Frontier International

International research insights from Frontier Advisors

Equities Research Team

Issue 16, October 2015

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

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Investing in the emerging consumers

Introduction

Emerging markets have experienced tremendous growth over the last few decades lifting hundreds of millions of people out of poverty through economic growth. The pace of this economic growth has been varied across shorter time periods and countries but the direction and trend has been clear. In an aggregate sense, this economic growth has been a function of investment/capital expenditure along with the commodities boom that was prevalent over the last decade. These dominant (and linked) drivers of growth have been fading in recent years with some of the larger emerging economies like China reaching a higher level of economic maturity. In order to follow the pattern of development that many of today's developed market economies like Japan underwent, it is anticipated that today's emerging market countries will need to transition to economies where GDP growth is increasingly driven by the consumer.

This paper presents Frontier's observations from numerous meetings with emerging markets and global equities managers during a recent equities oriented global research trip. During the trip we travelled to Singapore, Edinburgh, London and Paris meeting with investment managers specialising in the Asia-ex Japan region, emerging markets and global equities. We explored the notion of whether the emerging consumer will drive emerging markets growth and, if so, we sought to understand the best way to benefit from an equity investment perspective.

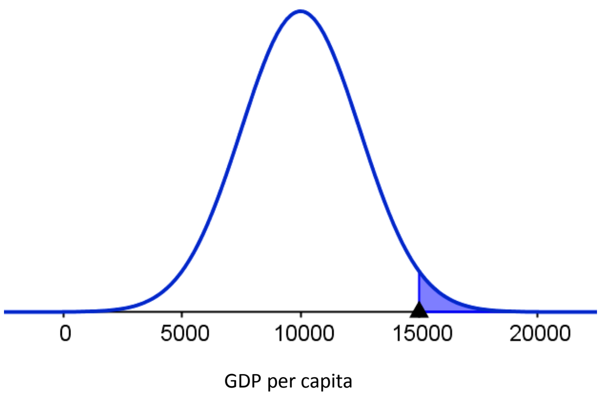
Background - Acceleration phenomena and S-curves

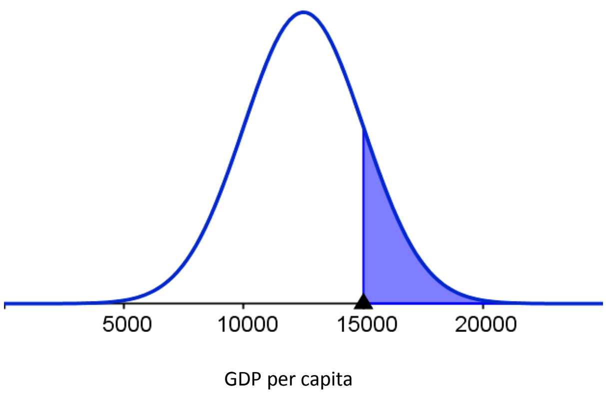
As emerging markets consumers become wealthier their consumption patterns change drastically with discretionary spending often increasing hundreds of percent (off a low base). This is termed the acceleration phenomena and is illustrated in the following stylised normal distribution plots.

In chart 1, the first plot shows a normal distribution of income in a given country with a mean income of $10,000 (and standard deviation of $2,500). The shaded region displays the proportion of the population with an income over $15,000, which in the case of the first plot is 2.3%.

The second plot shows the normal distribution of income a few years later after strong GDP per capita growth (real GDP/ capita growth of around 5.5% p.a. for four years) with the mean income now at $12,500 (and unchanged standard deviation of $2,500). At this level the shaded region displays the population with an income over $15,000 to have increased to 15.9%, a seven-fold increase in the population earning over $15,000.

Chart1: Stylised analysis of acceleration phenomena





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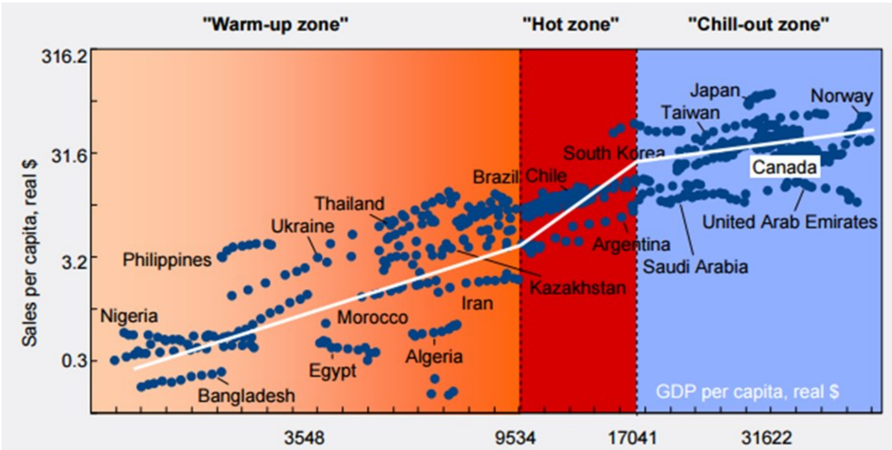
This acceleration phenomena results in S-curves across multiple discretionary products with Chart 2 illustrating sales of skincare products per capita across various countries and their level of GDP per capita.

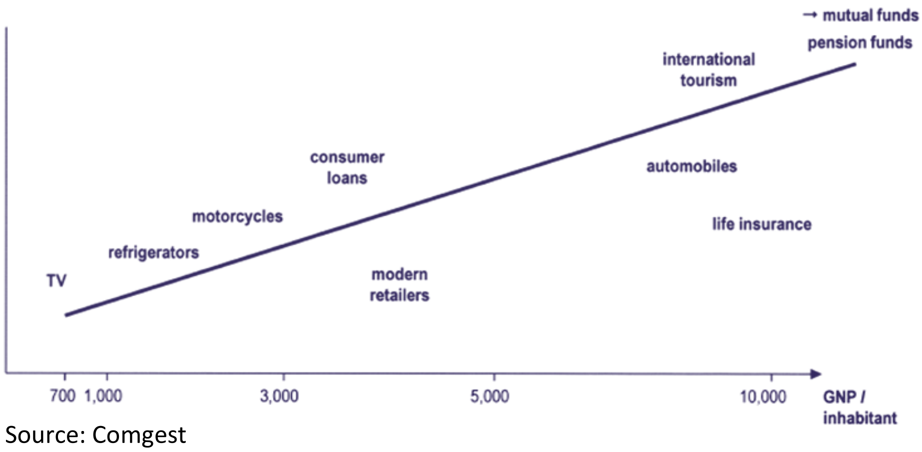
Within the hot-zone, where GDP per capita increases by around 100%, sales per capita on skin care increase by 1,000%. Although the image displays the example of skin care, similar S-curves exist for a host of discretionary products.

Chart2: S-curve as it applies to the skin care segment



Source: McKinsey & Company

Chart 3: Historic observations of threshold effects (S-curves)



Source: Comgest

Chart 3 provides an estimation of when certain products/services enter the S-curve. For example, with a GNP per capita of less than US$800 very few consumers have a refrigerator, however when GNP per capita increases to around US$1,500 the majority of the population has one.

A key takeout from the chart is that S-curves across various products tend to occur at different levels with ownership of relatively basic necessities (like refrigerators) occurring earlier in a given economy's development and uptake of higher order products/services (like mutual funds, international tourism etc.) being experienced considerably later.

Observations and insights

The emerging consumer will drive future GDP

Across our multiple discussions, each of the managers we spoke to concurred the consumer will lead emerging markets economic growth over the longer term.

This is very much a consensus view with a high level of confidence expressed by managers.

It was felt that capital investment would be a lesser component on GDP than historically and exports would be less significant than the domestic emerging markets consumer.

However, the importance of developed markets consumers was also recognised.

Developed markets consumers remain a key customer for emerging market manufacturing output, which is increasingly making its way into high-end products aimed at developed markets consumers.

Examples of this include components/ assembly of high-end cars, and other consumer products like iPhones, iPads and fashion apparel.

Well known stable consumer stocks may not be the key to returns

From an investment standpoint, making accretive investment returns from the emerging consumer theme was viewed as considerably more complicated.

Purchasing stable consumer stocks in food and beverage manufacturing may be direct and intuitive, however, managers consistently stressed this was not always the best way to benefit from the growth of the emerging consumer. This is due to a number of reasons including:

- Valuations – valuations in sectors with positive dynamics can become excessive from time to time in all markets. Many managers felt defensive stocks (including the more stable consumer stocks) are currently trading at elevated multiples in all markets, but at potentially extreme levels in emerging markets.
- Rising competition and industry dynamics - the emerging consumer growth theme, particularly in Asia has drawn a lot of competition, such that profit margins of Asian consumer stocks have been in decline.

Bottom up insights to exploit theme

Across the managers we met with, there was a preference to identify the most compelling sub-industries that were indirect beneficiaries of the emerging consumer theme, yet still appeared likely to follow the pattern of S-cuves. Several market segments/themes discussed included:

1. Health: rising incomes are correlated with improving life expectancy through higher quality food consumption and better healthcare facilities/services. As consumer expectations for life expectancy increases, consumers tend to in increase their focus on preserving quality of life in its later stages. Individuals gain a focus on health and fitness and seek healthier lifestyles supported by health supplements and more sports and fitness activities. From an investment perspective, this theme can be accessed via hospital operators, pharmaceuticals, health supplements, sports/active living apparel and other associated industries.

2. Financials: as economies develop, markets for more sophisticated financial services become more pervasive. This is not unexpected as increased household income results in increased demand for investments and products aimed at preservation and improvement of lifestyle for individuals and family members.

   In addition, consumers become more comfortable with debt and the potential to realise aspirational endeavours including pursuing business ventures or seeking to acquire luxury items via credit card debt, auto loans etc. From an investment perspective, this theme can be accessed via many parts of the financial services industry including banks, brokers, insurance providers and increasingly technology oriented financial services like mobile payments, mobile money transfers etc.

3. Leisure: As consumers' income increases, they often experience an increase in leisure time by cutting down on hours worked. Part of this excess free-time tends to be consumed with entertainment oriented leisure activities like cinemas, tourism, and increasingly, online social networks and gaming. From an investment perspective, this theme can be accessed via investing in cinema operators, theme parks, travel agencies, hotels, airlines, infrastructure, social networking service providers, mobile gaming companies, casinos as well as enablers like device manufacturers, component manufacturers and telecommunication companies.

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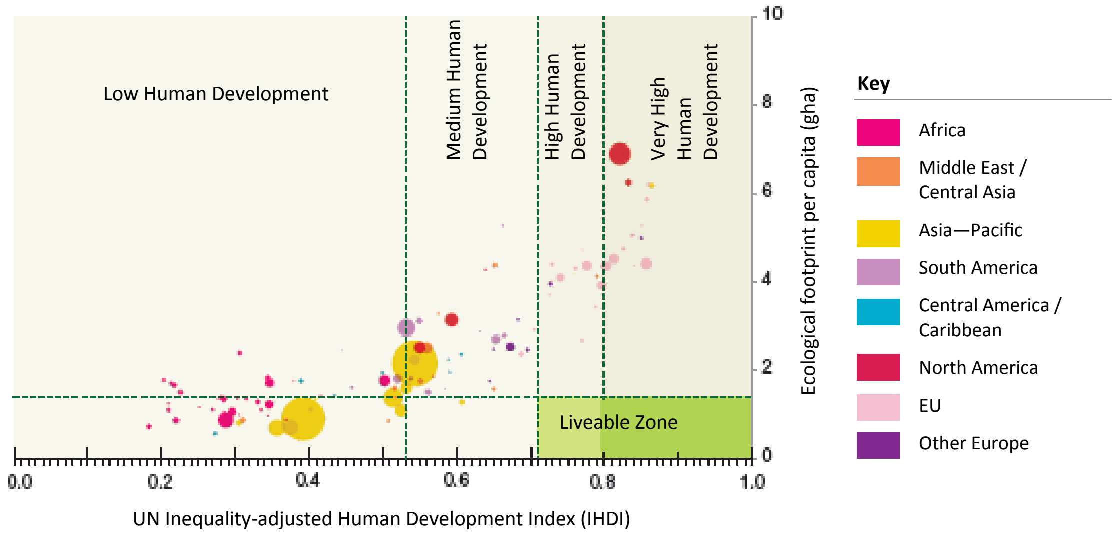
Risks

Most managers don't consider the risks to the continued growth of the consumer in emerging markets to be very high over the long term. Although there was strong consensus on the view the consumer would increasingly drive emerging market GDP growth, there was considerable dispersion in what the Managers considered to be possible risks to this occurring. The main risks discussed included the potential for social and political instability and cross border aggression/conflict. The more interesting and unique risks presented were based on:

- Moral development and education – Increasing wealth can be constrained by environments with high levels of inequality, crime, corruption, low confidence in the judicial system etc. These factors are considered to be a risk to society in general as they can trigger social unrest, revolution and ultimately retard aggregate economic growth. Education was seen as an equaliser within society, allowing the less fortunate to compete with the privileged and assisting to develop a stronger moral fibre within an emerging market.
- Sustainability – the notion that the Earth is unlikely to be able to support a considerably larger population living to the standards (including biological footprint) commensurate with the west today. This is illustrated in Chart 4. In addition, it has been shown that diseases associated with higher calorific consumption like diabetes can hamper the progress made to lift families/ communities out of poverty.

Chart 4: Human development index and ecological footprint



Source: Living Planet Report 2014

Conclusion

During this trip, we explored the notion the consumer will increasingly drive emerging markets growth and spoke to numerous investment managers about the best way to exploit this from an investment perspective.

The managers consistently agreed with the view from a thematic/top-down perspective, but differed in how this might be capitalised on to deliver an attractive investment return. The majority of managers agreed that a direct exposure via investing in the more stable consumer sectors of emerging markets countries was potentially ineffective due to a number of reasons like valuations and increasing competition.

Instead, managers regularly suggested alternative, indirect means to access the theme by discussing opportunities in health, financial services and leisure, which were regularly preferred over more stable consumer stocks.

Most managers didn't consider the risks to the continued growth of the consumer in emerging markets to be very high over the long term and there were varied responses on what those risks might be.

We felt our discussions highlighted that manager knowledge and expertise will be important to generate compelling investment returns from the rise of the emerging markets consumer. Also, that exploiting the theme is not simply about buying the most obvious and stable consumer stocks.

Our preferred means to capitalise on this theme is via specialist active emerging markets managers that are able to apply their investment philosophy to this insight and demonstrate a thorough understanding of the underlying markets, industries and consumers.