Emerging Markets Small Cap: Compelling Opportunities Ahead

By Leona Yang, CFA

Representing over 85% of world population and 58% of global GDP[1], emerging markets (EMs) have grown rapidly over the last two decades. Over this period, EM has transformed considerably, with higher consumption driven by rising income, market reforms, and expanding capital markets.

As technology penetration increases, we expect large scale structural changes to continue and accelerate. Once considered "followers", entrepreneurs in EMs now use their technical capabilities to bring innovations across borders and transform businesses. Digitization was well underway already in many parts of the world. The pandemic not only changed consumer lives, but also substantially accelerated digital transformation as companies adapted to their customers' new needs. As more consumers grow accustomed to digital channels for services, a seamless and streamlined experience will prove essential to maintaining customer loyalty.

One of the most significant achievements in the EM world over the last few decades has been the emergence and expansion of the middle class. With millions of people being lifted out of poverty each year, companies that cater to domestic demand have benefited from fast-growing incomes. In the near term, the COVID-19 vaccine rollout will continue to play a dominant role as global economic recoveries take hold. Thus far, vaccine distribution has been executed unevenly across regions, with the developed world far outpacing the emerging world. Most recently, the massive resurgence of COVID-19 cases in India highlighted the need for broadened vaccine rollouts in emerging countries.

While the short-term outlook remains challenging for some countries hit hard by COVID-19, we continue to find compelling structural growth opportunities – trading at attractive valuations – in the EM small cap universe.

Technology Adoption and Digital Transformation

Over the last decade, EMs have changed substantially. Unlike previous periods where much of the EM region was entwined with commodity, currency, or economic cycles, technological development helped transform EM economies. In fact, without the need to upgrade legacy infrastructure, companies in emerging countries have leapfrogged to the latest innovation and technologies.

China has certainly been the biggest EM success story in technology adoption. However, entrepreneurs in other EM countries are also forming companies and bringing products and services to customers in new ways. Since 2014, more than 10,000 technology companies have been founded in EM countries, with almost half of them outside of China. Though many of these companies have not yet achieved the same scales as China's internet giants Alibaba or Tencent, they are growing at an impressive pace. They are delivering customized offerings to suit the needs in their own countries and offering a long runway of growth as they expand.

[1] Based on purchasing power parity. World Economic Outlook, International Monetary Fund, April 2021

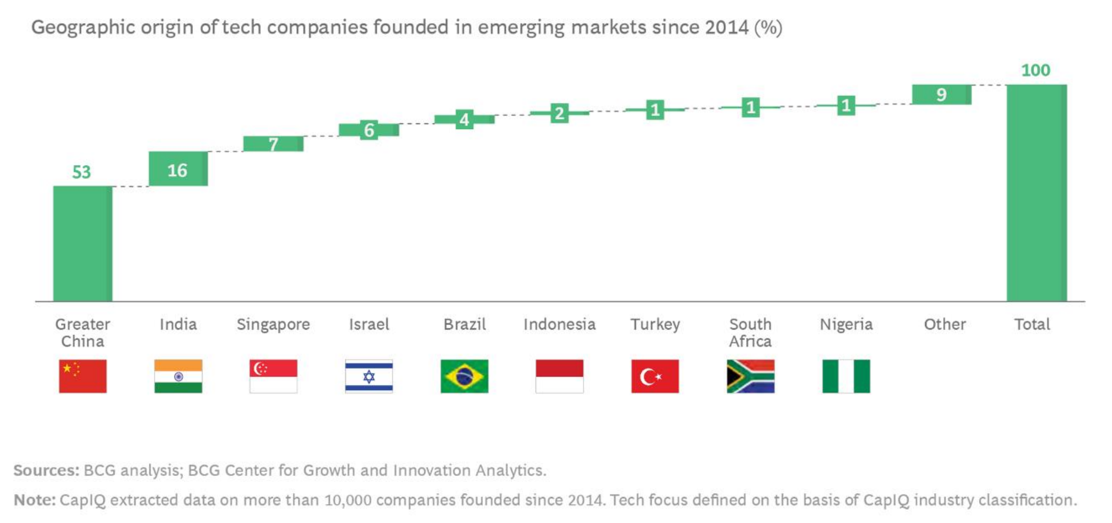

Exhibit 1 – Technology Companies Founded in EMs Since 2014
Sources: BCG Analysis; BCG Center for Growth and Innovation Analytics

What is also remarkable is that the acceleration of technological adoption that we witnessed in developed markets due to COVID-19 (such as the shift to remote work, online shopping and ecommerce, and online learning & entertainment) also happened quickly in many major EMs. Just like their developed country counterparts, EM consumers adjusted their normal behavior by embracing technology in a matter of days[2], and we believe many of these "new" practices will be here to stay.

Online Delivery
10-years-in-8-weeks
For increase in e-commerce deliveries

Telemedicine
10x in 15 days

Remote Working
20x Participants
On videoconferencing in 3 months

Remote Learning
250 million in 2 weeks
Students who went online in China

Online Entertainment
7 years in 5 months
Disney Plus achieved in 5 months what took Netflix in 7 years

Exhibit 2 – Many of the trends are accelerations of past behaviors
Source: McKinsey & Company

[2] How COVID-19 is changing consumer behavior – now and forever, McKinsey & Company

During the pandemic, those companies that invested in a well-executed digital strategy capitalized on their technological advantage to grow leads over competitors. As the reopening of economies begins, we believe these newfound capabilities will help companies expand. In Case Study #1, Kyochon F&B is a good example of how a traditional food business used technology to reinvent itself.

Case Study #1: Kyochon F&B (339770-KRX) / Korea / Consumer Discretionary

Kyochon F&B ("Kyochon") is Korea's leading fried chicken franchise, with approximately 1,270 stores in Korea and an expanding international presence in countries such as China, the US, and Southeast Asia. Originally founded in 1991, Kyochon focuses primarily on serving Korean-style fried chicken and associated sauces and condiments.

Over the years, Kyochon has built strong brand recognition through its emphasis on quality and taste. Its investment in technology also paid off with improved efficiency, increased customer engagement, and better decision making. For instance, the company's mobile app not only helps the firm improve customer loyalty and increase the frequency of purchases, but also reduces costs for franchisees, and allows them to retain real time data for better decision making at its corporate headquarters.

South Korea's food delivery market thrived in 2020 due to COVID-19 restrictions, with online food delivery transactions surging 78.6% from a year earlier. Of total transactions, 95% were mobile orders. The company continues to record impressive growth despite the high base in 2020.

For many years, technology adoption has been a source of cost efficiencies for companies willing to make those investments. However, with COVID-19 pushing us to the "new normal" environment, for companies to thrive, they will have to recognize that technology investment is no longer a discretionary component of their overall business strategy. For many companies, the road to digital transformation can be challenging, especially for small and medium-sized businesses that lack resources. Managed Services Providers ("MSPs") become critical in this process, helping level the playing field, allowing smaller companies to compete with larger enterprises.

Case Study #2: eCloudvalley Digital Technology (6689-ROCO) / Taiwan / Information Technology

Based in Taiwan, eCloudvalley ("ECV") is the leading Amazon Web Services ("AWS") Cloud MSP for the Greater China Region.

Founded in 2013, ECV was originally focused on being an exclusive distributor for Western Digital enterprise storage products in China. After CEO Tsai noticed that the majority of its products were being shipped to data centers, he began refocusing the business to cloud services, becoming one of AWS's first partners when it entered Taiwan in March 2014. Now as the largest and one of the oldest MSPs in the region, ECV has established a long track record. For the second year in a row was, it was named a leading MSP for the APAC region by the Gartner Group.

As more companies seek digital transformations and cloud migrations in Taiwan, Hong Kong, and Southeast Asia, we expect ECV to grow sustainably.

Growing Middle Class and Domestic Consumption Amid COVID-19

With the rapid growth of the middle class in EM countries, rising income brings structural growth opportunities for many providers of goods and services, from higher quality food to better health care. The demand for better goods and services also presents a longer growth runway than that of developed markets.

Oftentimes, we find entrepreneurs start off small and grow into local champions. Because of their domestic focus, the small capitalization companies in the EMs will benefit disproportionately from the continued growth of those countries. By comparing the portions of revenues from domestic sources for the various equity markets in Exhibit 4, we find the results to overwhelmingly favor small capitalizations.

Russell 1000	49.1%
Russell 2000	72.4%
MSCI EAFE	46.4%
MSCI EAFE Small Cap	69.8%
MSCI Emerging Markets	68.9%
MSCI Emerging Markets Small Cap	75.1%

Exhibit 4 – Percent of Sales from Home Country as Of December 30, 2020
Source: FactSet

In 2020, for the first time over the past few decades, the global middle class[3] shrank as the COVID-19 pandemic pushed millions down the economic ladder. While the impact on total consumer spending was severe, we expect the ascendence to middle class to resume in 2021 and beyond as a global recovery materializes.

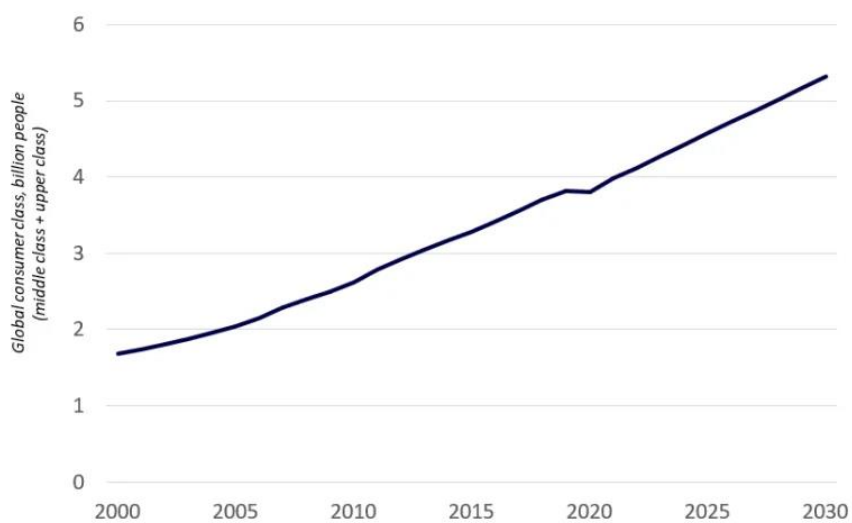

Exhibit 3 – Historical and projected population of global consumer class (middle class + upper class)
Source: World Data Lab

The speed of recovery will depend on various factors, from the handling of COVID-19 to the depth of the pandemic slump, as well as the governments' policy response. We believe it is important to carefully comb

[3] Defined as anyone spending more than $11 per day (in 2011 PPP)

through fundamentals and identify businesses that not only remained solid during the pandemic but that could also continue to benefit from the secular growth trends coming out of the crisis. Our case studies #3 and #4 are two unique companies, operating in two countries where the COVID-19 responses were starkly different, but both have flourished from the rise of the middle class in their respective countries.

迪安诊断
DIAN DIAGNOSTICS

Case Study #3: Dian Diagnostics (300244-CN) / China / Health Care

Dian Diagnostics ("Dian") was founded in 2001 and has emerged as one of China's leading domestic independent clinical lab companies. Today, Dian has a nationwide network of 40 labs and the capability to conduct ~2,500 different tests. Its clients include over 20,000 medical institutions across the country.

We expect Dian's revenue and profitability to grow sustainably over the long run due to:

1. Greater health awareness leading to higher volumes of clinical lab work, as well as high demand for increasingly advanced customized screening.
2. Chinese public hospitals continuing to outsource clinical diagnostics to labs. Currently the 3rd party clinical labs market is significantly under-penetrated compared to the U.S., Europe, and Japan.
3. Collaborations with Chinese telemedicine providers and e-commerce platforms that provide Dian with channels to offer clinical lab testing directly to customers.

QUERO·QUERO

Case Study #4: Lojas Quero-Quero (LJJQQ3-BR) / Brazil / Consumer Discretionary

Lojas Quero-Quero ("LJQQ") is Brazil's largest home improvement chain based on the number of stores. Its stores offer a wide selection of building materials, home appliances, furniture, and consumer electronics. With a focus on small cities (average population of 40,000), the company operates in markets where the big box home improvement retailers do not focus on.

Lojas Quero-Quero's competitive advantage can be attributed to the following factors:

1. LJQQ's unique model of "small stores in small towns" means its local competitors are mostly mom & pop hardware stores that lack product assortment and are largely unable to provide credit solutions to clients. This offers significant potential as the company expands across small cities in its geographies.
2. LJQQ takes pride in its customer service. Its "Palava Quero Quero" ("If it's late, it's free") program helps establish a deeper relationship between store managers and customers.
3. With a relatively low upfront investment to set up a store, the payback period is also shorter. LJQQ's attractive store economics allow the company to maintain attractive returns while expanding rapidly.

COVID-19 Resurgence and Vaccines

By the end of the first quarter of 2021, more than half a billion people had been vaccinated worldwide. However, there have been considerable disparities between developed and emerging countries with respect to vaccine distributions. Within EM, the situations are also very different from country to country. With relatively better handling of COVID-19, many Asian countries are en route to recovery. Meanwhile, the massive resurgence of COVID-19 cases in India has overwhelmed the nation's health care systems and forced many states to tighten restrictions, which could hinder its economic recovery. Additionally, as the main supplier of vaccine shots for the World Health Organization's COVAX initiative, India has stopped exporting vaccine shots. With many emerging countries relying on this initiative for COVID-19 vaccines, the delay could pose challenges to these economies as well.

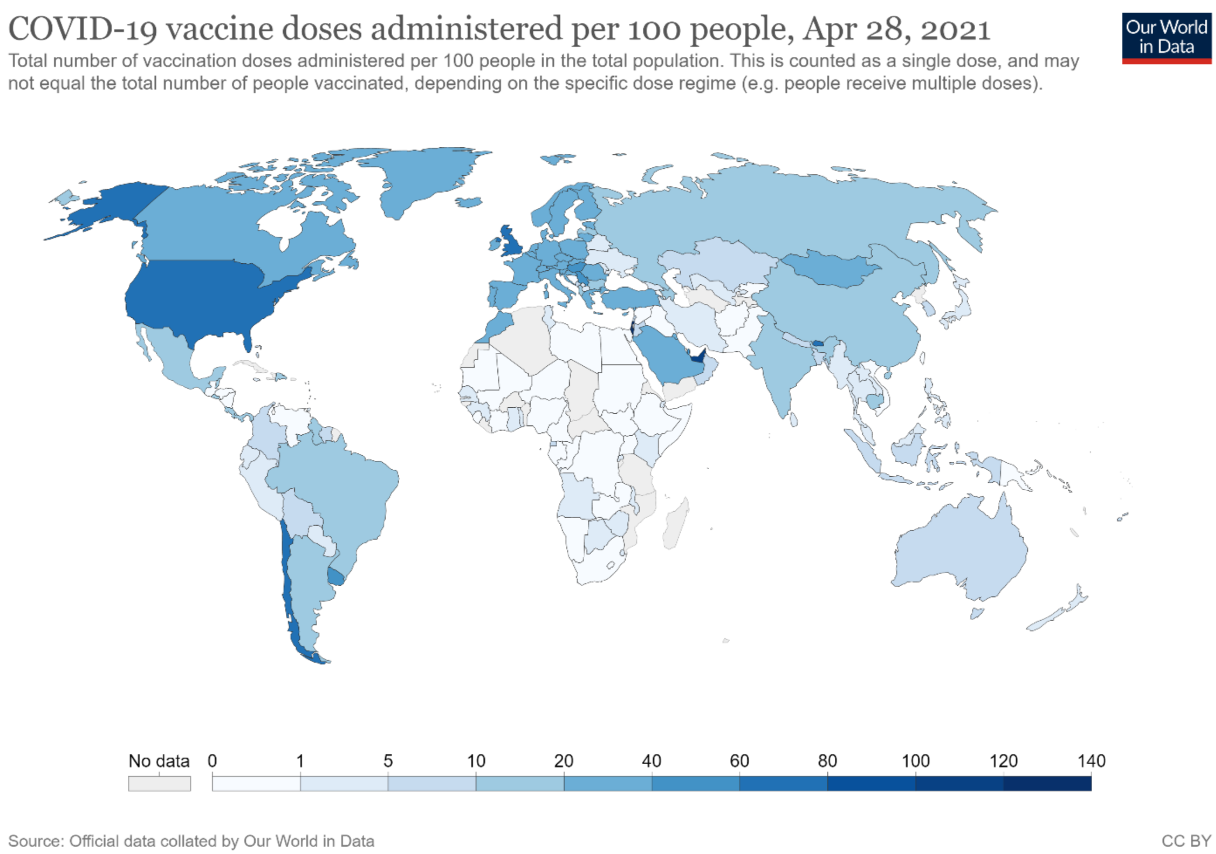

Exhibit 4 – COVID-19 doses administered per 100 people, April 28, 2021
Source: Our World in Data

While the near-term outlook is challenging in parts of the world, we believe the structural growth story remains unchanged, and continue to find attractive opportunities despite COVID-19, even in some of these hardest-hit countries, such as India.

Case Study #5: ICICI Securities (541179-BOM) / India / Financial Services

ICICI Securities (ISEC) is one of the largest retail and institutional equities brokerage firms in India, ranked among the top 3 brokers in the country based on active clients and overall clients. ISEC was originally founded in 1995 as a joint venture between ICICI and JPMorgan, and today is the sole equity securities arm of the ICICI Group. The firm has a presence in over 70 cities in India as well as a global presence in Singapore and New York.

ISEC's sustainable competitive advantage can be attributed in the following factors:

1. As India's middle class grows, the demand for financial products also increases.
2. ISEC was an early adopter of technology when it launched what was one of India's first online brokerages in the early 2000s. This technological edge gave ISEC a scalable business model and infrastructure. It also helped ISEC attract new clients, improve customer experience, and refine its offering faster than peers. The company presents its ever-expanding menu of products and services to customers in an easy "plug and play" manner, allowing for more cross-selling and commission-generating opportunities.
3. ISEC benefits from a low-cost, high-value customer acquisition channel through ICICI's brand name and extensive banking relationships throughout corporate India.

Conclusion

As the COVID-19 vaccine rollout continues, we look forward to a global recovery in the second half of this year and into 2022. Though the current resurgence in COVID-19 cases and bottlenecks in vaccine manufacturing and distribution has created uncertainty in economic recoveries for some parts of the world, we remain constructive on the structural growth outlook for EMs. Given domestic consumption's role as a significant driver of economic growth, we believe domestically focused companies will continue to benefit. In addition, we think the new technologies that were adopted during the pandemic will be here to stay, and digital transformation will provide tailwinds for emerging economies. Technological advancements have enabled a growing number of entrepreneurs in emerging countries to accelerate business formations and created a plethora of investment opportunities in smaller companies across the region.

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