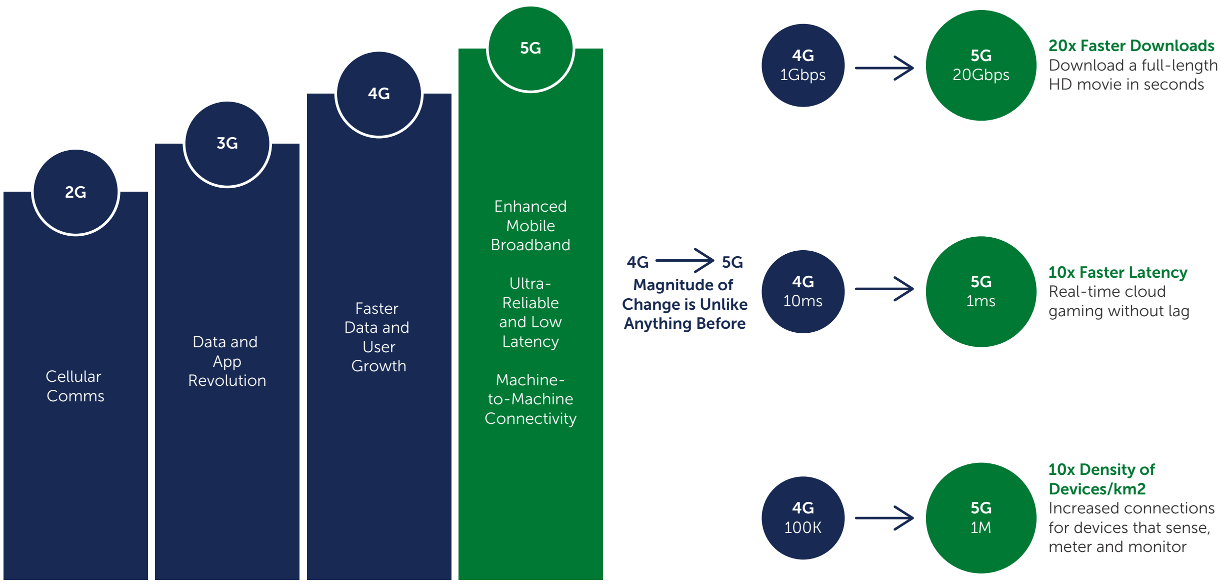


SOURCES: Barings; Intel. As of 2020.

6. Sources: Barings; Morgan Stanley. As of 2020.
7. Sources: Barings; Morgan Stanley; Intel. As of 2020.

Finally, as 5G technology continues to gain momentum globally, even more data will be created—and while the progression in mobile technology from 2G to 4G brought significant benefits, the jump from 4G to 5G is much more substantial, expected to enable 20x faster download speeds and 10x lower latency to eliminate lag. Connectivity will also increase exponentially between mobile devices, automobiles for autonomous driving, home and industrial internet of things (IoT), networking, and data centers. More and more data will be generated, meaning all devices will require upgraded microprocessors. We believe this ramp-up will occur over time, providing long-term demand for the memory and foundry industries, both of which are well-represented by EM companies.

FIGURE 3: 5G: Magnitude in Numbers



SOURCES: Barings; Intel. As of 2020. Gbps denotes the data transfer rate Gigabits per second.

EM Companies Capturing Changing Consumption Patterns

The changes in EM consumption patterns have been nothing short of significant, and represent a structural shift likely to shape the opportunity in EM equities for years to come. At a high level, EM GDP continues to expand rapidly, underscoring EM economies' strong consumer demand. A significant part of the consumer story has been supported by ongoing urbanization—as EM populations have shifted to cities in search of better jobs and living standards, economic productivity has increased and along with it, consumer strength. Compounding this, EM middle class populations are expanding, which means consumers are shifting from buying basic goods to having the power to consume on a discretionary basis.

While EM consumption growth is clear, and certainly structural in nature, what looks particularly compelling from an investment perspective is how many consumer companies in emerging markets are at the vanguard of these developments. In many cases, these companies are operating with innovative and differentiated business models, which serve the unique and often-changing tastes of EM consumers. For instance, one of the major trends that we have seen among EMs is the introduction and penetration of smartphones over the last few years—and we expect the penetration to continue accelerating, from roughly 45% currently to as high as 80% by 2025.[8] It is also worth noting that EM consumers appear to be far more engaged than their developed market peers, spending more time on mobile devices every day than the global average of three hours—in Indonesia and Thailand, engagement levels are already up to four hours daily.[8]

8. Source: Pew Research Centre: Smartphone Ownership Is Growing Rapidly Around the World, but Not Always Equally. As of 2019.

This backdrop, in our view, fosters significant opportunities in the EM space. E-commerce, for instance, has been one of the biggest beneficiaries of these changing consumption patterns. For the last several years, and even with the onset of COVID, online retail as a percentage of overall shopping has grown significantly across the EM landscape. China is currently leading this revolution, with penetration rates close to 20%. While this has led to some questions as to whether China's growth story has come to an end, we believe the market has consistently underestimated the growth potential of the Chinese e-commerce market, and expect penetration rates to increase further going forward. Looking across other EMs, penetration rates are lower, suggesting a significant opportunity for companies as consumers turn increasingly toward online shopping.

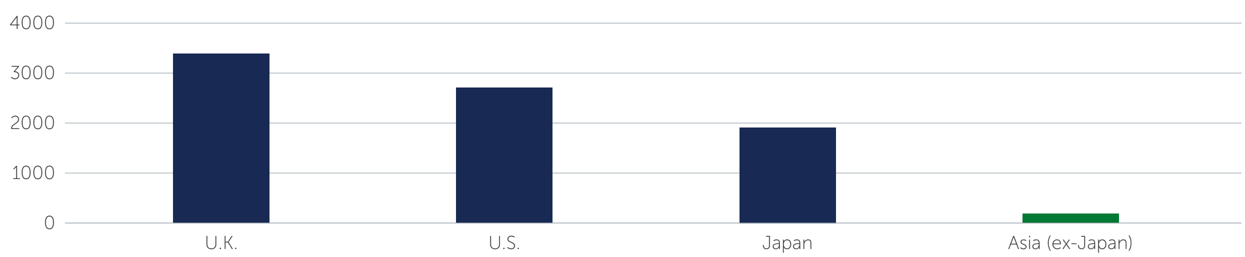
The breadth of goods and services available online has also expanded notably, now spanning a wide range of sectors. For instance, online grocery penetration rates are low but increasing. China, again, is in the lead, and we expect penetration rates to further increase given the ongoing competition between incumbent food retailers and new entrants in the market, most of which are e-commerce platforms. The online gaming industry presents further potential opportunity, and it has become a major form of entertainment across EMs. Revenues have already exceeded US$162 billion, dwarfing traditional forms of media consumption such as recorded music and box office—with China and Asia Pacific accounting for roughly 50% of the revenue pool in this space.[9] Particularly noteworthy, in our view, is the fact that a great deal of the intellectual property and talent driving this sector resides in EM countries. And the opportunity is broad-based. For example, Eastern Europe has a thriving gaming industry and is currently producing some of the most successful content being consumed across both developed and emerging markets.

Traditional Industries Forced to Adapt

As technologies evolve and consumer demand shifts, businesses in more traditional industries are facing pressure to adapt—which in and of itself has the potential to create further opportunity. Manufacturing and production industries, for example, are facing significant disruption in some areas, particularly from automation. While this presents challenges for companies with more traditional models, it also creates opportunities in select companies that are better able to adapt and use automation to improve their operating efficiency.

The insurance sector is a prime example. Consumers are increasingly buying high value assets like cars and homes, and with them, the insurance products to protect these assets. The lack of public health care has also led to demand for health and life insurance products. Looking at current penetration levels, insurance premiums per capita in EMs are low **(FIGURE 4)**. In our view, insurance companies that are adapting to this demand stand to benefit, particularly those using AI to collect and analyze data, to price risk and to cross-sell to consumers.

FIGURE 4: Insurance: Premiums Per Capita (U.S.$)



SOURCE: AIA. As of 2020.

The steady rise in household wealth across EM countries has also led to shifts in lifestyle, in particular an increased focus on health and wellness. In China, there has been a rapid surge in the number of marathons and running competitions over the last few years. With that, we have seen an acceleration in demand for leisure products, as well as for sportswear apparel and equipment—which has subsequently created a range of investment opportunities for both domestically produced and internationally branded products. And this trend is not unique to China; it is spreading across many other EM countries as well.

9. Sources: Newzoo; Goldman Sachs. As of 2020.

ESG on the Rise

In terms of the trends shaping the long-term opportunity in EM equities, environmental, social and governance (ESG) factors are also among the most prevalent. ESG standards for EMs, and ESG ratings for EM companies, are certainly below their developed market counterparts. This suggests to us that there is a significant potential opportunity for investors in EM equities to benefit from improvements in ESG over time. Also worth noting, many EM corporates are already improving their ESG standards—evident from the shift away from lower-ranking ESG scores in 2019 to higher-ranking scores in 2020. This change is a result of a few different factors, from government-mandated ESG practices to regulations set by the industry or stock exchanges.

There is reason to believe this momentum will accelerate going forward, particularly given the potential for a company's ESG credentials to impact its attractiveness from an investment standpoint. Companies that are actively trying to improve their ESG scores are often deemed as lower risk than those with deteriorating standards. At the same time, high ESG standards can help improve sustainability—and they can also have a positive impact on company valuation, with companies that show improving ESG standards often commanding a higher premium.

Further to this, as investors, actively engaging with companies on ESG issues is crucial. Ultimately, we believe that promoting improvements in ESG standards, in terms of disclosure and behavior, is a critical component in driving positive outcomes—not only for asset owners, but also for society and the environment.

Key Takeaway

Emerging markets are undergoing tremendous change and evolution, which is reshaping the long-term opportunity across the EM equities landscape. Looking at the markets today, we believe opportunities exist in companies that are exposed to, or are enablers of, the secular shift occurring in EM—in particular, companies with flexible business models, as well as those with improving franchises, unrecognized growth opportunities and other competitive advantages. As a fundamental, bottom-up manager, we see particular value in identifying companies with strong management, resilient balance sheets and positive ESG dynamics and policies. We also aim to capture macro risks through our cost of equity calculation, and we ensure that a company's ESG score automatically impacts this cost of equity. While near-term risks and uncertainties—whether around the pandemic, politics or economic growth—will likely continue to drive headlines for the foreseeable future, the long-term growth opportunity in EM equities remains quite compelling.

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