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Warakirri ASSET MANAGEMENT

5 Emerging Market Companies We Like

Identifying well capitalised, tightly managed, high quality emerging market companies with good corporate governance at attractive prices will remain key as we move forward.

This article has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Global Emerging Markets – Where to from here?

After a dramatic period of policy rate cuts in 2020 (in the wake of COVID-19 growth shock), there has been a pattern of countries raising rates in 2021. Over the last month there were five countries that raised policy rates on a net basis (Brazil +75bps to 4.25%, Russia +50bps to 5.5% and Mexico +25bps to 4.25%, Hungary +30bps to 0.9% and Czech Rep +25bps to 0.5%). We ask the question: is this a sign of more widespread inflation and policy rate tightening to come?

We emphasise - not yet. Recent increases (Brazil in particular) are part of some partial normalising from the extremely low rates of 2020.

Despite the rhetoric from some commentators about ongoing inflation risks, statements from central banks in advanced countries on balance continue to be more dovish than hawkish. Concerns over the sustainability of the economic recovery once income support/COVID-19 relief programs expire and worries about persistently high unemployment dominate central bank narratives.

Emerging Market 10-year government bond yields are still offering substantially higher nominal returns than Developed Markets (average 0.60% yield). Excluding the outliers like Turkey, the average EM bond yield at the end of June 2021 stood at 4.76%. South Africa, Brazil, Russia, Indonesia, Mexico and India bond yields are all still hovering between 5-10%.

In our view, these higher yields should continue to support fund flows back into EM debt and equity capital markets, as we have witnessed over 2021.

Vaccination programs are well underway, despite concerns that current vaccine efficacy against new mutant/variant COVID-19 viruses could disappoint, leading to a potential global third wave.

For Emerging Markets, while we are positive on the medium to long-term vaccination outlook, the short-term progress is still tracking well behind DMs. EMs on average have less than 12% of the population fully vaccinated versus UK (49%), US (47%) and Europe (35%). Therefore, many EM countries remain exposed to yet another wave of COVID-19 under the latest variants over the next 12 months or so.

Our base case is for normalisation from COVID-19 to occur in 2022-23, and virtually all companies in our portfolio have no 2021 earnings guidance or we have set these at relatively conservative levels.

5 Emerging Market Companies We Like

Below, we share our latest thoughts on where we are finding attractive opportunities to invest in Emerging Markets.

Most companies we own are market leaders within their sectors, with strong pricing power, and some companies that have been penalised by COVID-19 – with a view to the recovery in the years ahead.

1. Techtronic Industries *(HK/China)*

HK/China based Techtronic is one of the world's leading branded tools companies and is the #2 player in the US market. The company's brands include Milwaukee, Empire, Ryobi, Hart, Hoover, Oreck, VAX and DirtDevil. Techtronic has a long history of generating superior returns for shareholders and has strong management.

The company continues to gain market share in the US, a market which we believe is in the midst of a multi-year supernormal growth period for tool sales.

Leading Brands

The company has been an excellent long-term performer, with shares compounding at 28% p.a. over the past two decades underpinned by consistent strong earnings growth. For the year ended 30 June 2021, the shares rose 78% in US$, helped by an excellent second half 2020 result and a strong US economy.

An analysis of the leading brands in the global tool market shows all have a long brand history. This creates authenticity and trust and creates a strong competitive advantage for incumbent tool brands, like those in Techtronic's portfolio.

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Source: Bloomberg

Rising income levels in emerging markets coupled with a trend towards DIY and home improvement are laying the foundation for the industry's next growth phase. As the leading Asian tools company, Techtronic is well positioned to capture this EM growth opportunity.

The shift to Lithium-Ion rechargeable tools, in which Techtronic has a first mover advantage, sets the foundation for a golden period of market share gains for the company.

The interoperability of batteries combined with the cost (batteries are often more expensive than the tools) within a given brand creates high switching costs, and a strong network effect. As the leading player, this gives Techtronic a considerable competitive advantage.

Given the long-term strong outlook for earnings and a net cash balance sheet we think the current valuation continues to look compelling.

2. Top Glove *(Malaysia)*

Top Glove is based in Malaysia and is the world's largest rubber glove manufacturer with a market share of around 23%. It is one of the best long-term value creators globally; the total shareholder return since listing in 2001 has been 36% p.a., a remarkable compounder, and one of the best performers in the MSCI EM Index.

The company's main product is medical examination gloves, a category which has grown at around 12% p.a. in volume terms over the past 15 years due to factors including:

- increasing healthcare coverage in emerging countries
- improving hygiene awareness globally amidst increasing threats from epidemics [e.g. MERS, H1N1, COVID-19 etc.]
- ageing populations in the developed world.

We view examination gloves as an attractive structural growth category. Importantly, it is highly insensitive to economic conditions; glove volumes have grown equally strongly in recessions (GFC, Asia Financial Crisis) as in normal years due to the lack of substitutes and the main usage being healthcare.

Top Glove has earned an average ROE of more than 18% since first listing in 2001, and net profit after tax (NPAT) has grown at an exceptionally strong compound annual growth rate (CAGR) of 36% over the same period.

Over the year ended 30 June 2021, Top Glove shares underperformed due to the popularity of thematic trades where investors "sell Covid beneficiaries and buy re-opening plays". Whilst the glove sector certainly benefited from the pandemic, this overly simplistic top-down approach misses two key factors n our view:

1. The glove sector was a wonderful shareholder value creator for decades before the pandemic.

2. There are compelling reasons to believe that glove demand remains structurally higher post pandemic.

Revenue CAGR^	Profit After Tax CAGR	Average Profit After Tax Margin
Over 20 years since listing in 2001:		
28%	**38%**	**24%**

Source: Top Glove; CAGR = compound annual growth rate

As a consequence of selling pressure from both thematic investors and retail traders who crowded into the stock in 2020, the stock is now cheaper than it ever has been in the past.

Top Glove offers a current dividend yield of 17%, the highest in Asia, and is expected to pay fully 40% of market cap out in dividends over the next five years. Net cash on the balance sheet is equivalent to 11% of market cap.

Ultimately, we believe that fundamentals will prevail and the tailwind of economically-insensitive double digit volume growth will see Top Glove and peers' re-rate significantly.

3. Tata Consultancy Services *(India)*

TCS pioneered the Indian IT services sector in the 1970s and remains the leading industry player today. The company has delivered exceptional long-term shareholder returns (>20% p.a. in USD since listing in 2004). Despite its advantages and long history, TCS's share of the global outsourcing market remains tiny (<2%) – highlighting the long runway for growth.

India's advantage in global IT outsourcing is that its vendors can provide the same quality and range of services at much lower cost than almost any of its global peers, and significantly cheaper than if their clients were to in-source these functions. Underpinning the industry is India's huge pool of highly skilled English-speaking IT/engineering talent, which adds around 1 million graduates each year. TCS's own headcount now exceeds 488,000.

Ongoing growth in global IT expenditure will be driven by shorter tech lifecycles, increasing technology intensity and complexity across businesses, and the rise of digital/SMAC (Social, Mobile, big data Analytics & Cloud). These factors in turn will drive more outsourcing by corporates. Indeed, today companies need to adopt technology in order to survive, let alone be competitive.

Tata Consultancy Services
Share Price
5 Years to 30 June 2021

Source: Bloomberg

TCS has consistently generated the highest returns on capital and margins amongst its peer group – driven by:

1) its lowest cost per employee (lowest attrition and flatter employee pyramid),
2) most efficient employees (highest utilisation and leading automation/process efficiency),
3) its scale (the leading offshore player across geographies, verticals and services) and;
4) superior capital management.

The COVID-19 pandemic has mostly been favorable to TCS – there has been limited supply-side disruption with nearly all their employees able to operate from home. The pandemic has also pushed their clients to accelerate digital transformations that would have taken years into mere months. The company is seeing growing spends on cloud migration, AI, data analytics and enterprise level security.

We believe the company can continue to sustain double-digit revenue and earnings growth over the longer run.

4. America Movil *(Mexico)*

America Movil is the leading telecoms company in Latam America with over 300mn subscribers, operating across 17 countries. The main geographies are Mexico, Brazil and Colombia in terms of profit contribution.

The company is invariably the number 1 or 2 operator in every market – which brings significant advantages in terms of scale of network reach and capacity – vital customer value propositions in being able to provide ubiquitous and fast internet (at home, at work and on the move).

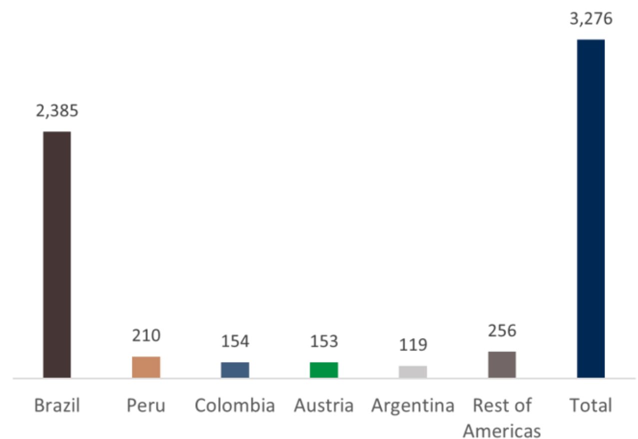
Returns have steadily improved over 2017-2021 as the company leverages its market power of a superior network quality, capacity and coverage for integrated wireless and fixed line data/internet services – and competitive intensity has abated as several opponents have become financially constrained.

Indeed, many of America Movil's key competitors are under-investing in their network capabilities, which should see industry returns migrate to the leaders that have kept the rate of investment up in terms of network capacity and coverage. This allowed the company to become a first mover in 4G and 5G.

In recent years we have continued to see evidence that pricing is becoming more rational, especially in the key markets of Mexico and Brazil, as weaker competitors look to improve returns on capital. Indeed, COVID-19 has seen a further reduction in competitive intensity, whilst creating strong additional demand for data services due to WFH.

The company is also taking an active role in consolidating its industry with acquisition of Nextel in Brazil (2018), Telefonica's operations in Guatemala (2019), and acquiring part of Brazil's #4 operator (Oi) in 2020. These acquisitions will enhance returns on capital in these markets.

3.3 Million Post-paid Net Additions (Thousand) in 1Q21



Source: America Movil – Latest Quarterly Results Q1 2021 presentation

The company generates high levels of free cash flow as such is in a strong position to reduce its debt level which is its key priority at present.

The company is aiming to reduce its net debt to EBITDA to 1.5x by end of 2021, which will be a precursor to a lift in the dividend payout and resumption of share buy backs.

The planned sale of AMX's US operation (Tracfone) and spinning out the South American towers business, will expedite debt reduction. As such the potential for substantial increase in dividends is quite real.

5. **Taiwan Semiconductor Manufacturing Company *(Taiwan)***

TSMC is the leading provider of semiconductor foundry services. Its technological leadership allows it to earn high real return on capital well above its cost of capital.

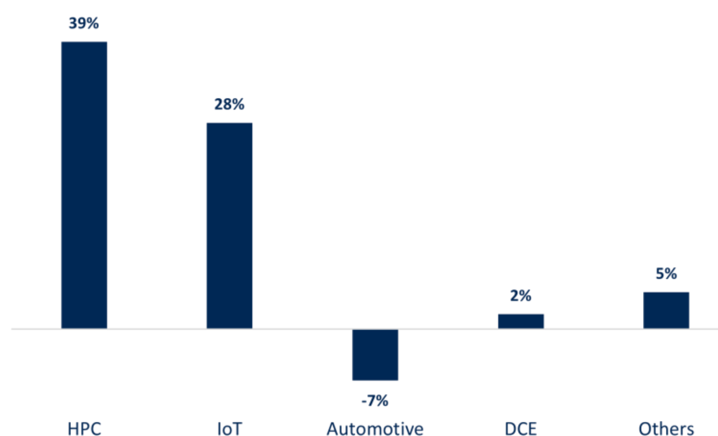
TSMC has significant long-term growth potential, driven by industry consolidation, a shift towards semiconductor foundries (away from in-house production) and the growing use of semiconductor “chips” in a variety of applications including mobile phones, automobiles, robotics, telecommunications and artificial intelligence. These trends have driven TSMC’s revenue growth of 12.4% per annum since 2010.

TSMC’s growth in the short term has been aided by the “work from home” phenomena, a result of the COVID-19 pandemic. TSMC continues to be positively impacted by this trend into 2022.

The decision by Intel in 2021 to use TSMC as an outsourced manufacturing partner represents an historic shift in the semiconductor industry. This shift will see a meaningful acceleration in TSMC’s High Performance Computing (HPC) sales over the next 5 years.

TSMC’s industry leading position appears to be highly defensible. Its business model is based on building an ecosystem of customers that share intellectual property amongst themselves. Competitors such as Samsung and Intel, that have a big internal demand for chips, are unable to build this ecosystem giving TSMC a significant competitive advantage. As this advantage has grown over time TSMC’s return on capital has improved.

2020 Revenue by Platform
Growth rate (YoY)



Source: TSMC

Over the longer term, the technological limitations of semiconductor devices may result in the industry’s commoditisation, however this is likely to take a significant amount of time (>7-10 years). This long-term risk is offset by TSMC’s reasonable valuation, increasing return profile and strong medium-term growth prospects.

The ***Warakirri Global Emerging Markets Fund*** *is long only, low turnover (30-50% p.a.) and selective. As such it will hold between 20-40 stocks of Emerging Market businesses with clear opportunities for growth.*

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

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