Emerging Markets: Mexico "nearshoring" opportunities

Our specialist Emerging Markets equities investment partner, Northcape Capital, recently returned from a trip to Mexico where they met with FEMSA, the country's fifth biggest company by revenue and a top 5 position in the portfolio. FEMSA operates the largest independent Coca-Cola bottling group in the world and Latin America's leading convenience chain, OXXO. Here the team discuss the growth of the OXXO chain and the valuation opportunity for FEMSA.

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

Mexico "Nearshoring": A Focus on Femsa

One of the highlights of Northcape's recent research trip to Mexico was our meeting with FEMSA (Fomento Economico Mexicano SAB de CV) in Mexico's northern border city of Monterrey. The city is often described as the centre of "near shoring", the practice of outsourcing to countries located in close proximity with similar time zones – in this case, the United States.

Particularly following the news that Tesla has purchased a large block of land there to build a Gigafactory assembly plant. Monterrey is located just 220km from the US border, with good infrastructure and lower levels of crime than the national average.

Exhibit 1: San Pedro Garza Garcia, Monterrey, Mexico

Source: Northcape Capital

There was certainly a **strong sense of economic boom** on the ground during our trip; in contrast to other parts of Mexico we visited, we saw many luxury European cars on the roads and noted the presence of high-end brand stores such as Salvatore Ferragamo and Hugo Boss. Indeed, we were told that the municipality of **San Pedro Garza Garcia (see Exhibit 1) now has the highest average per capita income of any local government area in the whole of Latin America.**

Monterrey is also home to **FEMSA, the fifth biggest company by revenue in Mexico** and operator of both the largest independent Coca-Cola bottling group in the world (via 46% stake in Coca-Cola FEMSA or "KOF") and Latin America's leading convenience chain (OXXO – see **Exhibit 2)**. It is the latter that was the highlight of our time in Monterrey and will form the basis of this newsletter piece.

Exhibit 2: A Typical OXXO Store

The first OXXO store was opened in Monterrey in 1979, initially focused on just beer, snacks and tobacco. The company steadily expanded its offering to include non-alcoholic beverages and more food options, finding a highly profitable niche within Mexico's retail landscape. Firstly, the small average size of stores (typically 50 to 80m2) allowed OXXO to open in locations inaccessible to other modern retail chains such as Walmart de Mexico, which focuses on larger store footprints. A smaller store size also allows for a smaller customer catchment area, allowing OXXO to address smaller communities not yet serviced by modern retail.

OXXO's main competitor was hence small, informal "mom & pop" stores. In this category, the company also enjoys two material competitive advantages:

- Scale - this gives OXXO buying power, enabling the company to procure product cheaply and hence offer lower prices to consumers.
- Sophisticated logistics and an efficient supply chain – this allows OXXO stores to hold less in-store inventory per item or Stock Keeping Unit (SKU) enabling a much wider range of products in the same store size than a "mom & pop" store, as shown in **Exhibit 3.**

Exhibit 3: OXXO – Sophisticated Supply Chain / Logistics Enables a Wide Range of Products Despite a Small Store Footprint, Without Risking Stock-Outs

Source: Northcape Capital

FEMSA's highly profitable "cash cow" businesses of brewing (sold to Heineken in 2010) and Coca-Cola bottling allowed the company to invest aggressively in expanding OXXO's store network before other potential competitors were able to get a foothold in the industry.

Consequently, the company was able to grow its store network to 1,000 stores over two decades until 1998, at which point the company believes critical mass was reached. As such, although the company added an average 500 stores each decade in its first twenty years of operation, it was able to add 8000 stores in its third decade.

This first mover advantage means that OXXO has no direct competitor in Mexico.

Like its U.S. parent, Walmart de Mexico focuses on larger format stores (as the Wal-Mex CFO told us in Mexico City on this trip, "we [Walmart and OXXO] manage to keep out of each other's way"), as do other modern grocery retailers such as Soriana and Chedraui.

The second largest modern convenience store operator in Mexico is **7 Eleven**, which has a paltry **1800 stores (less than 10% of OXXO's network)** and higher prices than the leaner, more cost-focused OXXO.

Despite its already dominant position with **22,000 stores** at 30 June 2023, OXXO still has plenty of opportunity for growth in Mexico. The company is **opening an average of three new stores every day** across the country and sees a pipeline for continued growth for at least the next decade, taking the store count to well over 30,000. Despite the huge growth potential of Mexico, it's amazing to realize that the **most attractive growth opportunity for OXXO is actually outside of Mexico.**

In 2009, FEMSA made the decision to expand beyond Mexico by bringing OXXO to **Colombia, and subsequently entered Chile in 2017 and Peru in 2018.** These markets offer good growth prospects for OXXO, with the company presently adding an average of **one new store a day across the three countries.** This pales in comparison, however, to the opportunity in Brazil.

In 2020, OXXO opened its first store in the city of Campinas, north of São Paolo. **Brazil** has a population of 214 million (about 70% larger than Mexico) and, remarkably, has no dominant modern convenience store chain, with small format retail dominated by "mom & pop" stores.

As such the competitive landscape resembles Mexico when OXXO began to expand aggressively in the late 1990s. FEMSA is currently adding one OXXO store a day, and says it plans to accelerate this to Mexico-speed growth (i.e. an average of three new stores per day) to build a first mover advantage before the success of OXXO in Brazil attracts competition. **According to the company there is no reason why in the long run Brazil shouldn't have even more OXXO stores than Mexico (i.e. more than 30,000), given the significantly larger population.**

Exhibit 4: Fresh Baked Bread in a Brazil OXXO Store

Source: FEMSA

Market Research and initial testing conducted by FEMSA showed that many of the small "mom & pop" stores which OXXO will compete with in Brazil offer simple, freshly baked bread. As such, in the words of FEMSA, the company "tropicalized" its offering by including a small bakery and hot fresh bread in its Brazilian OXXO stores (see **Exhibit 4**). The decision has proven to be a roaring success, even becoming something of a viral sensation on social media, driving foot traffic to OXXO stores and creating demand for new store locations.

Fresh "ready-to-eat" food is a key part of OXXO's strategy in its other geographies too as it is both the highest margin category and additionally drives more consistent, regular foot traffic to stores. The undisputed world leader in this space is Japan's 7 and I Holdings (operator of 7 Eleven in Japan), which offers everything from sandwiches & hot chicken to fresh coffee and donuts and reportedly has over 40% of store sales coming from ready-to-eat. FESMA informed Northcape that the company has studied 7 Eleven in Japan and, whilst Mexico is still in the early stages of this category, sees significant long- term potential in its home market**.** **Exhibit 5** shows a food counter within a typical OXXO store that we visited in Monterrey.

In addition to speed of service and of course taste, OXXO's ready-to-eat food also has an advantage in the important issue of food safety compared to traditional street vendors.

Exhibit 5: A Food Counter in an OXXO Store in Monterrey

Source: Northcape Capital

The company has also expanded its range of refrigerated ready-to-eat items such as sandwiches and yoghurt, as shown in **Exhibit 6,** which again gives it an advantage compared to competitors due to the complexity of cold chain logistics. **The expanding ready-to-eat offering drives both higher sales per store and higher gross margin** for the company.

Exhibit 6: Refrigerated ready-to-eat offering at an OXXO store in Mexico

Source: Northcape Capital

Overall, **OXXO is arguably the best retailer in Latin America,** with a strong competitive position, exceptional store level profitability and fantastic growth opportunities.

Remarkably, however, in our opinion this is still **not reflected in FEMSA's valuation.**

FEMSA Valuation

FEMSA is a top 5 position in our EM strategy and has been our best performing position over the past 12 months.

However, adjusted for its stake in Coca-Cola FEMSA (KOF), OXXO is presently trading at a 30% discount to Walmart de Mexico's (Walmex) valuation.

The cheap valuation is also confirmed by the discount FEMSA stock is trading relative to our discounted cashflow (DCF) valuation. This discount is despite the fact that OXXO is currently growing both revenues and profits at twice the rate of Walmex.

Also OXXO, as explained, has significantly greater long-term growth options than Walmex. This discount reflects FEMSA's conglomerate/holding company structure. However, the company has recently made an undertaking to address this anomaly by divesting non-core assets and tightening its focus on optimising the returns from both OXXO and KOF.

Accordingly, we see FEMSA's valuation discount to Walmex closing, and reverting in time to its traditional premium rating. **So, even though stock has performed well over the past 12 months, the combination of strong earnings growth and reduction in valuation discount to Walmex should deliver strong returns from our FEMSA position in the years ahead.**

Finally, **FEMSA is based in Mexico, an EM sovereign we are favorably disposed to,** which may deliver additional returns by way of "country equity risk premium improvements" (i.e., P/E multiple expansion) over the long-term.

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