Next Generation of Growth: Opportunities in Frontier and Smaller Emerging Markets
By Jenny Chou

While BRIC (Brazil, Russia, India, and China) countries have dominated headlines and are still an important source of growth for the world, the next generation of opportunities for growth and stock picking are in the frontier¹ and smaller emerging markets (FEM). We believe that FEM countries are in the early innings of a rapid transformation. Within these markets, we see this growth trajectory being fueled by economies benefiting from growing populations with young demographics, improving education and labor skills, urbanization, and rising consumption. However, these countries continue to be overlooked by many investors, as these capital markets tend to be smaller and in earlier stages of growth than larger emerging market (EM) counterparts. While some reservations are understandable, we believe this next generation of growth can be harnessed, especially with prudent active management.

Table 1: MSCI Select Emerging and Frontier Markets²

<table>
<thead>
<tr>
<th>Americas</th>
<th>Europe, Africa, and Middle East</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>Bahrain</td>
<td>Qatar</td>
</tr>
<tr>
<td>Colombia</td>
<td>Czech Republic</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Mexico</td>
<td>Egypt</td>
<td>Lithuania</td>
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<tr>
<td>Peru</td>
<td>Estonia</td>
<td>Morocco</td>
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<td></td>
<td>Greece</td>
<td>Nigeria</td>
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<td></td>
<td>Jordan</td>
<td>Oman</td>
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<tr>
<td></td>
<td>Kazakhstan</td>
<td>Poland</td>
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<tr>
<td></td>
<td></td>
<td>Bangladesh</td>
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<tr>
<td></td>
<td></td>
<td>Indonesia</td>
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<tr>
<td></td>
<td></td>
<td>Malaysia</td>
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<tr>
<td></td>
<td></td>
<td>Philippines</td>
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<tr>
<td></td>
<td></td>
<td>Thailand</td>
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<tr>
<td></td>
<td></td>
<td>Vietnam</td>
</tr>
</tbody>
</table>

Source: MSCI Select Emerging and Frontier Markets Index as of June 2020.

The case for FEM investment lays in their long growth trajectories and development of those capital markets. Countries in the emerging and frontier markets generally grow faster (Chart 1) than developed or global peers driven by continuing progress in literacy, growth in the middle class, consumption, technology, and positive structural reforms.

In theory, all markets were, at one time or another, frontier markets before graduating to emerging and developed market status. By most definitions, China qualified as a frontier market in the 1980s, yet the country now stands with a market capitalization second only to the United States.

¹ The term “frontier market” was first introduced in 1992 by the International Finance Corporation (IFC) of the World Bank to denote and create indices for markets that have lower market capitalizations and/or less liquidity than emerging markets.
² The MSCI Select Emerging and Frontier Markets Access Index is based on the MSCI Emerging and Frontier Markets Index, its parent index. The Index aims to represent the performance of 200 securities from select countries within the MSCI Emerging and Frontier Markets Index, specifically 150 securities from Emerging Markets and 50 securities from Frontier Markets. The Index screens securities classified in the Emerging Markets to target companies with high economic exposure to the Emerging and Frontier Markets excluding Brazil, Russia, India, China, Korea and Taiwan.
Human Capital Advantages

A key demographic advantage of the FEM countries is the significant proportion of youth (Chart 3) in their growing populations (Chart 2). This represents a large pool of potential future workers who could contribute to their local economies.

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3 This chart defines developed, emerging, and frontier countries as those designated by the U.N. as high income, upper middle income, and lower middle income respectively.
Also critical to the growth of economies is the strong association between improved levels of education and economic productivity. Education generally leads to higher wages, which subsequently leads to greater contributions to national economic growth.

Case Study: Vietnam – A Beneficiary of its Human Capital Resources

Vietnam is one of the fastest-growing economies in the world and a poster child for FEM success. Real GDP grew by about 7% in 2019, close to the rate reported in 2018, and is one of the fastest growth rates in the world. Vietnam’s population reached 96 million in 2019 (up from about 60 million in the late 1980s) and is expected to reach 110 million by 2050. Today, over half of the population is under 35 years of age. Vietnam made large public investments in primary education and has one of the highest literacy rates (Chart 4) amongst its Frontier peers. The literacy rate among people of age 15-24 was 98.5%. Its human capital advantage is now a stable, skilled, and affordable workforce (Chart 5).

Chart 4: Vietnam’s Literacy Rate Amongst the Population Ages 15 and Older

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1999</th>
<th>2009</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (US$)</td>
<td>95</td>
<td>363</td>
<td>1,217</td>
<td>2,567</td>
</tr>
<tr>
<td>Population (mn)</td>
<td>66.5</td>
<td>79.0</td>
<td>87.1</td>
<td>95.5</td>
</tr>
</tbody>
</table>

Source: UNESCO

Table 2: Vietnam Population & GDP

Source: The World Bank

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In addition, Vietnam is well positioned geographically with ample ports on its coastline and efficient logistics provided by its rail and expressways. Its close proximity to China also places Vietnam in a favorable position in the event foreign manufacturers with operations in China seek out alternative production venues. These advantages have enabled Vietnam to chip away on China’s iron grip on the global manufacturing sector.

With rapid economic growth, Vietnam’s emerging middle class, currently accounting for 13% of the population, is expected to reach 26% by 2026⁶. Whereas its GDP per capita was barely US$230 in 1985, that level has increased more than ten-fold⁷. The rise in Vietnam’s consuming middle class has yielded a healthy balance of payments supported by both an export-oriented economy and an internal consumption case.

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⁷ World Economic Forum: The Story of Viet Nam’s Economic Miracle
Rise in Middle Class and the Power of Consumption

With a young, growing work force, the “consuming class” has become a major economic force in FEM (Chart 6).

**Chart 6: Contribution to GDP Growth by Expenditure Component, 2018**

![Chart showing contribution to GDP growth by expenditure component, 2018](image)


**Case Study: Indonesia - Consumption Trends and the Home Field Advantage**

As the fourth most populous country in the world, Indonesia requires continual development to fulfill demand for housing, employment, and entertainment with roughly five million Indonesians\(^8\) entering the urban consuming class each year. The country is rapidly urbanizing, thereby fueling a rise in incomes and leading consumers to spend more (Chart 7) on consumer discretionary items presenting ample home-country focused opportunities.

**Chart 7: Urban Consuming Class**

![Chart showing urban consuming class trends, 2010-2020](image)

\(^1\) Compound annual growth rate for 2010-2020

*Source: McKinsey*

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\(^8\) McKinsey: The Evolving Indonesia Consumer, November 2013
In observing consumer trends, Indonesians have a strong preference for local brands which usually cater to the local population’s needs, tastes, and customs. Locally focused companies can quickly adapt to consumer changes in their local markets, giving them an at-home advantage. Consumers trust Indonesian companies, take pride in using local brands, and believe that local companies understand Indonesian consumers by providing better value for the money compared with foreign brands.\(^9\)

In a more recent survey\(^10\) on COVID-19’s impact on Indonesian consumer sentiment, value for money and Indonesians’ sense of community spirit continue to be important factors in driving consumption decisions. Fifty-six percent of respondents said they intend to buy more products that are produced in Indonesia. A home court advantage often presents a high barrier to entry for foreign firms trying to gain footing. If a foreign company would like to successfully capture the market, this is usually achieved through localization or acquisition strategies. These factors underscore the potential of the consuming class and domestically focused companies in the FEM countries.

**Technology Leapfrogging**

While the developed markets have had a clear time advantage on the earlier build-outs of their technological infrastructures through advances such as high-speed fiber and the presence of wireless towers, the appetite for internet adoption has grown steadily in the FEM countries (Chart 8). Technological leap-frogging affords considerable efficiency gains and offers developing nations a fast track into the globalized economy. The trajectory of technology adoption is an important factor for future economic growth. Digital transformation was already underway prior to the COVID-19 pandemic, but the economic crisis has accelerated the adoption as digital connectivity is critical to societal resilience and business continuity.

**Chart 8: Individuals Using the Internet (% of Population)**

![Chart 8: Individuals Using the Internet (% of Population)](source: The World Bank DataBank)

\(^9\) McKinsey: The Evolving Indonesian Consumer, November 2013

Case Study: Kenya – Mobile Money and First Mover Advantage

In Africa, millions of people are accelerating the technological evolution process, leap-frogging over now-obsolete technologies. This has resulted in Africa becoming the global leader in mobile financial services (Table 3). With the largest and most advanced economy in east Africa, Kenya is one of the world’s leaders in mobile money services. Its telecommunications operator pioneered M-Pesa services, which enabled consumers and small businesses – with no access to a bank – to send and receive money quickly and securely across great distances. The proportion of Kenya’s population with access to formal financial services has risen, driven largely by mobile technology. By building digital finance capabilities, companies gain the opportunity to develop new business models. Internet retailing has seen double-digit growth in recent years with increasing sales of smartphones and other mobile devices.

Table 3: Mobile Subscriptions for Financial Services in 2019

<table>
<thead>
<tr>
<th>Region</th>
<th>Registered Accounts</th>
<th>Active Accounts</th>
<th>Transaction Volume</th>
<th>Transaction Value (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia &amp; Pacific</td>
<td>158m</td>
<td>60m</td>
<td>4.4bn</td>
<td>78.9bn</td>
</tr>
<tr>
<td>Europe &amp; Central Asia</td>
<td>20m</td>
<td>7m</td>
<td>217m</td>
<td>3.8bn</td>
</tr>
<tr>
<td>Latin America &amp; the Caribbean</td>
<td>26m</td>
<td>13m</td>
<td>601m</td>
<td>16.5bn</td>
</tr>
<tr>
<td>Middle East &amp; North Africa</td>
<td>51m</td>
<td>19m</td>
<td>663m</td>
<td>9.1bn</td>
</tr>
<tr>
<td>South Asia</td>
<td>315m</td>
<td>91m</td>
<td>7.3bn</td>
<td>125.4bn</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>469m</td>
<td>181m</td>
<td>23.8bn</td>
<td>456.3bn</td>
</tr>
</tbody>
</table>

Source: GSMA

Given their long presence and from-the-ground-up build out, provincial payment companies are familiar with the local infrastructure and have a solid understanding of the trends and needs of their users. Their first mover advantage allowed them to establish deep roots and dominate the market, making it challenging for new entrants. The incumbent players are leveraging their leadership in mobile payments and replicating this business model into other regions of Africa.11 Margins on payments in Africa remain the highest in the world, indicative of the pricing power and strong market position of these participants. But even with the burgeoning uptake of money moving across mobile wallets by a young and tech-savvy population, Africa still remains largely cash-based and hence remains an attractive long-term opportunity.

Finally, in light of how the recent COVID-19 pandemic has affected lives across the globe - governments and regulatory bodies have started discouraging the use of cash during the recent coronavirus outbreak. As a result, this has forced users to switch to electronic payment options and the structural adoption of the digital payment solutions should increase at a rapid pace under this new normal.

11 McKinsey: Mobile Financial Services in Africa Winning the Battle for the Customer
**Positive Reform Tailwinds**

Positive structural reform, improving political stability, and the growing ease of doing business are also prominent strengths among select FEM countries. A focus on economic improvements attracts the foreign investment necessary to unlock the potential of these countries. Further, market dislocations are more frequent in FEM regions, but these represent an opportunity to capitalize on high quality, fundamentally sound businesses at attractive valuations.

*Case Study: Republic of Georgia*

With a population of 3.7 million and GDP of $54 billion (PPP, 2018), Georgia has a per capita income of approximately $15,000 (PPP, 2019). Over the past decade and despite numerous shocks (global financial crisis of 2007-08 and the drop in commodity prices since 2014 that impacted key trading partners)\(^\text{12}\) - Georgia’s economy has grown an impressive average annual rate of 4.5%. Arguably, Georgia is the ex-Soviet Republic that has moved the furthest in terms of democracy, transparency and anti-corruption. With a budget surplus, low debt-to-GDP, and a geographically favorable location on the Black Sea for trade, Georgia’s well-diversified economy remains sound.

The breakup of the Soviet Union in 1991 disrupted the long established Soviet economic plan and placed Georgia in unchartered territory. Subsequent deep economic and governmental reforms made Georgia one of the fastest reforming nations in the world. To bolster its private sector, the country introduced rules such as privatizing state-owned assets and relaxing regulations that make it easier to do business. As a result, the country’s international ratings on governance and the investment climate have improved notably.

For example, before it independence, Georgia had a system of centrally determined prices that bore no relation to local markets or costs. Phasing out subsidies after independence involved a multi-fold but necessary increase in the prices of essentials such as heating gas and bread. Additionally, tax revenues as percentage of GDP rose from the single digits in the early 1990s to now an average 22%. In the mid-2000s, Georgia reduced corruption and developed targeted social assistance programs. Poverty declined from over 30% in the early 2000s to below 20% currently\(^\text{13}\). More recently, the country has emphasized support for technological innovation.

Looking back on Georgia’s 30-year economic transformation, the country is now home to several well-structured institutions. For example, the Bank of Georgia (BoG) is the country’s leading bank has a well-diversified retail branch network as well as a strong position in deposits and loans. As the economy grows, BoG is well positioned to increase its loan book. On a similar note, such companies will benefit as the country continues on its growth trajectory.

**Capitalizing on Market Inefficiencies**

In our evaluation of smaller FEM opportunities, we consider each market’s “equitization ratio,” defined as a country’s total stock market capitalization divided by its gross domestic product. The equitization ratio measures whether a country’s economic activity has been fully reflected in its stock market (a level of 100%) or has unrecognized potential (less than 100%). As shown in Chart 9, both the frontier and emerging markets have significant potential for further capital markets development based on their sub-100% equitization ratios.

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\(^{12}\) Larisa Burakova and Robert A. Lawson, Georgia’s Rose Revolution

\(^{13}\) The World Bank: [https://data.worldbank.org/country/georgia](https://data.worldbank.org/country/georgia)
With the higher relative GDP growth projected by the IMF, we expect that the equitization ratios for FEM will become more attractive as the denominator of the ratio (GDP) continues to grow.

The relatively low equitization ratio is perhaps attributed to the nascent state of these markets. Many of these companies are not listed and there are ample opportunities for them to become equitized.

Another factor is the general lack of investor information, which is evident when one considers the level of coverage by sell-side analysts (professional analysts employed by investment banks, brokerage firms, and research boutiques that provide investment reports to institutional and retail clients). Emerging and frontier market stocks have generally been underfollowed by these analysts in comparison to those in developed markets (Table 4):

<table>
<thead>
<tr>
<th></th>
<th>Number of Stocks</th>
<th>Average Number of Analysts per Stock</th>
<th>Percentage of Stocks with Single or No Analyst Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 1000</td>
<td>1004</td>
<td>15</td>
<td>1.69%</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>2005</td>
<td>5</td>
<td>15.86%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>902</td>
<td>14</td>
<td>1.00%</td>
</tr>
<tr>
<td>MSCI EAFE Small Cap</td>
<td>2323</td>
<td>5</td>
<td>28.71%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>1385</td>
<td>14</td>
<td>6.71%</td>
</tr>
<tr>
<td>MSCI Emerging Markets Small Cap</td>
<td>1559</td>
<td>5</td>
<td>32.78%</td>
</tr>
<tr>
<td>MSCI Frontier Markets Small Cap</td>
<td>156</td>
<td>5</td>
<td>67.95%</td>
</tr>
</tbody>
</table>

*Source: FactSet*
The Case to Invest

Given the level of due diligence required to effectively assess individual emerging and frontier company risks and the potential impact of macroeconomic issues, we believe that an active approach is best positioned to generate alpha in these smaller markets. An in-depth familiarity with each country, local economies, geopolitical issues, and market dynamics provides active managers with an advantage to gain exposure to frontier markets. Global expertise married with local presence through networks of contacts built up over decades of combined experience offer competitive advantages within these markets.

References:

Burakova, Larisa and Lawson, Robert (December, 2013). Georgia’s Rose Revolution


MSCI Index Factsheets are available at https://www.msci.com/equity-fact-sheet-search


UNESCO information is available at https://en.unesco.org/.


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