GMO

WHITE PAPER

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# Emerging Consumers Just Want to Have Fun...

## *What Happens in Emerging, Stays in Emerging*

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### The Opportunity

We have been managing money in emerging markets for nearly 18 years and it has been fascinating to see changes in not only where opportunities to make money could be found, but also in how the nature of those opportunities has evolved. Back in the 1990s, companies that did best were those that were export oriented, as outsourcing became an established phenomenon. During the 2000s, as commodity prices rose steeply, it was the commodity producers that did extremely well. Now, with economics and demographics moving away from developed markets, we believe we are in the early stages of another major shift, toward companies that serve domestic demand within emerging markets.

In the past, emerging markets were too small and illiquid to allow investors to commit substantial assets to narrow strategies, but in recent years, emerging markets have increased in size and liquidity to the extent that it now makes little sense to view them as a monolithic asset class. With an investable market cap of $4 trillion and daily trading volume of around $40 billion, emerging markets are rapidly approaching the size and liquidity of developed markets.

While there are many ways to segment emerging markets – by region, big cap vs. small cap, value vs. growth – we believe a more appropriate segmentation is to think about companies based on the ultimate customers they serve. Within this view, we see businesses as belonging to one of three distinct groups: exporters, global commodity producers, and those that serve domestic demand in the form of consumption and infrastructure.

In recent years, there has been much talk about the coupling/decoupling of emerging markets vis-à-vis the developed world. We find this either/or characterization misses the mark when, in fact, the reality is far more complicated. Perhaps a better way to think about growth in emerging markets is to characterize it as having two components: *correlated growth*, which is driven by links with the developed world, and *uncorrelated growth*, which depends more on the internal dynamics and demographics of the emerging markets themselves.

From this viewpoint, exporters and global commodity producers largely represent *correlated growth*, while domestic demand mostly represents *uncorrelated growth*. Obviously, in a globalized world, there is a large overlap between these two, with both positive and negative feedback loops. However, in light of an economic environment in the developed world that seems increasingly vulnerable to a "seven lean years" scenario, we think the case for investing in domestic demand is particularly strong relative to other segments within emerging markets because domestic demand represents a "pure play" on the economic growth of these countries.

### The Case for Domestic Demand

Looking at the prospects for each of these segments separately, it is hard to see how companies that export primarily to the developed world can do well unless economic growth in the developed world picks up. Given the large debt burdens prevalent in most major developed economies, it seems increasingly unlikely that the U.S., Europe, or Japan will experience high economic growth rates over the next few years. Thus, for exporters to do well, they would have to take market share from both developed and emerging competitors. In addition, because they compete globally, margins are likely to be squeezed by having to go toe-to-toe with well-capitalized global competitors.

Global commodity producers may continue to do well (as they have over the previous decade) if commodity prices stay high or rise even further. For most institutional investors, it makes sense to have an overall commodity strategy with commodity producers from emerging markets in the mix. However, we do not believe that they represent an emerging "pure play" as they are driven by global rather than purely emerging market forces.

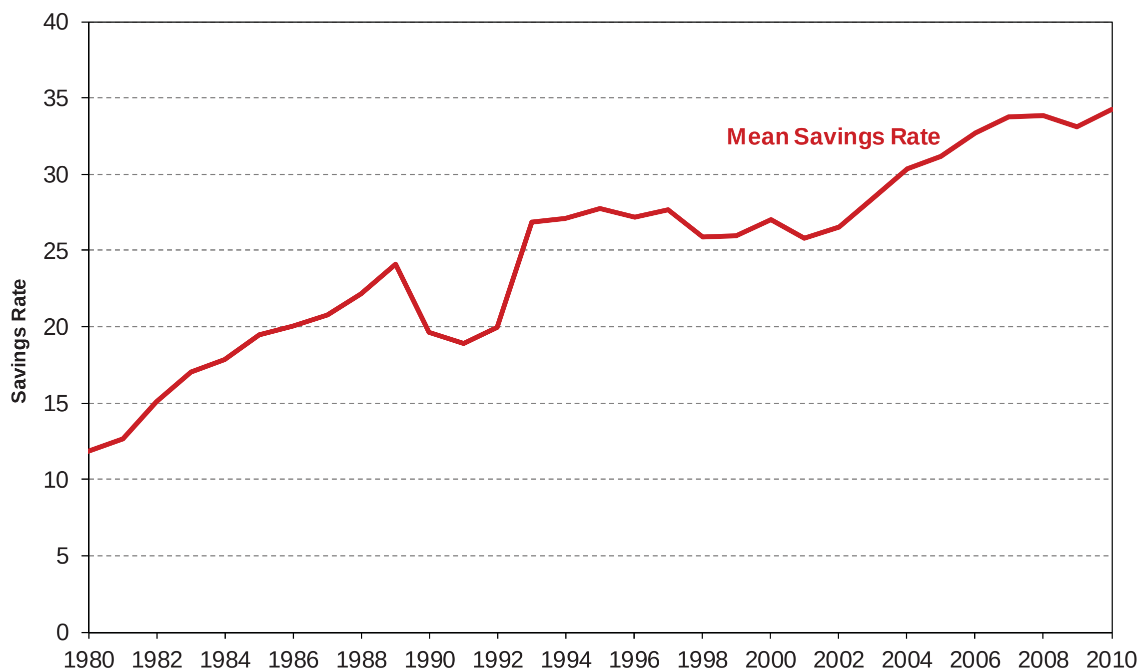
The main case for the domestic demand story today (as opposed to 5 or 10 years ago) is based on the confluence of two forces: economics and demographics.

### The Economic Case

The economic case is predicated on a high proportion of emerging market countries arriving at the "sweet spot," where increases in income cause consumption to rise steeply. As poor countries begin to get richer, citizens faced with an uncertain future save as much as they can, especially when they cannot reasonably expect society to provide for them. For example, we have seen savings rates in emerging markets rise from 13% of GDP in the early 1980s to nearly 35% today (see Exhibit 1).

### Exhibit 1

### Savings Rates Have Risen with Income in Emerging Markets



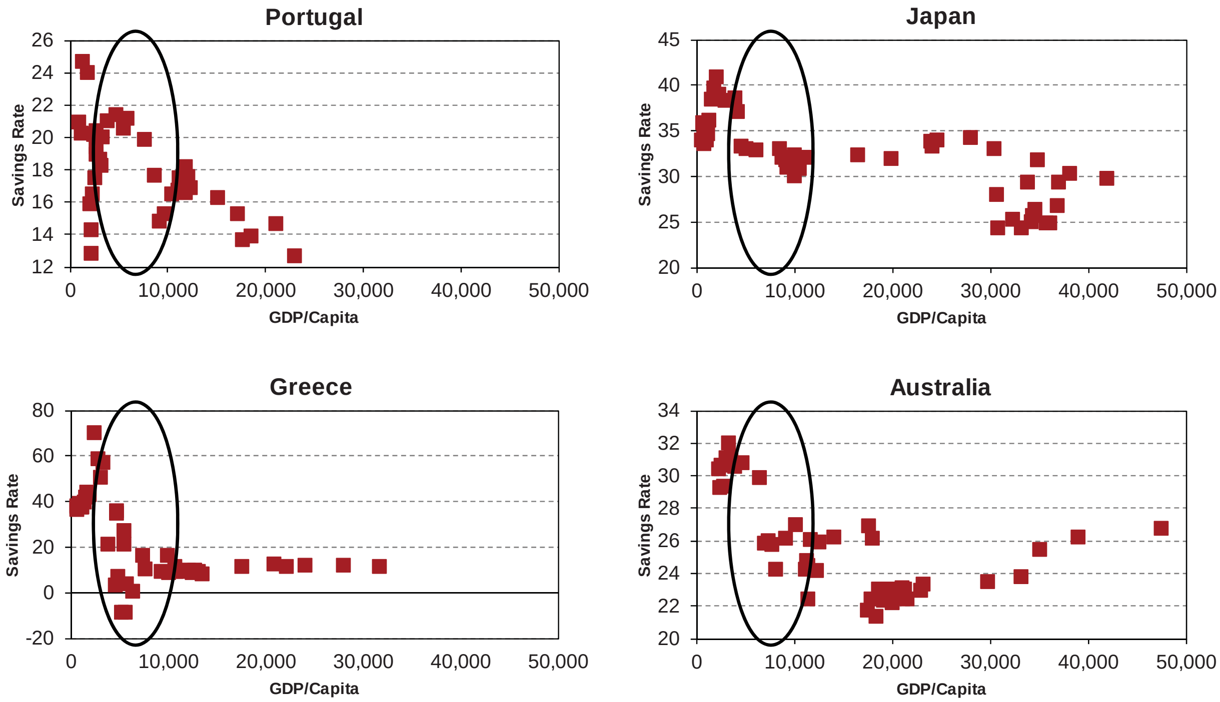

*Source: Bloomberg, World Bank, GMO*

However, once per capita GDP levels reach the range of \$3,000 to \$10,000, consumption rises and savings rates inevitably drop. We believe that this occurs for two reasons. First, at these levels of national wealth, societies become rich enough to start providing social safety nets. Second, individuals have newfound discretionary income, which they increasingly spend on consumer goods. Savings rates tend to peak around this "sweet spot" of \$3,000 to \$10,000 per capita GDP and then drop. Exhibit 2 shows this pattern in a number of developed markets as they became richer. In recent years, we have seen the same pattern repeated in emerging markets such as Korea, Taiwan, Israel, etc.

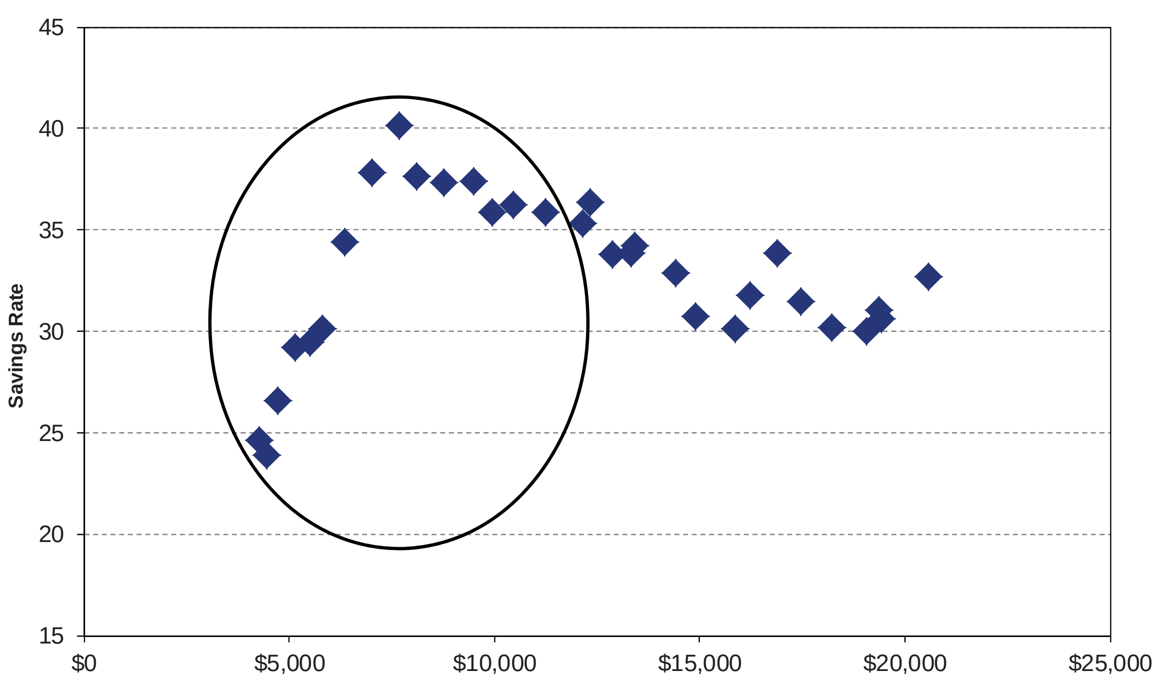
**Exhibit 2**

## However, Savings Rates Drop Dramatically When GDP/Capita Reaches the $3,000-$10,000 Range

***We've Seen This in Developed Markets at a Similar Stage of Development***




## Korea Savings Rate vs. Per Capita GDP




*Source: Bloomberg, World Bank, GMO*

What makes consumption in emerging markets particularly interesting today is that over 50% of emerging market countries (by market cap) are in this sweet spot (Exhibit 3). This was not the case 10 years ago, or even 5 years ago. Thus, if economic growth remains strong in emerging markets, one can reasonably expect to see large increases in the number of consumers and, therefore, discretionary spending.

**Exhibit 3**

**50% of Emerging Countries Are Now in the Sweet Spot of Shifting from Savings to Consumption**

| Weight in S&P/IFCI Composite Index | 2005 | 2010 |
|---|---|---|
| Less than $3,000 per capita GDP | 19% | 13% |
| Between $3,000 and $10,000 per capita GDP | 41% | 50% |
| Greater than $10,000 per capita GDP | 40% | 36% |

*Source: S&P/IFC, EIU, World Bank.*

While a number of sell-side analysts suggest that this story is already well-known and priced into markets, we beg to differ. We believe when incomes reach this sweet spot, the elasticity of demand becomes highly non-linear, where small increases in per capita income lead to large increases in consumption.

A simple example can be seen in Chinese auto sales. In the year 2000, Chinese crossed $1,000 per capita GDP. In that year, auto sales first exceeded 1 million vehicles. Ten years later, Chinese GDP more than quadrupled, to $4,400 per capita. What happened to auto sales? Did they go from 1 million to 4 million?

No. They went from 1 million to 17 million!

No analyst that we know of predicted anything close to these numbers. It's very difficult to forecast this kind of growth, so high growth forecasts tend to be 20% to 30% at each point in time, followed by upward revisions on a regular basis.

As a result of these factors, we are reasonably confident that per capita consumption in emerging market countries will rise substantially in the next few years and that much of this consumption growth is not anticipated by markets.

### The Demographic Shift

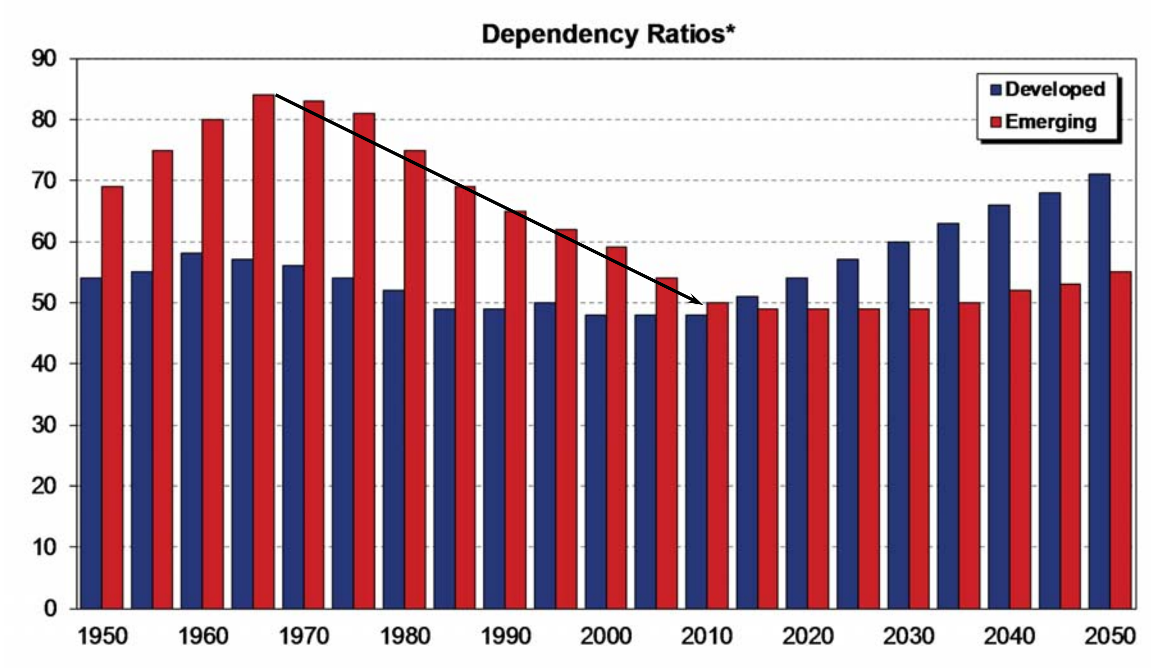
What makes an already good story potentially explosive is the fact that demographics are not static and indicate that the number of people in their prime working (and consuming) years will also rise dramatically in the next few years (both in absolute terms and relative to the developed markets).

Exhibit 4 shows the dependency ratio, which is defined as the ratio of non-working-age to working-age people in both the emerging and developed markets. As the downward sloping line shows, demographics in emerging markets have improved dramatically over the last few years (with the dependency ratio falling) and they will remain in this sweet spot for the next few decades. What this means is that the number of people that are working relative to those not working has dramatically improved and will remain there for the next 20 to 30 years. (Obviously, this is not true for all emerging market countries. Eastern Europe's and China's dependency ratios deteriorate quite rapidly over the next 25 years, while those of India, Indonesia, and Turkey improve.)

**Exhibit 4**

**Growth: Demographics Play An Important Role**

***Improvement in Demographics Has Played a Significant Role in Increased Growth Rates***




** Percent of non-working to working people.*
*Source: United Nations*

Conversely, as baby boomers retire in the developed world, the dependency ratio will worsen and there will be fewer workers (as a proportion of the population) and the overall number of hours worked will decrease. The overall global effect will be to shift consumption (as a result of increasing income) from the developed world to the emerging world.

### Economic Changes + Demographic Shift = Huge Increase in Consumer Base

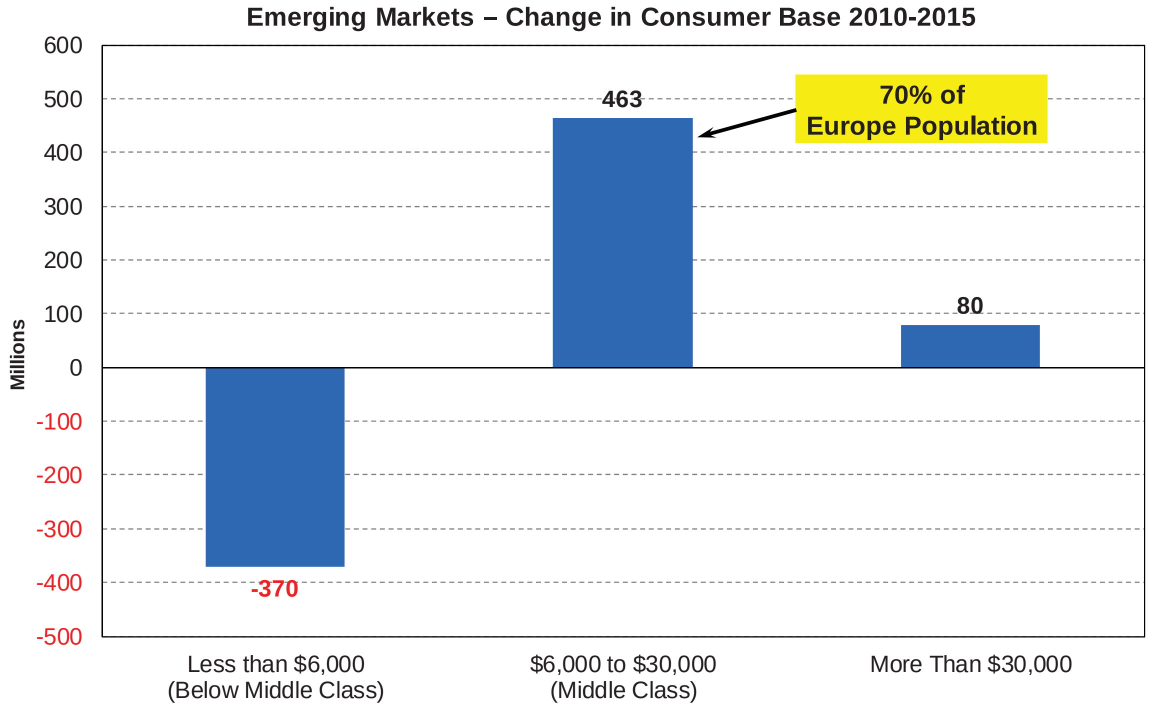
With these global shifts in economics and demographics upon us, the focus of economic activity is likely to shift toward domestic demand providers within emerging markets. Exhibit 5 shows the number of people that one might term "middle class" (defined as having an income greater than $6,000) that will be added to the emerging markets over the next five years (assuming the continuation of current growth rates). This number is far greater than the current population of the United States.

We are very confident that, absent some global catastrophe, domestic demand in emerging market countries will be robust over the next few years, irrespective of what may or may not happen in the developed world.

So, what could derail this story? The most likely candidate is oil rising to $200/barrel and staying there for an extended period. In general, very high commodity prices would have a major impact on consumption in emerging markets, and would shift potential return from domestic demand companies to commodity producers.

**Exhibit 5**

**If Current Trends Persist, the Emerging Middle Class Will Increase by around 500 Million People in the Next 5 Years**




*Source: Goldman Sachs, World Bank*

## How Does One Take Advantage of This?

Recently, we've been asked by a number of our clients if this anticipated growth in demand in emerging economies is best captured by investing in multinational companies or in domestic companies within emerging markets. In the long term, our view is that this is not an either/or issue – the ideal portfolio should be indifferent to domicile, but focus on which companies are best able to take advantage of these opportunities.

At this point in time, however, we believe the more interesting opportunities are in companies domiciled within emerging markets. Currently, there are very few multinational companies that derive a substantial part of their revenue or income from emerging markets and thus most multinationals do not represent a "pure play" on emerging domestic demand.

For example, if we screen the MS World Index universe for companies that derive at least 50% of their sales from emerging markets, we find 183 companies that match. These 183 companies have a total market value of $574 billion and make up only 2.1% of the market value of the MSCI World Index. Exhibit 6 shows the 10 largest companies in this group – not exactly the household names one expects to see.

**Exhibit 6**

| Name | Country | Market Value ($M) | % Sales to EM |
|---|---|---|---|
| QUALCOMM Inc. | USA | $91,866 | 66% |
| Anglo American | UK | $62,850 | 54% |
| SABMiller | UK | $35,711 | 68% |
| Texas Instruments | USA | $34,545 | 55% |
| Las Vegas Sands | USA | $34,393 | 73% |
| Newmont Mining Corp. | USA | $27,114 | 55% |
| Wynn Resorts | USA | $19,173 | 60% |
| Inpex Corp. | JAP | $17,022 | 61% |
| Murata Manufacturing Corp. | JAP | $13,159 | 58% |
| Jardine Matheson | HK | $13,001 | 84% |

In addition, our view is that locally-domiciled companies in emerging markets have substantial home-field advantages relative to foreign companies at this point in time. These advantages come from numerous sources, including high barriers to entry, the expenses associated with building brand awareness relative to well-established local brands, government policies that tend to favor locals, and the fact that local competitors are likely to have high profitability and substantial economies of scale that make it easy for them to defend – rather than build – their market share.

A good example is the Russian retail sector. For a foreign entrant like Walmart or Carrefour to be able to acquire land, build stores, and establish supply chains in Russia, it would be extremely expensive. In addition, they would have great difficulty competing against a well-established player such as Magnit, which runs 4,000 plus stores across all Russian regions and has a return on equity north of 20% (both of which allow it to make life very difficult for new entrants). We believe it makes more sense for Walmart to buy Magnit rather than try to build out its own chain of stores in Russia. In fact, Walmart has done precisely that in South Africa, where they paid a large premium to acquire a majority stake in MassMart, a local retailer. Thus, one of the fringe benefits of investing in dominant local players is the optionality of being bought out at a premium at some point in the future.

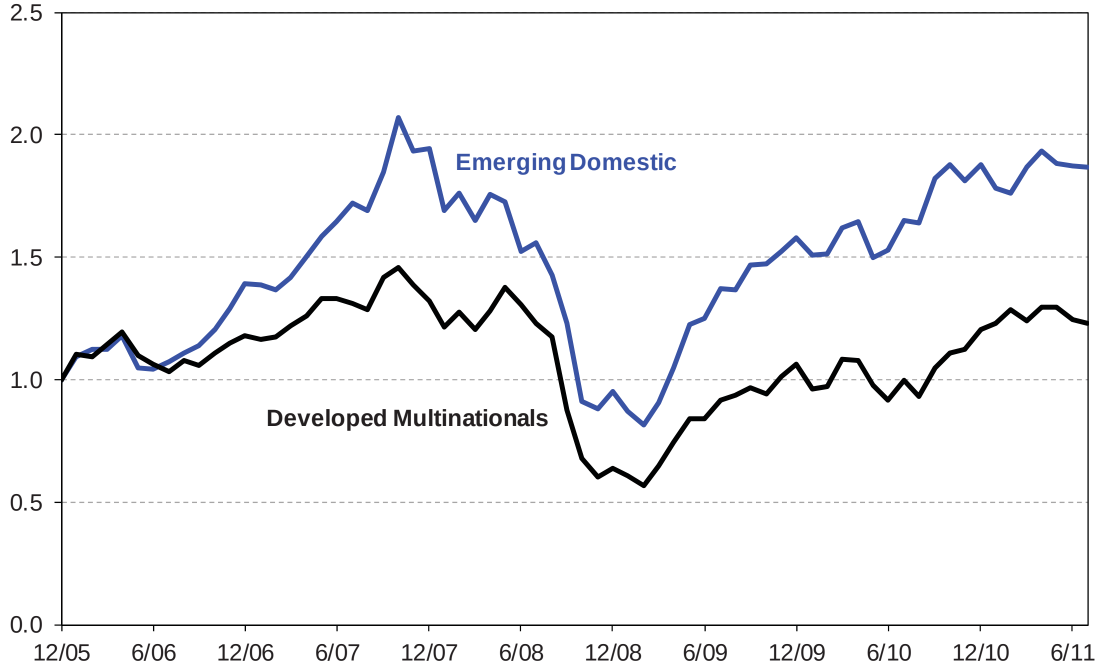
This is not to say that multinationals cannot be as successful as domestic companies in local markets. In cases where multinationals have a long-standing presence and have adapted their product and distribution strategies to suit local conditions, they can be very successful. For example, Unilever has had local operations in countries like India, Indonesia, and Nigeria for many decades and has established astonishingly high profitability in each market. In some cases, it makes more sense to buy the locally-listed subsidiary of the multinational, and in others to buy the global company, based on the trade-off between "pure-play" and valuation. For example, Domino's Pizza has a market cap of $1.6 billion, while its Indian subsidiary Jubilant Foodworks has a market cap of $1.3 billion, despite contributing less than 10% of the sales and 18% of the profits of the overall company.

If our thesis of home field advantage is correct, one should expect emerging domestic companies to have outperformed multinationals in recent times. Indeed, that has been the case over the past 5 years. Exhibit 7 shows the performance of domestic emerging and developed multinationals stocks.

One might conclude from this outperformance that emerging domestic companies might now be expensive from a valuation point of view relative to developed multinationals. Exhibit 8 shows that despite the large outperformance, emerging domestic stocks trade at a slight discount to multinationals. The reason domestic emerging companies outperformed was because their earnings grew faster, not because of valuation expansion.

**Exhibit 7**

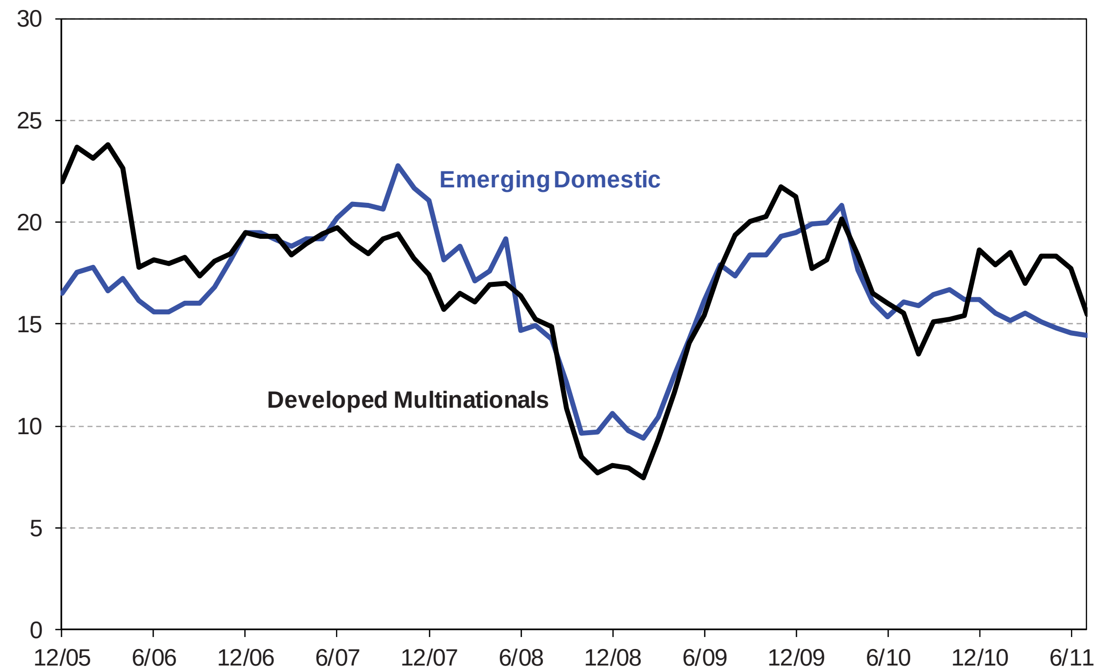
**Performance of Emerging Domestic Companies* vs. Multinationals****




** All companies in the MSCI Emerging Markets Index less exporters and commodity producers, weighted by market capitalization.*
*** All companies in MS World Index with sales greater than 50% to emerging markets, weighted by market capitalization.*
*As of 7/31/11*

**Exhibit 8**

**P/E Ratio of Domestic Emerging Companies* vs. Multinationals****




** All companies in the MSCI Emerging Markets Index less exporters and commodity producers, weighted by market capitalization.*
*** All companies in MS World Index with sales greater than 50% to emerging markets, weighted by market capitalization.*
*As of 7/31/11*

At the end of the day (as we mentioned earlier), it's not about multinationals versus locals, but which companies are able to best take advantage of the large growth in demand. What we care about is not overall GDP growth or even revenue growth; what matters are profits that companies are able to make and distribute to their shareholders. At this point in time, we find that the best (but not all) opportunities are local.

### Not All Domestic Opportunities Are Attractive

Attractive domestic opportunities are not evenly distributed across countries, and within countries where they are present, some sectors are far more attractive than others. At the country level, countries with large populations that are in the sweet spot of consumption growth (e.g., India, Indonesia, Brazil, China) are more attractive than countries that are already relatively developed (e.g., Korea, Taiwan, Israel).

Similarly, not all sectors within these countries are attractive. Some sectors have a competitive structure that prevents high profitability. Indian telecom, for example, is a sector with very high sales growth, but the competitive structure of the industry does not allow for high profitability. While India adds an astonishing 10 to 15 million net new subscribers each month, there are 15 companies competing in this space so profitability is low and likely to remain so until there is a fair amount of consolidation. Thus, high growth in this sector is unlikely to translate into high returns for shareholders.

On the other hand, the financial sector in India is more attractive because the nature of competition is highly oligopolistic, with high barriers to entry and well-established, highly profitable banks. Only 2% of Indians have credit cards, and one can reasonably expect this number to double in the next few years. Thus, banks with established brands and branch networks should benefit from this growth without having to lower their margins.

The key is to look for fast-growing country/sector combinations where the nature of competition is such that it allows for players to have high profitability. Within these country/sectors, companies that have a proven franchise that will allow them to command high profitability in the face of non-linear demand increases are most attractive. Profitability, brand, franchise, supply chain, and experience matter. In GMO parlance – focus on quality within fast-growing country/sectors.

### Conclusions

As a result of economic and demographic changes, we believe that we are in the middle of a major shift in global demand patterns. More of the hours worked, more of the money earned, and therefore more of the money spent will be located in the emerging markets. Inevitably, this will be reflected in the earnings and valuations of companies that serve emerging consumers.

The winners will likely be drawn from both the developed and emerging markets, although our view is that over the next several years, locally domiciled companies within emerging markets have an edge due to various home-field advantages.

Not all countries and sectors provide the same opportunities. Well-established, high quality companies that have a sustainable edge in fast-growing country/sectors are likely to be the big winners.