AORIS INVESTMENT MANAGEMENT

# The Emerging Market Fallacy

# Feature - The Emerging Market Fallacy

## INTRODUCTION

*Over the last decade real EPS at an index level has more than halved in three of the five largest emerging markets. We debunk the myth that faster EPS growth follows faster GDP growth.*

The very words ‘emerging markets’ evoke images of faster growth than the ‘developed world’. It certainly sounds a lot more promising than ‘less-developed economies’, the designation used in the 1980s and 1990s. There is a widely held belief that reversion to the mean will work like a gravitational force, pulling ‘emerging’ economies upwards. However, this force has proved to be remarkable in its absence when it comes to earnings per share (EPS) of emerging market (EM) companies. Over the last decade, real (after inflation) EPS at an index level has gone backwards in four out of the five largest EM’s. Remarkably, in three of them real EPS has more than halved over that period.

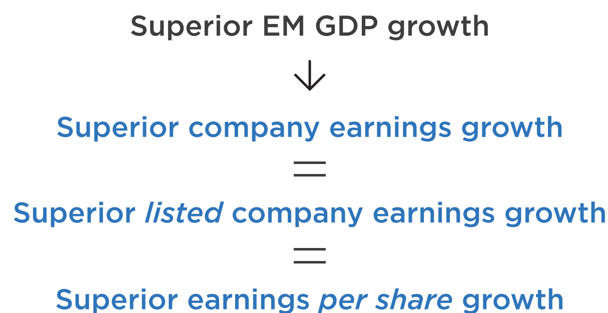
In this report we explain why there is a difference between economic growth and EPS growth in all countries and why this difference has proved to be particularly pronounced in EM’s. We show that the belief that faster economic growth in EM’s will produce a higher rate of EPS growth on average from EM companies is a fallacy.

At Aoris, we participate in the economic development of EM’s via our developed market (DM) listed multinationals, such as LVMH and Accenture. In the future, we may well invest in businesses based in EM’s. However, a view on the economic prospects of emerging economies plays no role in our appraisal of the investment merits of individual businesses.

## THE GROWTH CONSTRUCT

Faster economic growth is often assumed by investors to drive commensurately higher corporate earnings growth, which in turn is expected to produce equity outcomes superior to that of developed economies. In the minds of many, it works like this:

The presumption of superior economic growth in emerging economies has been severely tested by deep recessions in Brazil, Argentina and Venezuela in recent years, but that is not the focus of this report. Nor is the belief that faster economic growth produces higher equity returns. Our focus here is the first of the two linkages above: the assumed causal relationship between economic growth and corporate earnings growth. We have highlighted in blue below the 'leaps of logic' that are embedded in this supposed relationship, which many investors are unaware they are making.




The belief that corporate EPS will closely follow economic growth is a misperception that applies to investors in all countries. However, because economic growth expectations are higher in EM's, the disappointment when it comes to corporate EPS has also proved much greater – as we shall see.

## THE GROWTH GAP

The underlying presumption of many EM investors is that:

(a) emerging economies are growing faster;

(b) which will drive faster earnings growth; and

(c) which will in turn drive superior equity returns.

In recent years, this construct has disappointed on multiple fronts – economic growth has not met the expectations of the optimists and equity market performance has, in aggregate, fallen short of that of DM. However, it is the gap between real GDP growth and real EPS growth that is our focus in this report. This gap is shown in the far-right column in the table below, with a negative number indicating that EPS has grown at a lower rate than GDP. (Note that we do not include South Korea as an EM as

it is a member of the OECD, unlike the countries listed below. It is included in the MSCI definition of emerging equity markets, but not that of FTSE.)

## GDP GROWTH VS. EPS GROWTH – 10 YEARS TO 2018 - P.A.

| | Real GDP | Real EPS | Growth gap |
|---|---|---|---|
| **Emerging Markets:** | | | |
| Brazil | +1.2%. | -8.8% | -10.0% |
| Russia | +0.7% | -9.4% | -10.2% |
| India | +7.2% | -8.5% | -15.8% |
| China | +7.9% | +3.0% | -4.9% |
| South Africa | +1.5% | -4.6% | -6.3% |
| **Developed Markets:** | | | |
| Europe ex-UK | +0.6% | -2.4% | -3.1% |
| UK | +1.1% | +2.7% | -3.8% |
| US | +1.7% | +6.6% | +4.8% |

Sources: Factset country indexes, Aoris analysis, OECD

*Real EPS has grown at a slower rate than GDP in each of the five largest EM's and by an average of 9.4% pa.*

The gap between 10-year real GDP growth and real EPS growth is large in all five EM's. It is an eye-popping, double-digit number in three of them: Brazil, Russia and India. In those three countries, real EPS has declined at a rate approaching 10% p.a. over a decade, equivalent to a fall of two-thirds over the 10-year period.

Imagine if in 2008 you had been provided with a crystal ball that revealed to you that real GDP in India would grow at the blistering pace of 7.2% p.a. over the ensuing decade. Would you have felt bullish, bearish or neutral on the prospects for EPS of listed Indian companies? You would likely have never believed that the real EPS of listed companies would fall by an average of almost 60% over the same period. Imagine that at the same time you had been told that over the next 10 years the Chinese economy would grow at a rate more than four times faster than the US economy. You would have been incredulous upon discovering in 2018 that real EPS growth in China had been a positively pedestrian 3% p.a., less than half the rate of real EPS growth in the US and less than half the rate of growth of the Chinese economy. Why is there a disconnect between the growth of the economy and the EPS of listed companies, and why has the growth gap been so large in EM's?

Below, we analyse the linkage between GDP growth and EPS growth and to do this we deconstruct it into three steps. The relationships between:

(1) GDP growth and corporate earnings growth;

(2) corporate earnings growth and earnings growth of the *publicly listed sector*; and

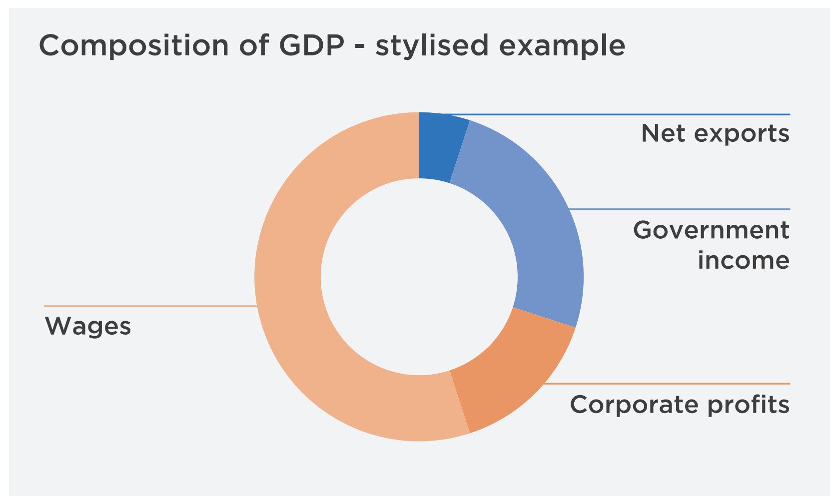
(3) earnings growth of the listed corporate sector and *earnings per share* growth.

To be clear, the lack of a linear, causal relationship in each of these steps is true of both DM's and EM's but the gap between GDP and EPS, and between expectations and outcomes, has proved to be wider in EM's. We explore these linkages and the reasons why they are a particular issue in EM's.

## 1. The relationship between GDP growth and corporate earnings growth

A country's GDP growth does not drive the profits of its corporate sector with the tight one-to-one relationship that is often presumed. Far from it. The composition of the economy is not constant, particularly over shorter periods of time.

*The division of the GDP 'pie' does not stay constant. The share of GDP going to corporate profits changes over time.*



*We are wary of interventionist EM governments. When we own businesses we want them to be 'at the top of the food chain'.*

Three key reasons why the composition of GDP changes over time are:

**a) The public vs. corporate sector**

Government spending is rising faster than GDP in many economies, including the US and Australia. One reason for this is health care, a structurally high-growth part of the economy, much of which is provided by the public sector. As such, private sector activity may grow at a slower rate than GDP.

In EM's, the government is generally not a benign force when it comes to industrial policy and the fortunes of the private sector. Petrobras, Brazil's largest public company, has for many years been used by the Brazilian government as an instrument to control inflation through capping petrol prices. To add to Petrobras's pain, during periods when prices are capped it has to meet rising local demand by importing oil and selling it at a loss. Further, the government has applied onerous local purchasing requirements to Petrobras, to support local businesses and employment. This has forced up the prices Petrobras pays for everything from labour to fuel tankers, undermining its profitability.

In China, around 40% of state-owned enterprises (SOEs) lose money, yet SOEs are growing faster than private companies and taking an increasing share of bank credit. In 2018, profits of SOEs rose while those of private companies declined (source: Assets Supervision and Administration Commission of the State Council). Some commentators believe the government has deliberately favoured SOEs, increasingly using them as an instrument to further the government's aims, at the expense of the private sector. 'The state advances, the private sector retreats.'

At Aoris, when we invest in businesses we want to be at the 'top of the food chain'. When we own companies, we want to be confident that they are being run for us, as foreign minority shareholders, and that there aren't competing interests that are 'ahead of us in the queue', such as a local or national government.

**(b) Labour vs. business**

The proportion of GDP ending up in the form of wages and salaries has declined over the last decade or so in both emerging economies and the developed world. Among the sharpest falls in the labour share of GDP has been in China. In many countries there are now broad political and social forces pushing to increase workers' share of economic output. This is evident in everything from 'yellow-vest' protests in France, to increases in minimum wages in Brazil promised by the newly-elected president, to the proposed introduction of a 'living wage' by the Australian Labor Party. Should labour compensation rise at a faster rate than labour productivity, then we will see an erosion in the share of GDP accruing to corporate earnings.

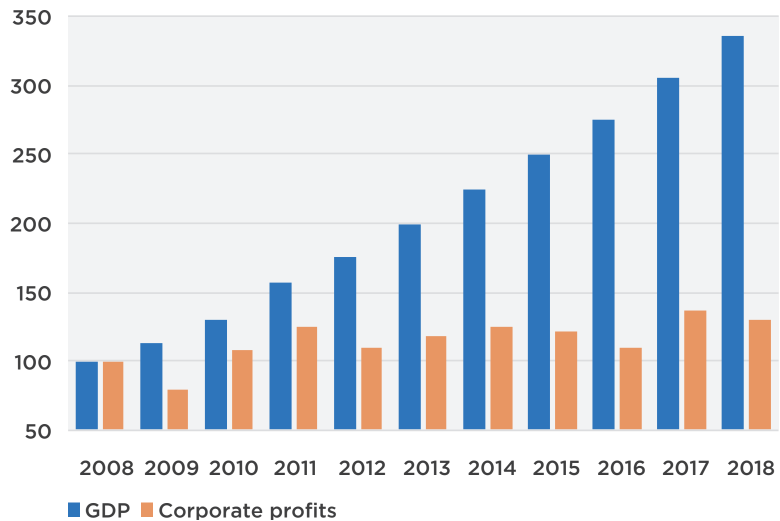
**(c) Foreign vs. domestic demand**

The linkage between an economy and the businesses operating within it is further weakened though exports and imports. A strong local economy may drive up demand for imported goods, which will be reflected in income to overseas companies. For example, industrial activity in China will drive demand for exports for Norilsk Nickel, one of Russia's largest mining companies, more so than will the strength of the Russian economy. Exports account for about 26% of Russia's GDP, well above the 12% contribution to the US economy and even the 21% weight in Australia's GDP.

We have provided three reasons why profits of domestic companies may grow at a different rate from the economy in which they are based. In other words, the proportion of GDP accruing to corporate earnings, like the other three 'slices of the economic pie' in the chart on the prior page, can change. India provides a stark example of the divergence between corporate earnings and the economy. The profits of all listed and unlisted companies in India relative to GDP declined from a peak of 7.8% in 2008 to 3.0% in 2018. Over that period, India's nominal GDP (including inflation) grew at a rate of 12.9% while earnings of Indian companies grew by just 2.6% p.a.

*In India, total corporate earnings have barely moved over a decade, and more than halved as a share of GDP.*

India - GDP and corporate profits. Indexed to 100




Source: Motilal Oswal

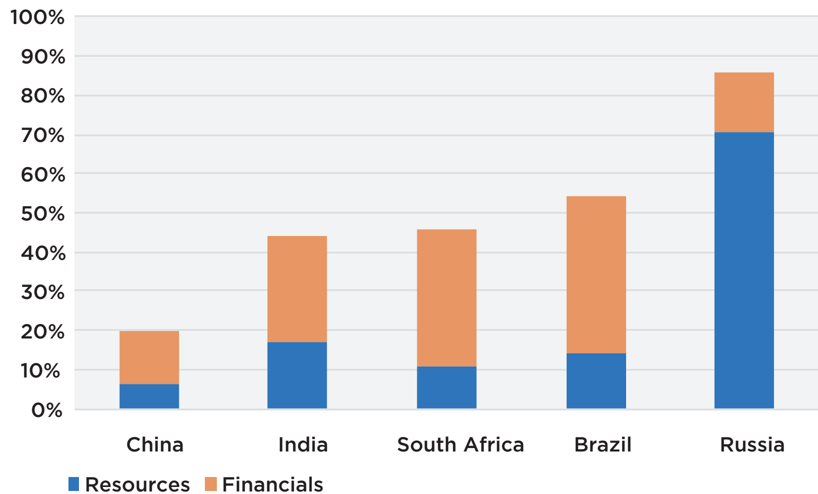
## 2. The relationship between corporate earnings growth and earnings growth of the *publicly listed sector*

- A country's stock exchange is a poor representation of the profile of its corporate sector. Companies listed in one country often have overseas subsidiaries, so they will capture economic activity from outside their country of listing. Sales from products and services produced outside the US account for roughly 45% of revenue for the S&P500 and 70% for the UK equity market. For Tata Consultancy Services, India's second-largest company by market capitalisation, 94% of its sales come from outside India. So, the Indian economy is going to have very little to do with Tata's earnings.
- Corporate earnings of the publicly listed sector in one country do not capture earnings of domestic private companies. America's 10 largest privately-held companies include names such as Deloitte, PricewaterhouseCoopers, Ernst & Young and Mars, and between them employ over 1.6 million people.

In many EM's, the finance and resources sectors account for a far larger portion of the stock exchange than they do of the domestic corporate sector.

*In emerging countries the listed corporate sector has little overlap with the domestic economy.*

Resources and financials as % market capitalisation




Source: Factset

Companies drawn from the resources sector account for 17% of India's equity market capitalisation, 14% in the case of Brazil and 71% for Russia, which compares to the contribution that sector makes to their economies of 7%, 6% and 22% respectively. The South Korean equity market is similarly unrepresentative of the domestic economy, with Samsung Electronics, which primarily serves the export economy, accounting for over 40% of the Korean equity market – six times the size of the second-largest listed company.

## 3. The relationship between earnings growth of the listed corporate sector and *earnings per share* growth

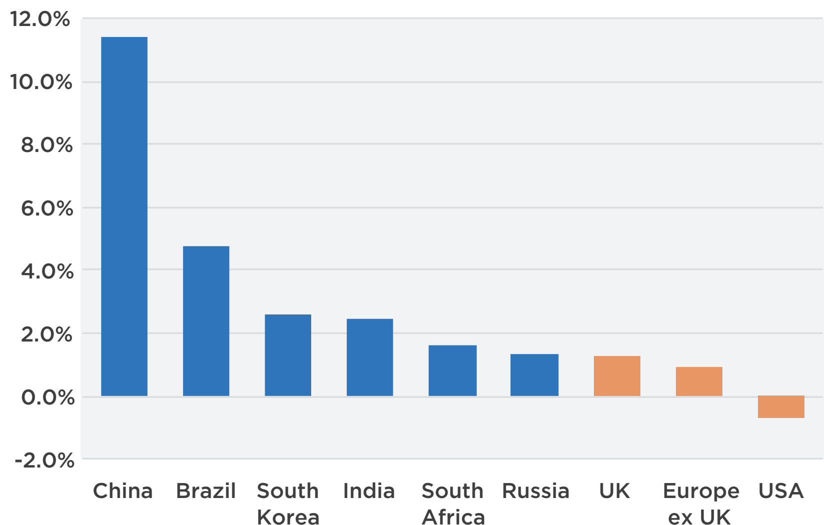
*EPS dilution arising from growth in issued shares is greater the lower the return on capital.*

What matters to investors is their proportional interest in the earnings of a company. So, it's not earnings so much as EPS that count. We have to think about the change in the denominator (number of shares on issue) as well as the numerator (total profits). The number of shares on issue for an individual company may increase to fund an acquisition, fund the capital it needs to grow, or form part of employee compensation. Net profits need to grow faster than the number of issued shares in order for EPS to rise.

We can measure the dilution from the issuance of new equity at an aggregate index level by comparing the change in the market capitalisation of an index relative to the change in the price of the index. The more capital intensive the average listed company is and the lower the return on capital, the greater the dilution from the issuance of new equity. Energy, mining and banking are among the most capital intensive of all sectors and they earn low, through-the-cycle returns on invested capital. This is one of a number of reasons why at Aoris, we will never own companies from these sectors. As we saw in the previous section, resources and financials constitute a large portion of the equity indexes in EM's. It is no surprise, then, that dilution from equity issuance has been far greater in EM's than in developed ones.

*EPS dilution from rising share count has been far greater in emerging than developed markets.*

**Annualised change in share count 2008-2018**
**Emerging vs. developed markets**



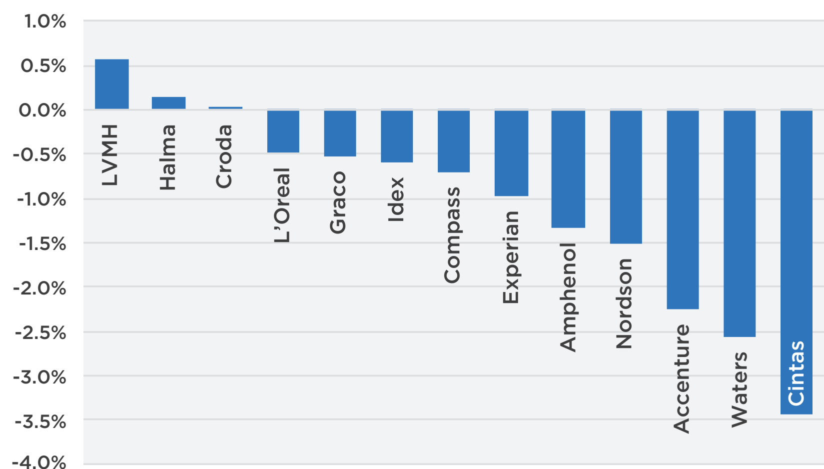

Sources: Factset, Aoris analysis

This chart shows that in Brazil, after-tax profits of listed companies in aggregate would have had to rise at a rate of 5% p.a. just for EPS at the index level to remain constant in nominal terms. Research by Schroders over the 10 years to 2017 estimates the dilution across all EM's at 3.8% p.a. on average, significantly larger than the 0.5% p.a. dilution for DM's.

Looking at the companies in the Aoris portfolio, shares on issue have declined on average by 1.0% p.a. over the last decade. Rather than act as a drag or 'handbrake' on EPS growth, the reduction in shares on issue has meant that EPS has grown at a faster rate than after-tax profits.

*Rather than dilution, across our portfolio most companies have reduced shares on issue, so EPS has risen faster than profits.*

**Annualised change in share count 2008-2018**
**Aoris portfolio holdings**

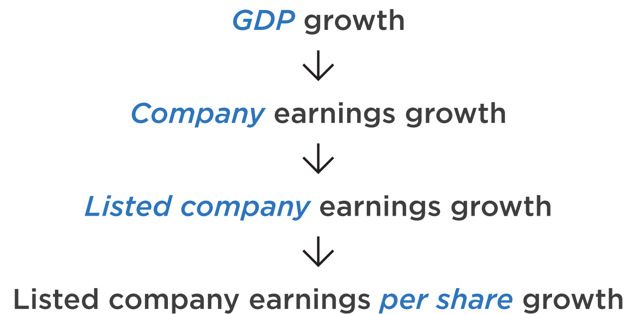



Sources: Factset, Aoris analysis.
Note that CDW is not included as it has less than 10 years' history as a public company.

## CONCLUSION

*Emerging market investing is often based on the premise that faster economic growth will produce superior EPS growth. We have shown this to be a fallacy.*

We have shown that the economic growth of a particular country does not translate into EPS growth of listed companies in the linear, causal way that many people believe. In EM's, companies from the resources and financials sectors account for a far higher portion of the equity market than they do of the economy, therefore much of the local economy is not represented in the equity market. Most listed businesses operate in many countries, so economic activity from their home country will have only a partial flow-through to their profits. On top of this is the 'denominator effort', or the dilution to EPS caused as companies increase the number of shares on issue. Dilution has been a far greater drag on EPS growth in EM's, reflecting the lower average returns on investment and greater capital intensity in those countries.




EPS growth in EM's has fallen significantly short of GDP growth over the last decade. You may feel bullish on the Chinese economy or the recovery prospects in Brazil. However, counterintuitive though this may feel, your view on an economy should have no bearing on your expectation for EPS growth from that particular country.

EM's account for an average of 25% of revenue across our portfolio companies and in six of them account for a third or more. Importantly, these companies have been able to generate growth in EM's without relying on the local economy to be their primary driver. For example, Accenture has been consistently growing at a double-digit rate in both China and Brazil, including in the three months to February of this year. L'Oréal grew at a 16% rate in EM's in 2018, the fastest rate for over a decade, including 33% growth in China. China accounts for 18% of sales for Waters and sales there grew at a rate of 15% in the December quarter, driven by increasing demand for Waters' equipment for use in food safety testing. Halma, a leading maker of specialised equipment for use in markets including process safety, infrastructure safety, environmental testing and medical, grew its sales in China by 18% in the year to June 2018.

# Stock Profiles

## EXPERIAN

*Experian is a global credit bureau, with its credit files on hundreds of millions of consumers and businesses used in bank lending decisions.*

Experian is a leading global credit bureau and provides credit data and analytical tools to help banks, insurers and other businesses make better lending decisions. It generated revenue of UD$4.7 billion in 2018, employing 16,500 people to serve clients in 39 countries. Experian holds the number one or two position in most markets in which it operates.

A credit bureau is an extraordinarily large and comprehensive dataset. It is what is known as a contributory database, and in a given geography every bank will submit to the bureau every loan repayment from every single borrower. This is supplemented with a wide variety of public records data. Experian periodically adds new sources of data like rentals and telco payments history to its database. This provides a valuable overlay to customers, especially when primary credit scoring data points like past loan and credit card data don't exist. Along with the core credit information, this continual compiling and integration of wide-ranging, credible datasets has allowed Experian to extend its product applicability beyond the traditional banking industry, to insurers, healthcare providers and marketers, among others. This global capability has created a very powerful offering.

Barriers to entry, in the form of data security and the IT infrastructure required to ingest and process vast quantities of data, are immense. Further, the 'standardised' offering means there is no economic need for more players in the industry. This has led to an oligopolistic industry structure, i.e., a market dominated by a small number of large sellers. We like this industry structure as it promotes sensible competition among players, without each trying to undercut the other on price, which only leads to diminished returns for the whole industry over time.

Starting as a data supplier, Experian transformed its reputation to be a more strategic partner, where major banks today place their staff alongside Experian in data labs to co-create products. This strategic partnership, combined with its strategy to bundle solutions such as decision analytics and marketing services, has allowed Experian to become increasingly valuable to its customers, resulting in very high customer retention rates.

Experian's competitive moat is built around a culture of continual

innovation and unrivalled global reach and scale. Strategically, the management has a very clear sense of direction and is continually driving the business to get better all the time. Experian shows a long history of operational discipline and smart capital allocation, which is demonstrated in its steady growth in profitability. The business has consistently generated returns on capital of 13–14% p.a. over the last 10 years. The company has sensibly reinvested in the business, supporting GDP-plus organic sales growth and EPS growth of 5–6% p.a.

## COMPASS GROUP

*Compass feeds more than 20 million people each day through its restaurants that it runs on behalf of corporates, hospitals, universities and sports stadiums.*

Compass Group is the world's leading contract catering company. It operates at 55,000 client locations across 50 countries, serving schools, hospitals, oil rigs, corporate offices, to big entertainment venues. Clients include Google, the Cleveland Clinic, Harvard University and the Dodger's Stadium. Compass's customer retention rate has been an impressive 95% for many years.

Compass is the largest player in most of the markets in which it operates, and this brings with it many advantages. Its above-industry growth over many years - particularly in the US, its largest market - has enabled scale benefits to drive further efficiencies in food procurement, labour management, and back-office costs, underpinning Compass's competitiveness in being the lowest cost and most efficient provider of food services. Compass has a long history of strong operational management. Like his predecessor, Compass's new CEO Dominic Blakemore continues to run the company with discipline, purpose, a clear sense of what it is good at, where its core strengths lie, and with the objective to keep driving more operational and efficiency improvements at every step.

Compass has shown uncommon discipline in recently announcing its exit from the weakest 5% of operations in order to focus on what it does best: 'We are at our best when we focus on food'. Removing the tail will ease management distraction and provide incremental capital to be invested in areas of strength where Compass can extract the best returns. Management's clarity of thinking around what kind of acquisitions the business is willing to engage in, and at what price, is noteworthy – small bolt-ons within core sectors with

emphasis on achieving returns greater than cost of capital by the end of year two. This is a very high hurdle rate and demonstrates a value-oriented ROIC mindset. The largest deal in early 2018 – for US$280 million – has achieved its return targets ahead of the end of year two objective.

Unlike peer Sodexo, which runs a multi-service strategy (food catering as well as fitness centres, equipment maintenance, landscaping, security, and a host of other services), Compass is focused on staying true to its core and strengthening its market position by growing organically in doing what it does best. This strategy has led to expanding return on capital, which steadily increased from around 15% a decade ago, to 20% currently. Compass consistently reinvests 50–60% of its internally generated cashflows to deliver stable organic sales growth of 4–5% p.a. and EPS growth of around 10% p.a.

Sustainability has been receiving a heightened focus in recent years to the extent that one of Compass's large clients ran a sustainability RFI (request-for-information) process even before a food quality and cost process. Compass, with its long-established business and global scale, is well positioned to drive investments and excel in the area of sustainability, in which it has already made substantial progress. Compass applies supply chain integrity measures of sustainable farming, fair trade and ethically sourced products across the majority of countries in which it operates. Impressively, it is working towards a 20–25% efficiency increase in food waste, water and energy usage over the medium term.

AORIS INVESTMENT MANAGEMENT

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You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.