TimesSquare Capital Management, LLC

Emerging Markets Small Cap: Compelling Opportunities Ahead

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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 domestic consumption driven by rising income, market reforms, and expanding capital markets.

While digitalization was well underway in many parts of the world, we have found that technology and innovation continued to have a particularly transformative impact in the EM context. Once considered technology “followers”, companies, entrepreneurs, and even government entities in EMs are bringing innovations and technology across borders, adapting them to local conditions, while creating new opportunities and markets. The COVID pandemic only accelerated this process. As technology penetration increases, we expect large scale structural changes to continue, which should provide fertile ground for investment opportunities.

Another enduring investment theme we find in the EM world is 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 are benefiting from fast-growing incomes and new consumption habits. Despite global macro uncertainties, we are seeing resilient domestic consumption trends across most EMs. India’s impressive 6.3% GDP growth this year [2]is hard to overlook. Brazil has also been an attractive market, and with its monetary tightening cycle closer to its end, it is seeing strong interest and inflows from foreign investors.

Two more themes that we see persisting for the next few years are U.S.-China geopolitical tensions and localization of supply chains and manufacturing capacity. U.S. policies have already had a major negative impact on China’s semiconductor industry. We expect the U.S. to take additional action targeting other areas where the U.S. wants to limit the threat of Chinese sector dominance, such as pharmaceutical research and renewable energy. Future actions may even include a wider ban of U.S. investments in China. As a result, we have turned more cautious and selective on Chinese equities despite a deep pool of opportunities. However, this situation has also highlighted the opportunities within the EM small cap asset class, which has been much more representative of EMs outside of China, and who are also the EMs benefiting from increased investment flows. In fact, as we wrote this paper, Apple announced its plans to move productions out of China to elsewhere in Asia, particularly India and Vietnam.[3]

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

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[1] Based on purchasing power parity. World Economic Outlook, International Monetary Fund, October 2022

[2] Gross Domestic Product (GDP) for the second quarter (July-September) of 2022-23 (Q2 2022-23), "PRESS NOTE ON ESTIMATES OF GROSS DOMESTIC PRODUCT FOR THE SECOND QUARTER (July-September) 2022-23". Ministry of Statistics and Programme Implementation. 30 November 2022. Retrieved 5 December 2022.

[3] “Apple Makes Plans to Move production Out of China”, The Wall Street Journal, December 3rd, 2022

Technology Adoption and Digital Transformation

Over the last decade, EMs have changed substantially. Unlike previous periods where much of the EM region's success 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 scale as China's internet giants Alibaba or Tencent, they are growing at an impressive pace. They are delivering customized offerings to suit needs in their own countries and offering a long runway of growth as they expand.

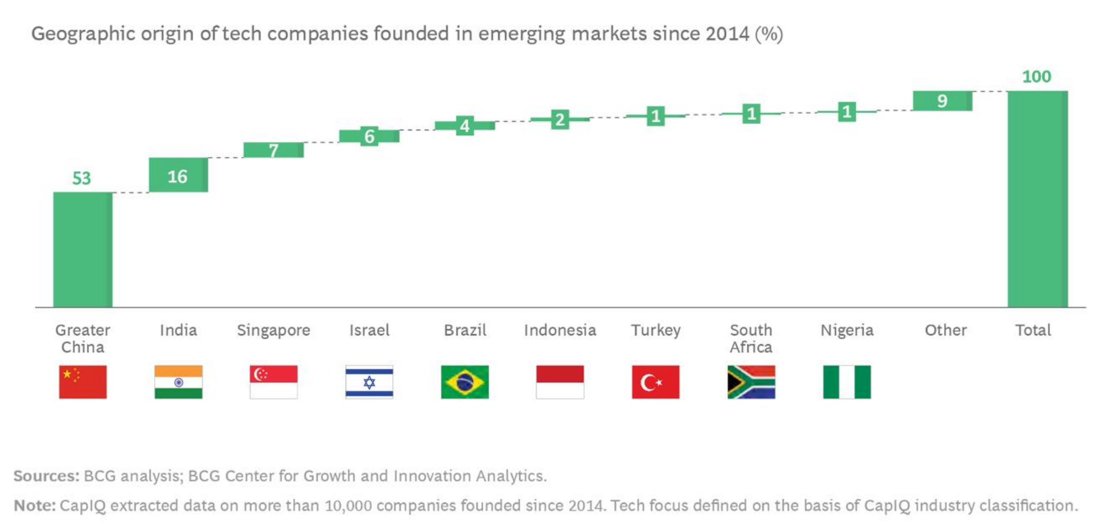

Exhibit 1 – Technology Companies Founded in EMs Since 2014
Sources: BCG Analysis; BCG Center for Growth and Innovation Analytics

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, the behavior of EM consumers changed in a matter of days with respect to technology adoption[4], and we believe many of these "new" behaviors 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

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

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

Those companies that invested in a well-executed digital strategy capitalized on their technological advantage to grow leads over competitors. We believe these companies will continue to expand. In Case Study #1, Arabian Contracting Services is a good example of how a traditional billboard advertising business used technology to reinvent itself.

Case Study #1: Arabian Contracting Services (4071-SA) / Saudi Arabia / Communication Services

Arabian Contracting Services ("ACS") is the market leader in outdoor billboard advertising in Saudi Arabia, with more than 60% market share of outdoor advertising spend.

ACS has been converting more and more of its static billboards to digital billboards, with the goal of achieving 80% of its ad inventory available as digital by 2025. The benefits of converting its billboards to digital are manifold:

1. Ad inventory increases from ~2 faces per board to ~9 faces per board, resulting in revenue potential that is several times that of static with minimal additional investment or cost.
2. Coordinated billboard campaigns are possible due to control of billboards from a central location.
3. Cost savings from no longer needing crews to manually change billboards.
4. Better measurement of audience impressions due to technology embedded within the billboards, leading to greater advertiser interest.

This digital conversion is already resulting in higher revenue growth as well as higher margins.

ACS is also increasing its presence outside Saudi Arabia with the larger goal of becoming a regional "go to" advertising services giant for companies looking to plan and launch advertising campaigns in the region and has already struck deals in countries such as Egypt, the UAE, and Qatar.

For many years, technology adoption has been a source of cost efficiencies for companies willing to make those investments. However, COVID-19 has forced companies 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") have become critical in this process, helping to 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' 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, 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

With the rapid growth of the middle class in EM countries, rising incomes bring 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 3, we find the results to overwhelmingly favor small capitalizations.

Russell 1000	62.1%
Russell 2000	81.6%
MSCI EAFE	32.5%
MSCI EAFE Small Cap	60.2%
MSCI Emerging Markets	66.2%
MSCI Emerging Markets Small Cap	73.1%

Exhibit 3 – Percent of Sales from Home Country as Of September 30, 2022
Source: FactSet

In 2020, for the first time in decades, the global middle class[5] shrank as the COVID-19 pandemic pushed millions down the economic ladder. While the impact on total consumer spending was severe, and the war

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

in Ukraine added to the already challenging landscape, we expect the structural trend of the ascendence to middle class to continue.

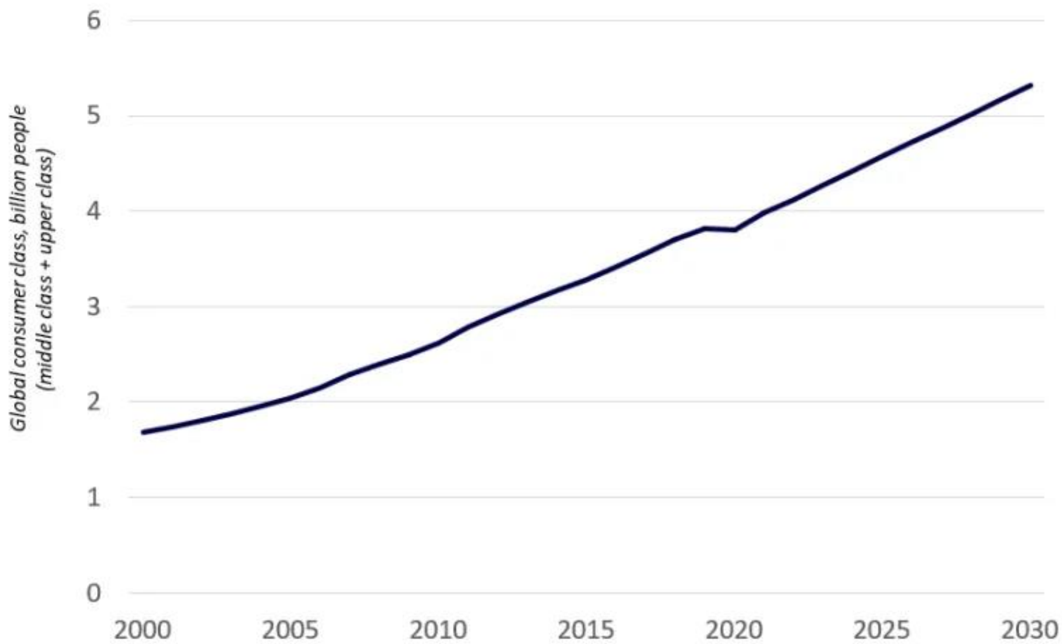

Exhibit 4 – Historical and projected population of global consumer class (middle class + upper class)
Source: World Data Lab

We believe it is important to comb through fundamentals and identify businesses that not only remained resilient 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, both have flourished from the rise of the middle class in their respective countries.

Case Study #3: 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 seen in the following factors:

1. ISEC aims to be the "Charles Schwab" of India, meaning it wants to offer retail traders a premium yet competitively priced retail brokerage experience with sophisticated "prosumer" trading features that sets it apart from lower end discount platforms. To that end, the company is focused on continually investing resources into technology to ensure its customer experience and mobile app capabilities are market leading.
2. ISEC recently acquired Multipie, an online investor community that allows its users to exchange ideas and share views on stocks, with the goal of increasing retail investor engagement and education and making this investment community a key part of its overall offering.
3. ISEC benefits from a low-cost, high-value customer acquisition channel through ICICI's brand name and extensive banking relationships throughout corporate India.

As India's middle class grows, the demand for financial products also increases. ISEC believes that its focus on providing its customers with superior technology and customer service and an engaging social community will position the company well for future growth, particularly among the younger generation of Indians who are much more digitally native than prior cohorts.

Case Study #4: Arcos Dorados (ARCO-US) / Argentina / Consumer Discretionary

Arcos Dorados is the largest McDonald's independent franchise globally, and has the exclusive right to own, operate and grant franchises of McDonald's restaurants in 20 countries and territories in Latin America and the Caribbean. As of the end of 2021, Arcos Dorados operated or franchised approximately 2,300 McDonald's-branded restaurants in the region.

Arcos offers menu items with aspirational appeal at reasonable prices, thereby selling well across a wide swath of demographic and income groups in the region, particularly the middle class. The company benefits significantly from the digital know-how of McDonald's, and its own investments into technology enable customers to order from a mobile app (which has reached over 79 million downloads), third party food delivery apps, and in-store digital kiosks. These digital-enabled channels now represent 42% of sales and have resulted in higher revenues per customer in addition to lower in-store costs and more efficient targeted marketing.

While these digital channels saw a boost in adoption due to COVID, Arcos' recent results indicate that customer preferences and habits toward its digital channels have become ingrained, further boosting the company's confidence in its ability to grow profitably and sustainably in the region.

Geopolitics, The Reshuffling of Supply Chains, and the Emergence of the Next Emerging Markets

Sino-U.S. tensions and COVID-19 exposed vulnerabilities in global supply chains. While most of the countries have moved on from draconian COVID-19 restrictions, China's zero COVID policy highlighted the need for companies to diversify their supply chains. While this process takes time, companies have started taking steps to add production capacity outside of China.

The latest round of tensions has also heightened the risks related to Chinese equities, specifically as it relates to future U.S. policies that may target certain sectors (most recently with semiconductors) and in the future may even target any U.S. investment into the region.

While this leads us to be more cautious and selective with regard to the weight and selection of Chinese equities in our portfolio, we believe that this situation has also highlighted the more balanced weighting of the EM small cap asset class. Moreover, it has helped investors to better appreciate the growth stories in the EMs outside of China, such as in India, ASEAN, EMEA / Middle East, and Latin America. These EMs not only have strong domestic growth stories, but are also the beneficiaries of investment flows due to 1) natural resources, particularly related to commodities that will fuel the green energy transition (such as nickel and copper); 2) lower labor costs, avoidance of tariffs, or supply chain redundancy; and 3) geopolitical neutrality, as these countries are choosing not to align exclusively with any country, and in doing so, are able to reap benefits from having good relations with both China and the U.S.

In Case Study #5, PT AKR Corporindo is a good example of how Indonesia has benefitted from this trend.

AKR

Case Study #5: PT AKR Corporindo (AKRA-IJ) / Indonesia / Industrials

PT AKR Corporindo ("AKR") is a leading distributor of chemicals and petroleum products, provider of logistics and storage solutions, and owner and operator of a massive industrial estate zone called JIIPE (Java Integrated Industrial and Port Estate) located in East Java.

Indonesia has been a key beneficiary of increased investment as a result of:

1. Electric Vehicle (EV)-related industries seeking to secure raw materials and set up related EV manufacturing in the country;
2. Supply chain diversification away from China;
3. Generally favorable investment outlook within the ASEAN region.

All AKR's business segments benefit from these trends as increased economic activity has significantly boosted AKR's customer count and volume of products delivered. Meanwhile, more companies have been purchasing land tracts in the JIIPE zone to set up more infrastructure and manufacturing.

Conclusion

We remain optimistic in the structural growth outlook for emerging markets. Given domestic consumption's role as a significant driver of economic growth, we believe domestic-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. The technological enablement of entrepreneurship in emerging countries has accelerated business formation and created a wealth of investment opportunities in smaller companies across the region.

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