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THE CHANGING DRIVERS OF EMERGING-MARKET GROWTH

Seeking out structural growth opportunities against an evolving backdrop

CONTENTS

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INTRODUCTION

This article aims to demonstrate how emerging-market economies have evolved over time. It is worth starting by looking at how the emerging-market investment backdrop has been transformed over the last two decades.

Emerging markets have come a long way since the early 2000s.

Today:

- infrastructure is predominantly in place (including the widespread availability of high-speed broadband)
- technology is advanced
- consumers are wealthier.

The confluence of these factors has resulted in changing consumer behaviours, greater consumer resilience and new categories of consumption, which have driven the rapid development of consumer-facing services industries in emerging markets.

The same three elements also make emerging markets less dependent on global-demand dynamics than they may have been historically, and allow for emerging-market growth to be more internally driven, and consumer-led, in the future.

Against this backdrop, we see significant opportunities from the changing drivers of emerging-market growth.

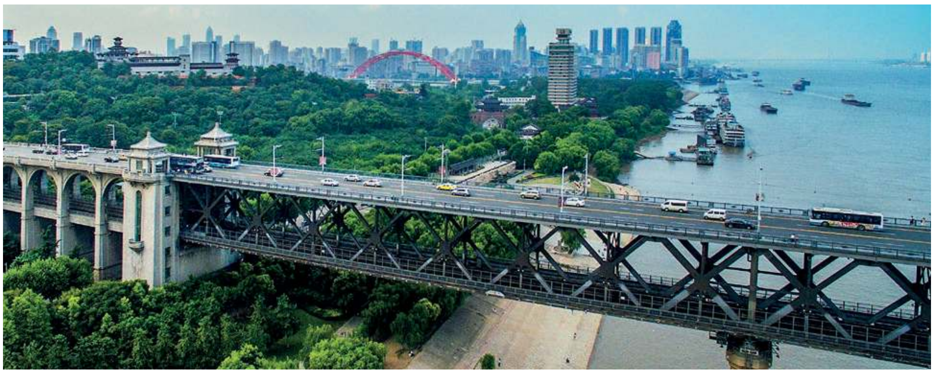
Furthermore, we anticipate that the Covid-19 pandemic will accelerate the technology-driven shifts that we have been seeing in recent years, and highlight the relative resilience of certain emerging markets, especially China, in the current environment.

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

FROM 2005 TO NOW:
HOW EMERGING MARKETS HAVE EVOLVED

The emerging-market investment case in 2005:

When the US 'sneezed', the world used to 'catch a cold'



First, it is a useful exercise to look back at how different the global economy looked just 15 years ago. The irony of the often-heard phrase above is not lost on us as we navigate an unprecedented and relentless global novel virus outbreak that has brought much suffering, both socially and economically.

Yet it is telling how much things have changed over this time frame: historically, the caricature of an emerging market has either been that of a commodity exporter (countries such as Brazil, South Africa and Russia) or an outsourced-manufacturing centre (countries such as Mexico, Vietnam and China).

As a result, discussion about the growth trajectory for emerging markets has been linked closely to discussion about conditions in developed markets and the global demand story. This perhaps made sense in the context of more generous allocations towards export sectors (materials, mining) in the index in the past, but it is not so valid now.

The need for infrastructure helped drive the commodity boom of the 2000s

Secondly, it used to be that domestic investment cases within emerging markets centred on the importance of infrastructure driving growth.

Infrastructure needs sparked by increasing urbanisation and mobility in large metropolitan areas dominated almost every sector: we saw store roll-outs by retailers, hospital building in the health-care sector, new roads and airports in transport, bank branch construction, and the rapid development of 2G, 3G and 4G mobile networks. Returns could be low on these capital expenditure-heavy businesses, with regulation weighing heavily on expectations.

Now that infrastructure is broadly in place across much of the emerging world, investment cases focus more upon the efficient use of that infrastructure – particularly in an increasingly digital world.

Consumers: 'Stuff' not services

Finally, in 2005, consumer-oriented investment cases in emerging markets centred upon consumer goods, and gradual increases in basket size and aspiration towards higher-quality items. Service demand was not yet significant, on account of much lower wealth per capita, and also underdeveloped infrastructure networks.

Two decades ago, distribution was the key differentiator; today, e-commerce has transformed this backdrop by democratising access to goods and customers.

The emerging-market investment case in 2020

Today the situation is different. The old yardsticks previously used to understand activity and growth in emerging markets, such as fixed-asset investment and electricity demand, are no longer helpful: infrastructure has improved, consumers are generally wealthier, and technology (especially consumer-facing technology) is more advanced and widespread, allowing the leap-frogging of demand for physical 'bricks-and-mortar' assets via the burgeoning e-commerce sector.

We can see the impact of these transitions in the changing shape of the emerging-market index, with falling allocations to export sectors and rising allocations to more domestic-linked activity, including the IT and consumer sectors.

> “Emerging markets have far more room for self-generated growth, independent of the global-demand environment.”

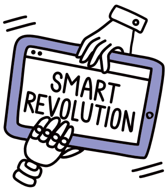
Emphasis moved to self-generated growth

This dramatic shift in emphasis has real implications for how we invest in emerging markets today; emerging markets have far more room for self-generated growth, independent of the global-demand environment.

In particular, we see opportunities for companies to provide services to a consumer that is more technologically empowered and increasingly wealthy; recent lockdown conditions related to the containment of the pandemic can only accelerate demand. In our view, this environment is conducive for well-placed companies to compound earnings at high returns, with reduced capital intensity.

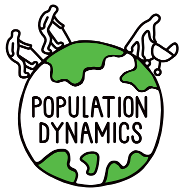
INVESTMENT IMPLICATIONS

To help us unearth attractive long-term opportunities against this transformed backdrop, we use our global investment themes, such as *smart revolution*, *healthy demand*, *population dynamics* and *net effects*, to identify areas of structural growth. Below is a brief overview of the main dynamics behind these themes.

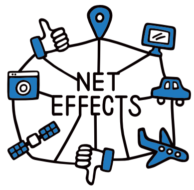


Our *smart revolution* theme reflects how a range of technologies are making networks, systems, processes and products of all kinds increasingly responsive and intelligent. The revolution in connectivity is leading to profound changes to business models for many companies across the world and in many sectors. These technological advances are likely to lead to increased productivity.

Demand for health-care products and services is increasing as ageing populations fuel demand in developed economies, and expanding incomes and changing lifestyles create new markets in the emerging economies.



Populations are shifting significantly – with unprecedented ageing in mature economies, and income growth driving changes in developing economies. This leads to differences in growth and fiscal burdens.

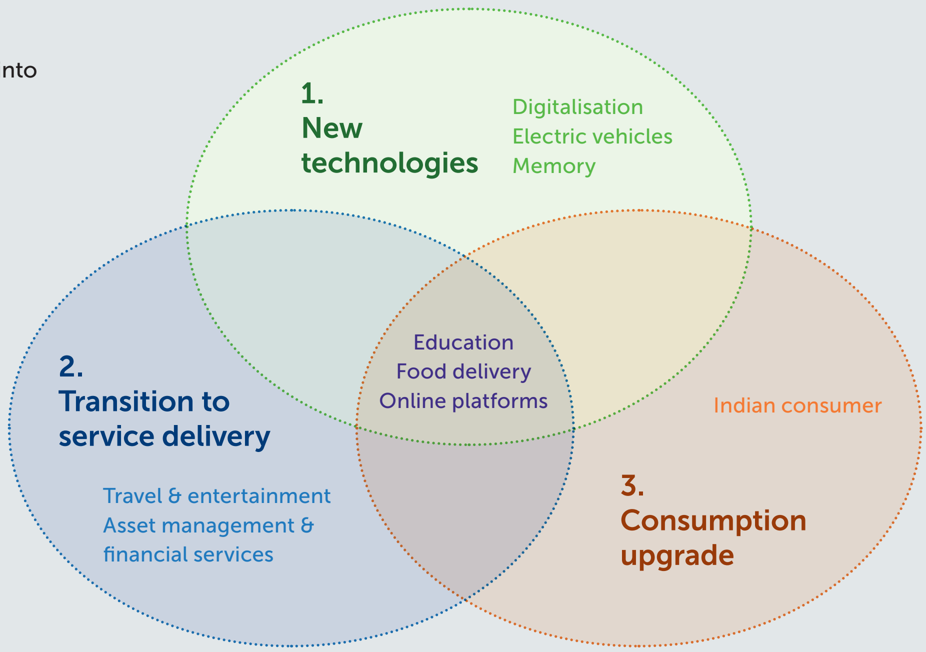


The world has made the transition from connecting places (landline phones), to connecting people (mobile phones), to connecting devices (satellite navigation). The rapid rise in the 'internet of things' is transforming lifestyles and traditional business practices globally.

Our investments tend to be consumer-focused, and seek to exploit structural changes in behaviour and demand. We believe these structural shifts in activity should be more independent of headline GDP growth and global demand dynamics, allowing greater growth resilience while still benefitting from economic development.

Exhibit 1: **The companies we prefer fit into three overlapping categories:**

1. **New technologies** – and their supply chains
2. **Transition to service delivery** – as facilitated by the development of the internet
3. **Consumption upgrade**



Source: Newton, 2020.

> Today's technology is increasingly consumer-facing and serving a massive domestic market, making services cheaper and more accessible.

At the heart of all three broad categories lie education, food delivery and online platforms, which are all providing significant growth opportunities for us, but we will now look at the three broader areas in more detail.

1. NEW TECHNOLOGIES

As mentioned earlier, one of the most significant changes in emerging markets, and globally, over the last ten to 15 years is a rapid acceleration in technological development.

Inventions like the internet and the smartphone have spurred major technological breakthroughs, and the role of technology in emerging markets has changed with it. Whereas historically technology in emerging markets was geared towards developed-market companies and their manufacturing chains, today's technology is increasingly consumer-facing and serving massive domestic markets, making services cheaper and more accessible.

China's rise

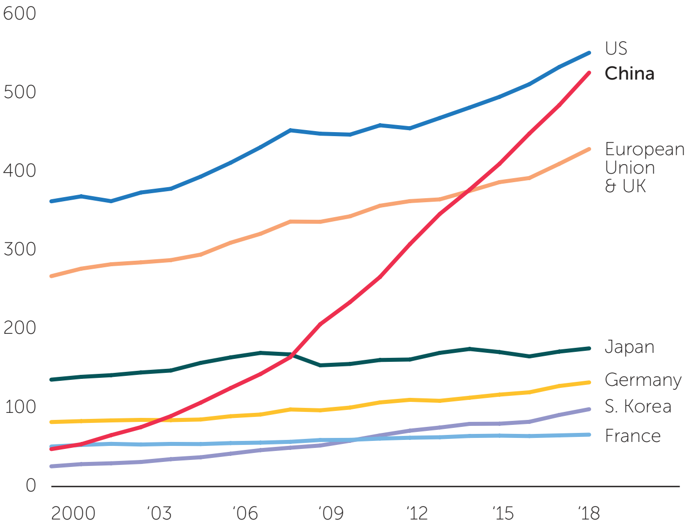
Technological activity in emerging markets now is also more indigenous, with major centres of technological leadership and innovation:

- China overtook Japan in 2017 to become the second largest patent applicant in the world, and its spending on research and development (R&D) has continued to rise at a rapid pace. World Bank data shows that as of 2017, China had 1,177 R&D researchers per million of its population – three times the level it had in the 1990s, and in line with the global average.
- The US produces many more researchers per million – at 4,321 – but that is more than offset by China's population being about four times larger.[2]

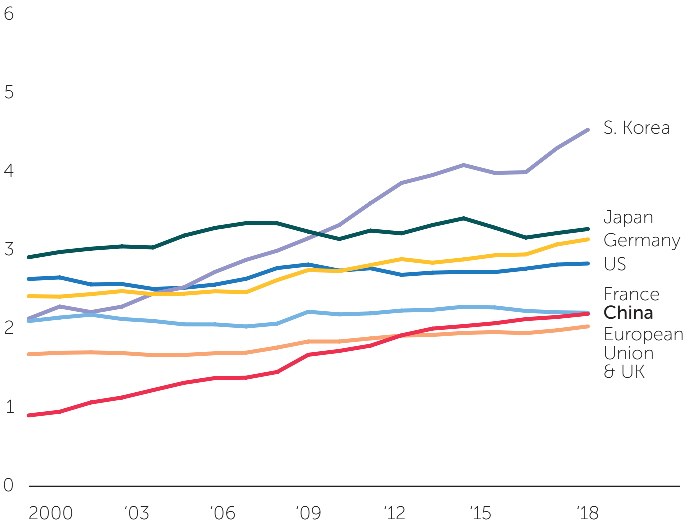
In our view, the current trade war simmering between the US administration and China will only accelerate China's ambitions to close the gap in self-sufficient technological leadership; pertinently, China has been able to move up the value chain and has increased its competitiveness irrespective of US tariffs.

Spending in R&D

Exhibit 2: **In million US dollars**



As a percentage of GDP



Source: OECD. https://data.oecd.org/rd/gross-domestic-spending-on-r-d.htm

2 Source: The World Bank. https://data.worldbank.org/indicator/SP.POP.SCIE.RD.P6?end=2017&locations=CN-US&start=1996&view=chart

> Large groups of emerging-market populations have become richer, and we are particularly focused on the rising per capita GDP in India and China, and the changing consumer needs associated with growing wealth.

The rise of electric vehicles

Such technological advances, and the changing nature of technological activity in emerging markets, has created investment opportunities which barely existed ten years ago. One obvious and specific example of how we seek to tap into these new technological advances is the electric-vehicle (EV) supply chain, which is a significant area of investment interest for us.

Three out of four EV battery manufacturers are now based in emerging markets, along with the majority of the world's lithium supplies.

It is important to note that here, the investment case is driven as much by emerging-market demand, as by demand from developed markets: of an estimated planned US$300bn to be spent by global automakers on the development and procurement of batteries and EVs, 45% of budgets have been targeted at China, according to Reuters analysis of public data.[3]

2. INFORMATION TECHNOLOGY (IT) IN THE DIGITAL AGE

More broadly, we are tapping into the rising global demand for IT services and sophisticated consultancy services from companies seeking to navigate the rapid shift into the digital age successfully. The focus of IT spend has gone from back-office cost-cutting to being a front-end revenue driver.

Having digital capability has now become an essential, non-discretionary, element of business strategies and corporate budgets: in its 2018 integrated report, IT services company SAP estimated that by 2022, 60% of global GDP will be digitised, with growth in every industry driven by digitally enhanced offerings, operations and relationships, and almost US$7 trillion in IT-related spending between 2019 and 2022.[4]

Indeed, in its 2019 predictions for the IT sector, International Data Corporation (IDC) anticipated that between 2018 and 2023, 500 million new logical apps will be created – equivalent to the number built over the last 40 years. By 2022, it predicts that 50% of servers will encrypt data at rest and in motion, over 50% of security alerts will be handled by artificial intelligence (AI)-powered automation, and 150 million people will have blockchain-based digital identities. By 2024, IDC predicts that AI-enabled user interfaces and process automation will replace one third of today's screen-based apps.[5] Even if the levels predicted are not fully realised, it is clear that such a backdrop places huge pressure on companies to invest to remain relevant, and to be able to serve the growing army of digital consumers.

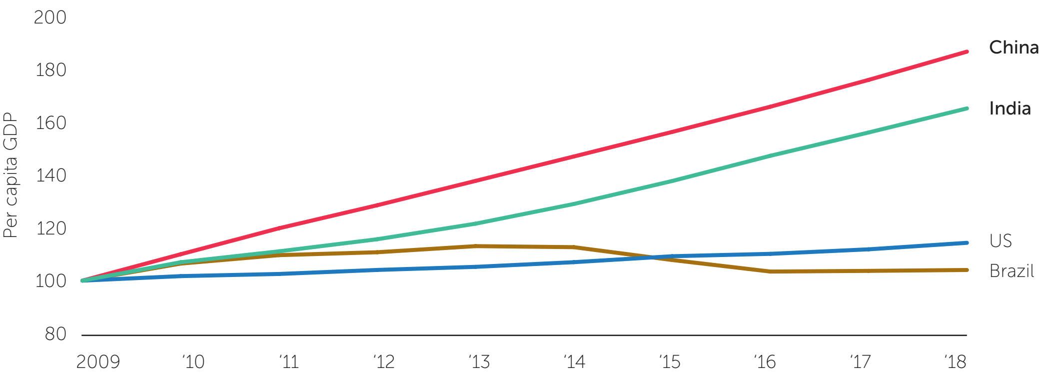
In our view, emerging markets are specifically well-placed to benefit from demand for services to assist these companies with the digital transition, given that the key centres for offshore software engineers include Argentina, Ukraine, Poland and India.

3. INDIA AND CHINA DRIVE THE CONSUMPTION UPGRADE

At the same time that technology has become more advanced, large groups of emerging-market populations have become richer, and we are particularly focused on the rising per-capita GDP in India and China, and the changing consumer needs associated with growing wealth.

Exhibit 3 shows just how much China and India are driving rapidly rising per capita GDP, which in turn feeds the emerging-market consumer-demand story.

Exhibit 3: **Growth in per-capita GDP in India and China drives the consumer-consumption story**



Source: World Bank, Bloomberg, November 2019.

3 Source: https://uk.reuters.com/article/uk-autoshow-detroit-electric-exclusive/exclusive-vw-china-spearhead-300-billion-global-drive-to-electrify-cars-idUKKCN1P40GI 10 January 2019.
4 Source: https://www.sec.gov/Archives/edgar/data/1000184/000110465919013502/a18-38214_4ex99d1.htm January 2019.
5 Source: https://www.idc.com/getdoc.jsp?containerId=prUS44417618 30 October 2018.

Next, we will look at some of the key drivers of growth within these two emerging-market giants.

CHINA

China has seen a massive increase in the number of upper-middle class citizens over the last decade. As shown in exhibit 4, the upper aspirant segment of China's urban population and above, now represent 49% of the Chinese population; this reveals a huge jump from just 8% in 2010.

Exhibit 4: **29% compounded annual growth rate rise in the Chinese upper-middle class**

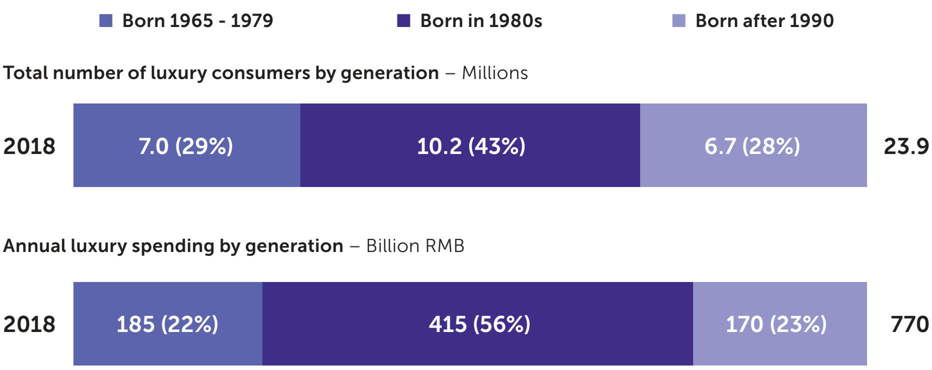
Annual household disposable income 2018 real RMB terms		**Urban population in China** (millions) 2010	2018
Global	>350K	6	16
Affluent	297-350K	3	10
Mass affluent	197-297K	10	63
Upper aspirant	138-197K	34	311
Aspirant	79-138K	403	257
Lower aspirant	49-79K	134	89
Poor	<49K	79	79
Upper aspirant and above population, % of total		~8%	~49%

Source: McKinsey Global Institute, 2019.

“One of the most interesting characteristics of this group of spenders is that they are predominantly young, with income being concentrated in those under the age of 50.”

One of the most interesting characteristics of this group of spenders is that they are predominantly young, with income being concentrated in those under the age of 50. Indeed, according to the 2019 China Luxury Report,[6] consumers born in the 1980s and later are the largest luxury spending group in terms of both consumer numbers and total spending. This belies the perception from some in the developed world that China will suffer the impact of a demographic time bomb owing to the Chinese government's former 'one child' policy, as China is far less vulnerable to declining consumption by the ageing baby-boomer population than most developed markets. Below, exhibit 5 reveals the relatively young age of China's consumers.

Exhibit 5: **The Chinese consumer is young**



Source: China Luxury Report, 2018.

This rapid change in China's income profile is associated with a shift in both consumption categories and behaviours.

Obvious growth areas include luxury and entertainment, but one of the most interesting demonstrations of greater income security that we have been watching is the ability and willingness to save and invest for the future. The incentives for doing so are high, against a backdrop in which poor social safety nets are too common, as they are across many of the emerging economies.

As emerging-market investors, we believe it is prudent to have significant but selective exposure to insurance and asset-management companies, which are managing the transition of newly created wealth away from bank deposits and into savings products. Education is another favoured home for middle-class consumers, in an increasingly competitive world.

6 Source: https://www.mckinsey.com/~/media/mckinsey/featured%20insights/china/how%20young%20chinese%20consumers%20are%20reshaping%20global%20luxury/mckinsey-china-luxury-report-2019-how-young-chinese-consumers-are-reshaping-global-luxury.ashx April, 2019.

INDIA

> With so many households able to upgrade their two-wheelers to small cars for the first time, it appears inevitable that automobile sales are poised to accelerate significantly over the next ten years.

India too has seen growth in income per capita, but from a lower base, and the character of what we regard as the most attractive Indian consumer stories are not the same as those in China. In 2018, India had roughly 97 million emerging consumer households (between US$4,000 and US$8,500 in household income), 61 million aspiring households (c.US$8,500-US$40,000) and eight million affluent consumer households (US$40,000+), giving a total of 166 million households actively participating in the modern consumer economy.

Owing to urbanisation (average household incomes in Indian cities are twice those in the countryside) and overall GDP growth, the number of households active in India's consumer economy is estimated to have grown by 163 million to 329 million by 2030. Within this total, the number of emerging consumer households in India is tipped to rise to 132 million; aspiring households will nearly triple to 168 million, and the number with incomes above the affluent threshold will leap almost fourfold to 29 million.

These transitions into higher wealth categories result in an 'acceleration phenomenon', whereby demand for products at particular price points can grow at many times the overall rate of income growth, according to the shape of income distribution.

Exhibit 6: **Evolution of the household-income profile in India**

	Total households	2005: 219 million	2018: 293 million	2030 forecast: 386 million	
Modern consumer economy		68 million consumers	166 million consumers	329 million consumers	
	Affluent >US$40k	1m 1%	8m 3%	29m 7%	High income and upper middle income segments 1 in 4 households today 1 in 2 households by 2030
	Aspiring US$8.5k - 40k	16m 7%	61m 21%	168m 44%	
	Emerging US$4k - 8.5k	51m 23%	97m 33%	132m 34%	
	Low income <US$4k	151m 69%	127m 43%	57m 15%	~70 million fewer low income households by 2030

Source: World Economic Forum, *"Future of Consumption in Fast-Growth Consumer Markets: INDIA"*. January 2019. Projections based on People Research on India's Consumer Economy (PRICE) ICE 360° Surveys (2014, 2016, 2018).

Note: Income per household in real terms. Projections with annual GDP growth assumed at 7.5%.

Diversified India exposure

As a result of this shift in consumer cohorts, the most attractive opportunities we see in India are diversified across several different consumer categories, mostly discretionary in nature, including a cinema chain, the local franchise of a global pizza chain, a mortgage company, a jewellery retailer and the leading car manufacturer and distributor.

Trends in the auto market are a good example of how consumption patterns are evolving:

- Over the last ten years, the market for two-wheelers, which typically sell for under INR100,000 (c.US$1,400), has almost tripled in size, with annual sales rising to more than 21 million.
- Over the same period, sales of passenger cars (an entry-level hatchback costs around INR300,000 – c.US$4,200) have been much slower, climbing from 1.2 million to just under 2.2 million.

With so many households able to upgrade their two-wheelers to small cars for the first time, it appears inevitable that automobile sales are poised to accelerate significantly over the next ten years.

TRANSITION TO SERVICE DELIVERY – THE RISE OF INTERNET PLATFORMS

Technological advancements and rising GDP per capita, when coupled with the urban infrastructure developments of the early 2000s (principally the broad availability of high-speed broadband along with the smartphone), have created the perfect conditions for growth in the consumer services sectors across emerging markets.

The internet, and related improvements to logistics, have made consumer services more accessible and affordable, creating a huge opportunity for companies to reach consumers who were historically difficult to serve.

We are attracted to internet platforms which can benefit from this structural growth in demand for consumer services, with business models ranging across e-commerce, food delivery, classifieds platforms, music streaming and social media.

China is probably the best live demonstration of a structural shift from a capital intensive, infrastructure-driven economy to a domestic consumption-driven economy. The improvement in living standards has led to significant changes in consumption behaviour by moving away from basic needs to more discretionary expenditures, from physical goods-oriented spending to consumer and experience-oriented expenditure. This has led to a proliferation and adoption of consumer and other services that are targeted at improving people's lives.

> "High penetration of mobile internet and availability of online payment infrastructure has accelerated the adoption of paying for both online and offline transactions via mobile devices."

Mobile internet user growth

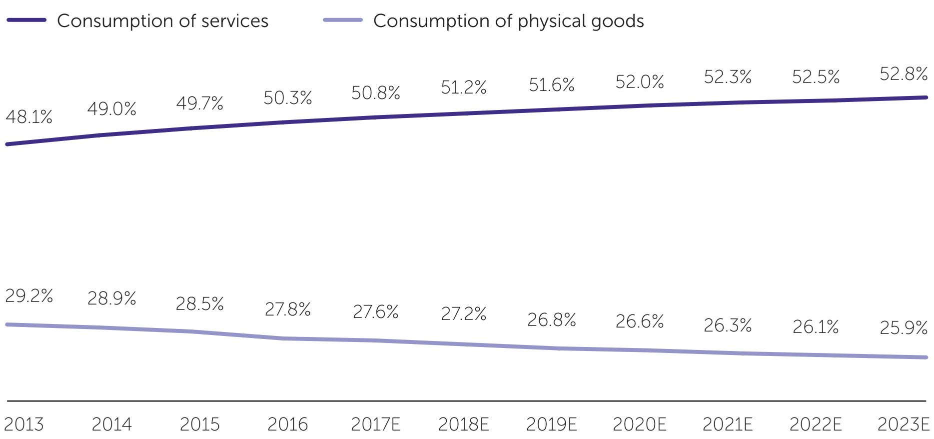
Massive numbers of mobile internet users and location-based connectivity enable consumers to discover and enjoy more services; this is a transition which is occurring across emerging markets.

High penetration of mobile internet and availability of online payment infrastructure has accelerated the adoption of paying for both online and offline transactions via mobile devices, which has accelerated the growth of e-commerce and made it easier to shift more areas of GDP online.

Consumer-service e-commerce companies help connect consumers with a large number of merchants without the constraint of physical stores and distance, where traditionally consumer choice has been limited by fragmented and stale information, lack of access to services, and the inability to complete transactions efficiently.

Consumer-service e-commerce platforms now enable consumers with location-based information discovery, decision making and real-time processing to complete transactions on mobile devices, transforming consumers' ways of daily living.

Exhibit 7: **Mix of private consumption per capita shifting towards service consumption**



Source: iResearch, quoted in Meituan Dianping prospectus (NB, excludes housing consumption), 2019.

> “A major trend is that the increase in the ease and convenience of delivery is leading to more consumers choosing to order food online and receive delivery offline.”

Food delivery

Food delivery is one of the consumer services areas where we see the most sustainable structural demand in emerging markets. Food consumption is the most essential part of consumers’ daily lives today; it is a purchase we make most frequently, whether through buying groceries, pre-made meals, or restaurant dining, take-out or delivery. A major trend is that the increase in the ease and convenience of delivery is leading to more consumers choosing to order food online and receive delivery offline.

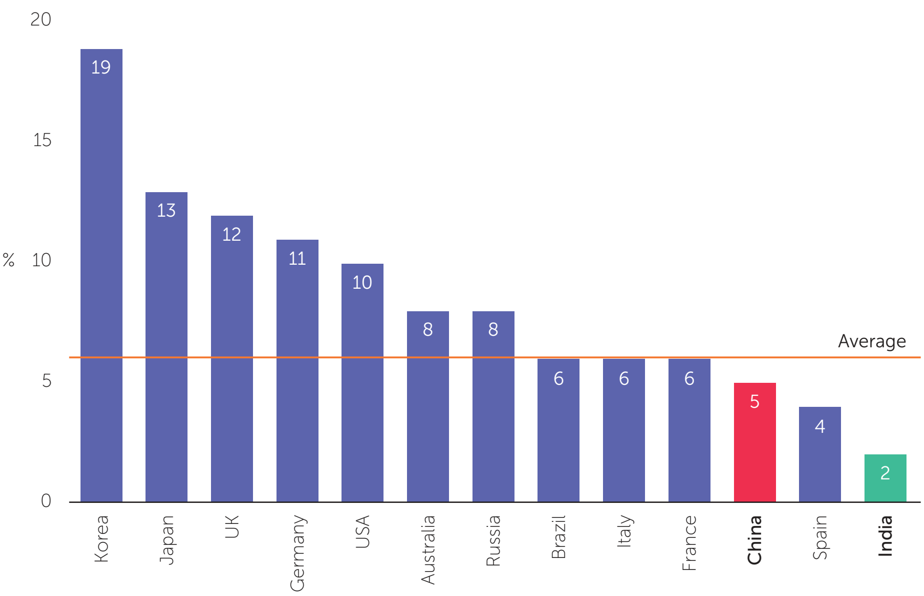
On-demand food delivery and online non-restaurant food retail are in large ways replacing cooking at home or buying pre-cooked food from grocery stores because these methods are fast, convenient and, in many cases, more cost-effective. This is especially prevalent in younger generations which may have limited amounts of time and energy to dedicate to cooking, and are more willing to pay for convenience. On the other hand, as people spend more time at work today, many people use these services and change their way of living to be more accustomed to e-commerce.

We believe the area is attractive because penetration levels remain low, which leaves plenty of room for further growth.

Exhibit 8 shows that food delivery represents only 2% and 5% respectively of India and China’s food services sector, well below the levels in many developed markets.

We invest in food-delivery platforms across emerging markets both directly through focused food-delivery players, as well as indirectly through broader internet platform companies.

Exhibit 8: **Food delivery as a percentage of food services (GMV)**



Source: Euromonitor, UBS estimates, GMV: Gross merchandise value. January 2019.

CONCLUSION

In this article, we have sought to show that today’s drivers of emerging-market growth are very different from those in the early 2000s.

We have moved on from the idea of emerging markets being dependent upon developed markets, either as commodity exporters or outsourced-manufacturing centres for developed-market corporations.

The combination of improved infrastructure, higher wealth per capita, and significant technological advances, allows room for greater resilience and structural growth led by domestic demand. Importantly, growth is likely to be increasingly consumer-led, and no longer linked to capital-intensive infrastructure development.

In our view, it makes sense to capture the value of these shifts in technology and consumer conditions through targeting what we believe to be the most attractive runways for growth; the sustainable growth rates of these businesses are often far higher than that of the broader emerging-market index.

We anticipate that the dramatic changes brought about by the coronavirus pandemic will only accelerate the technology-driven shifts that we have identified in this article as offering attractive long-term structural growth stories.

WANT TO FIND OUT MORE?

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