Investing in emerging markets

June 2016 | FEATURE | FINANCE & INVESTMENT

Financier Worldwide Magazine

June 2016 Issue

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BY

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During the strains and stresses of the financial crisis, the world's undeveloped nations proved a safe haven for investors. Flush with resources and opportunities, emerging markets such as Brazil, Russia, India, China and others were the ideal destination for beleaguered investors.

For years, the emerging markets experienced astronomical growth and development. Infrastructure projects were announced and completed, financial hubs developed and a consuming middle class emerged. For a while, the emerging markets were posited as the next influential force in global business and economics.

Yet in 2016, the rapid ascent enjoyed by many of the emerging markets is now a thing of the past. Brazil is in the midst of its worst recession in living memory and gripped by a political corruption scandal. Russia is beset by financial and geopolitical difficulties. China is wrestling with a substantial economic shift as its ruling class re-tools the national economy away from manufacturing and production toward a service based economy. Though China's economy is still growing at a pace that many western leaders would happily accept, it is a shadow of what it was just a few years ago.

Though the stratospheric growth experienced in the emerging markets was never going to be infinite, the scale and speed of the decline has been eye opening. And investors, in recent years, have responded by shunning emerging markets and diverting their capital elsewhere.

This reversal in fortunes is reflected in declining inbound M&A. KPMG International's Cross-border Deals Tracker recorded a 3 percent decline in developed to emerging market deals last year, including a 50 percent drop in developed to emerging market activity in China. Much of the decline in investment into China from developed markets relates to the difficulties foreign firms encounter when entering the Chinese economy. Although it is a global powerhouse, the growth of the country's economy does not really translate into viable investment opportunities for overseas investors, according to Peter Fuhrman, chief executive officer of China First Capital. China's unwillingness to allow foreign investors into its financial markets and currency act as considerable barriers to international investment. "As long as this situation persists, China will likely continue to be rather unfriendly terrain for global capital," says Mr Fuhrman. "The result is that the non-Chinese world's investment institutions remain under-allocated to China. Its economy and capital markets are the second-largest in the world. But that size doesn't translate into genuine global financial clout."

BRICS and beyond

Given the scale of the opportunities available to investors, it is imperative to think beyond the traditional BRIC nations – Brazil, Russia, India and China – when considering the developing world. Though it is true that the BRICs have dominated the discussion around emerging markets since the acronym was first used in 2001, they have suffered more than most over the last few years and other developing nations have risen to prominence and attracted considerable investment.

Countries like Mexico – which has enacted internal reforms to make it more attractive to investors – have risen out of the ashes of the BRICs. For every Brazil and Russia there is a Mexico and Philippines. While some of the BRICs have stumbled in recent years, a number of non-BRIC nations have driven emerging market growth. ASEAN and GCC countries have made great strides, as have a number of Sub-Saharan African states. Indonesia, Nigeria, Bangladesh and Pakistan have also seen considerable activity. Mexico has emerged as a burgeoning Latin American powerhouse. According to a new study by the IE Business School, Mexico is the top investment destination in Latin America, and this optimistic outlook is supported by a recent announcement by Ford Motor Company which will be expanding into Mexico, creating 2800 new jobs by 2020. The country has also attracted considerable attention – and investment – from Asian investors of late.

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Chile, too, has seen a rise in foreign investment. Its economic performance has been far from stellar in recent years – the country's GDP has failed to recover from the steep slowdown seen in 2014-2015 – yet it has remained attractive to foreign investors. For Francisco Ugarte, a partner and co-head of corporate M&A at Carey, there are a number of reasons for the uptick in dealmaking activity in the country. "Among the most relevant reasons is the large currency depreciation that emerging markets have experienced, posing their assets at cheaper prices in dollar terms," he says. "In Chile, for instance, $1 was 549 pesos about two years ago, whereas today $1 equals 661 pesos. Also, the current lacklustre market conditions make, in-house investing projects look less attractive and as a result industry consolidation cycles are triggered in search of greater operational efficiencies. We have seen this in Chile. A few examples are the US$600m acquisition of Cruz Verde by Mexican Femsa and the US$1bn acquisition of 50 percent of Zaldivar by Antofagasta Minerals."

Turning the tide

Despite the headwinds prevalent across developing nations, it would seem that investors are slowly returning to emerging markets. In March and April alone, around $10bn of capital entered the emerging markets – a reversal in fortunes when compared with 2013-2015 which, according to research from Bank of America Merrill Lynch, saw $103bn leave emerging market debt.

Much of this resurgence has been predicated on a number of factors, including low valuations, currency movements, diversification and commodity prices which have risen gradually since February following persistent declines over the last two years. Furthermore, investors have been drawn back to emerging markets by expectations that the Federal Reserve will raise US rates in 2016 fewer times than previously thought.

Argentina, too, has contributed to the emerging market resurgence. In April, it issued debt to the international capital markets for the first time since its default in 2001, selling $15bn in the biggest single issuance of debt from an emerging market country, according to Dealogic.

One key stock index for emerging nations, the MSCI, is up 6.5 percent so far in 2016. That is markedly better than European markets, and ahead of the recent turnaround in US markets. "If valuations continue to be attractive relative to overall market conditions, deals will continue to be made," says Wael Jabsheh, a partner at Akin Gump. "For the time being, as long as global markets remain stable and the cost of capital remains low, investment in emerging markets should not significantly subside."

According to the Institute for International Finance, foreigners ploughed some $36.8bn into emerging stocks and bonds in March 2016 – the highest inflow of capital in nearly two years and well above monthly averages for the past four years. Investors were especially drawn to Brazil's equities, due to attractive valuations and hopes for political change in the wake of the ongoing corruption scandal and potential impeachment of President Dilma Rousseff. Investors also sought out emerging markets as commodity prices slowly began to rebound and confidence grew that the Fed was on a slower path to raise interest rates.

Although there have been fears around the performance of emerging markets of late, there are many reasons why companies should not abandon the developing world yet. By taking a nuanced, measured approach, investors can still benefit. They must adopt a more studied approach, taking into account a number of factors including location, sector and risk-hedging strategies.

Patience will also be key for companies pursuing deals or investments in emerging markets. The rapid decline of prices may serve as a beacon for firms to dive in. Currently, emerging market stocks are trading at lower prices than developed stocks, but may not have bottomed out. Furthermore, prices may not be low enough to offset the high risk of investing in some markets. Nevertheless, the developing nations, with their burgeoning populations and nascent middle classes, are the future of global economic growth.

Local focus

For companies looking to invest in emerging markets, there are a number of precautions they must take. Chief among these is tapping into local knowledge and experience. Without embracing local experts, investors risk misunderstanding local business culture, which may be very different to their own. Equally, by utilising local expertise, investors can speed up processes and improve communications. "Local knowledge for investing in emerging markets is fundamental," says Mr Ugarte. "Developed economies tend to be alike but each developing economy has its own rules. Several failures have happened when companies from developed markets operate in the developing world assuming certain rules as theirs. Successful deals in developing markets require knowledgeable local advisers, local insiders and usually a mix of local-foreign management capacity. Collaboration is likely to play a vital part in the successes – or failures – of many organisations' efforts in the emerging markets." As such, engaging with local talent and drawing on their knowledge and expertise is a step which investors should not overlook. Acknowledging that the cultural gap varies tremendously between countries does also help. "Chile, which has a free market economy and a good political stability index, is impregnated with western business culture, which in turn makes the country much more predictable for investors that relate to similar values. This partially explains the economic success we have seen in past years", says Mr Ugarte.

Local experience can provide investors with an insight into issues which they might not otherwise have taken into consideration. "When investing in new markets, investors can sometimes fail to appreciate some of the intangible factors involved in their deals," says Mr Jabsheh. "The political and cultural dimensions of the market and the business in which you are investing are just as important to understand as the legal and regulatory dimensions. While clearly there is no substitute for conventional due diligence, investors often overlook these less tangible factors because they are not necessarily top of mind when those investors do deals closer to home," he adds.

Future prosperity

The end of the commodity boom has dealt a significant blow to the economic prosperity of the developing markets. But all is not lost. Many developing markets will continue to prosper, although that will be relative. "China provides proof that investment returns do not correlate neatly with GDP growth," says Mr Fuhrman. "While the Chinese economy will add $600bn in new output during 2016 – more than the entire GDP of Taiwan – it remains a place where global investors' hearts are routinely broken. It's proven so hard consistently to make money there."

Yet China is stabilising. Although only 2.8 percent growth was recorded in the Chinese stock market, all is not lost. Since February, the economy has been relatively stable, with the Chinese economy in the midst of a huge transitional period, moving away from domestic stimulus and infrastructure development toward a more 'Western' model of relying on domestic consumers and urbanisation. The fact that China's financial markets and currency are still out of bounds for non-Chinese investors acts as a roadblock, according to Mr Fuhrman; nevertheless, it makes sense for investors to keep China on their radar.

Emerging market investment will continue to be a risky business. Political and economic risks are a fact of life when operating in certain emerging markets, and investors must be mindful of the risks inherent in pursuing opportunities. But for those investors with the requisite appetite, there may yet be rich rewards.

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