SKERRYVORE GLOBAL EMERGING MARKETS EQUITY STRATEGIES

Investing in Emerging Leaders

May 2025

Skerryvore
ASSET MANAGEMENT

Investing in Emerging Leaders

'I skate to where the puck is going, not where it has been'

Wayne Gretzky

HAVE GLOBAL EMERGING MARKETS BEEN LIBERATED?

The Trump administration's extraordinary new tariff regime, announced on 2 April 2025, has set in motion a significant shift in the post-war international trade system. Although the initial pronouncements may be seen as mere negotiating ploys, they represent a seismic shift in global leadership. The United States, the architect and anchor of a global economic and financial system that had its roots in the Marshall Plan, has renounced its willingness to guide, lead and protect its economic partners and geopolitical allies. The cost in terms of its persistent trade deficits, wealth inequality and de-industrialisation is no longer a price that its electorate is willing to pay. In echoes of the United Kingdom's referendum on Europe in 2016, America has potentially 'Brexited' itself from the rest of the world.

What makes this moment even more pivotal from an investment perspective is that the United States is seeking relative isolation at a time when global asset owners and institutions have fully embraced and cheered its long-term exceptionalism. Even though international revenues contribute 30% of S&P 500 revenues[1], and up until very recently the United States had never been more highly valued or attracted so much of the world's equity investment, the United States has imposed significant barriers to trade on itself.

This juxtaposition presents a real opportunity for a change in the investment landscape of the past 15 years. Leading global emerging businesses can be liberated from a financial and technological regime that has benefited those businesses that prosper in times of frictionless trade and the reinforcing power of winner-takes-all network effects. For years, this dynamic drove both the businesses and the market capitalisation-based indices that house them. But now, with the United States less willing to accept the responsibilities imposed by its self-appointed role as Goliath, other markets and investments can vie for the role of David.

EMERGING ECONOMIC LEADERSHIP

Economically, global emerging markets have punched above their weight for a while. Although the global equity markets' centre of gravity has shifted ever westward over the past decade, economic activity has shifted eastward and has broadened significantly. Emerging markets represented 50% of global GDP in 2023 and 57% of global GDP growth in the 10 years between 2013 and 2023[2]. This is expected to rise to 67% by 2035[3]. Such growth will be driven mainly by emerging economies in Asia-Pacific, including China, India, Vietnam and the Philippines. By 2035, India will be cemented as the world's third-largest economy, with Indonesia and Brazil ranking eighth and ninth, respectively – (*see figure 1 overleaf*).

KEY EMERGING MARKETS WILL RANK IN THE TOP 20 LARGEST ECONOMIES BY 2035

2035 projection of top 20 economies by nominal GDP (US$bn)

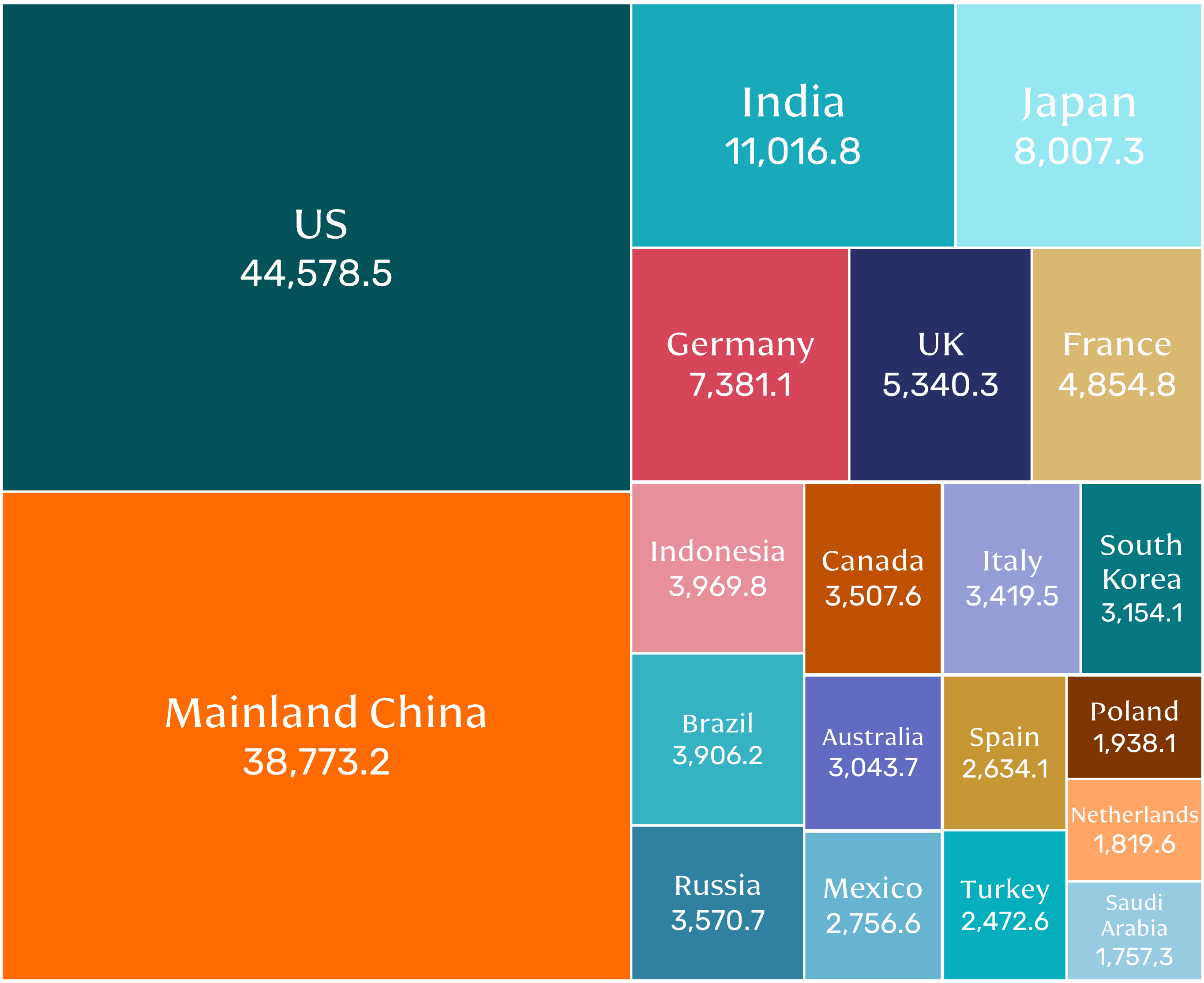

Figure 1. Predicted top 20 global economies by 2035.
Source: S&P Global, data collected September 1st 2024

EMERGING IN-MARKET TRADE

One more immediate tailwind for the emerging world is the likely growth of in-region trade. Skerryvore's Edinburgh base and familial links to Ireland for some members of our investment team mean we are only too aware of what can happen when one country decides to place barriers between itself and its largest trading partners. This is because capital flows to where it is treated best, and there is always someone willing and able to step in to fill a competitive vacuum. The Republic of Ireland's GDP per capita has almost doubled since the United Kingdom announced that it was leaving the European Union in 2016[4], whereas GDP has stagnated in Britain. We have also seen this dynamic play out after the Covid crisis, with a number of industries adopting a 'China plus One' supply chain. This has benefited the likes of India, Mexico and Vietnam. For example, Apple now produces 14% of its products in India, a percentage that is only likely to increase during this latest round in the trade war between China and the United States.

LOVE THY NEIGHBOURHOOD

Intra-emerging and developing Asia trade, % total trade

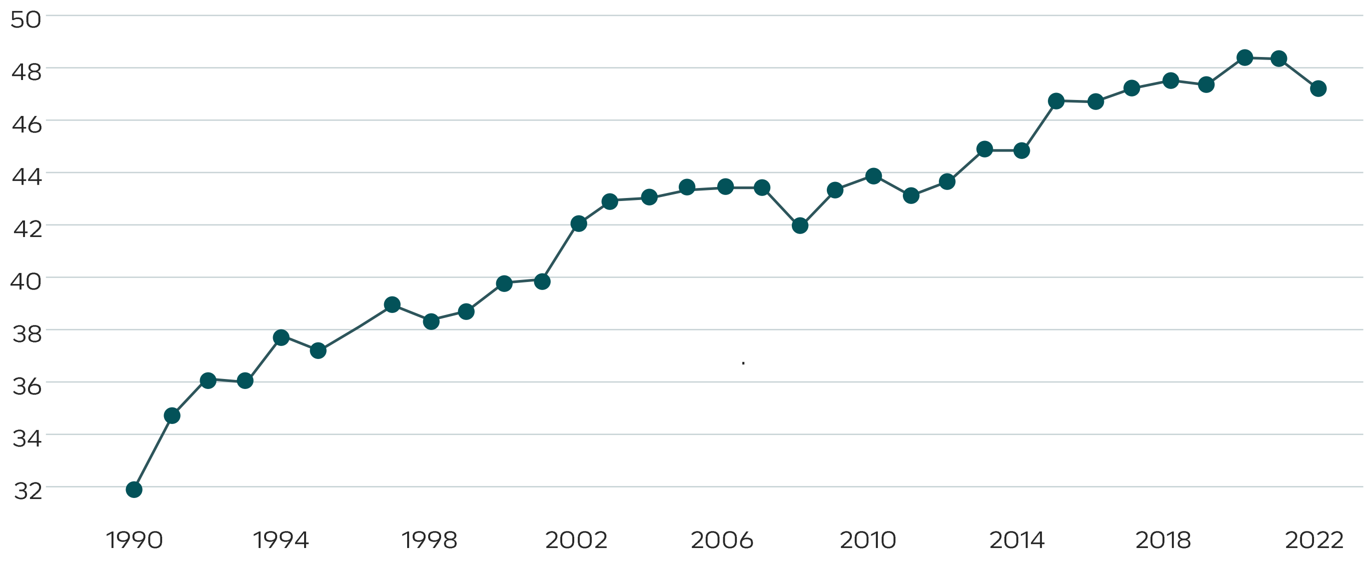

Figure 2. The growth of in-region trade in Asia.
Source: Asia Regional Integration Center; Economist Impact calculations

Recent investment patterns corroborate this trend, as can be seen in figure 2. Emerging markets, alongside developing ones, are investing more and trading more within their neighbourhoods. Intra-regional investment across emerging Europe grew by around 18%, and trade within the Americas (excluding the United States) saw a 27% increase between the 2015–2020 and 2020–2022 time periods. While Asia's intra-regional investment decreased over the same period, trade between the developing economies of the region experienced a boom. In 1990, about 32% of the trade of emerging and developing economies in Asia was intra-regional, yet by 2022, this share had climbed to 47%. This shift, underpinned by a distancing from emerging and developing Asia's reliance on western markets for growth, could be a long-term opportunity for global emerging businesses.

EMERGING BUSINESS LEADERS

A key reason we enjoy spending our time picking stocks in emerging markets is that from a bottom-up perspective we can see an increasing number of dynamic and leading businesses that would happily grace a global stage. The likes of **Advantech, Mercado Libre, Bank Central Asia (BCA), Cipla** and **Hindustan Unilever**, to name but a few, all have the necessary qualitative and financial characteristics to become emerging global leaders. Our contention is that they are likely to do so in the coming decade. In fact our investment philosophy and process are designed to ensure that we can stand behind our belief that you don't have to make any compromises in terms of quality of the businesses you own to invest in the developing world.

An emerging banking leader: Take our current largest holding, **HDFC**, for example. The bank has compounded its book value growth by over 21% per annum since its inception in 1977, while writing off only a cumulative 28bps of its loan book through that entire period[6] – a lending record that would put most developed market banks to shame! This globally leading lending culture is attached to, and able to profit from, an attractive long-term demand environment for its loans and financial products. The real estate industry in India is expected to double its contribution to economic growth over the next two decades[5], driven by increased urbanisation and a growing middle class. India's urban population is expected to reach 600 million by 2030, and the home loan market is expected to grow at 15% per annum over the next decade, supported by rising incomes and government-backed initiatives[6]. With this industry tailwind in mind, we can make what appear to us conservative assumptions about future growth for HDFC and still envision a business and market capitalisation that will put this bank above globally leading banks such as Bank of America, Royal Bank of Canada and China Construction Bank. Assuming that HDFC grows in line with the industry for the next five years, and then at 10% for the latter part of the next decade, it has the potential to be the world's third-largest bank by today's measures even if we take a 40% haircut to the current price-to-book multiple. What this demonstrates is that investors in the developing world need to have confidence in the incredible power of compounding and not get in its way.

SPARKLING DRINK SERVINGS PER CAPITA - 2023

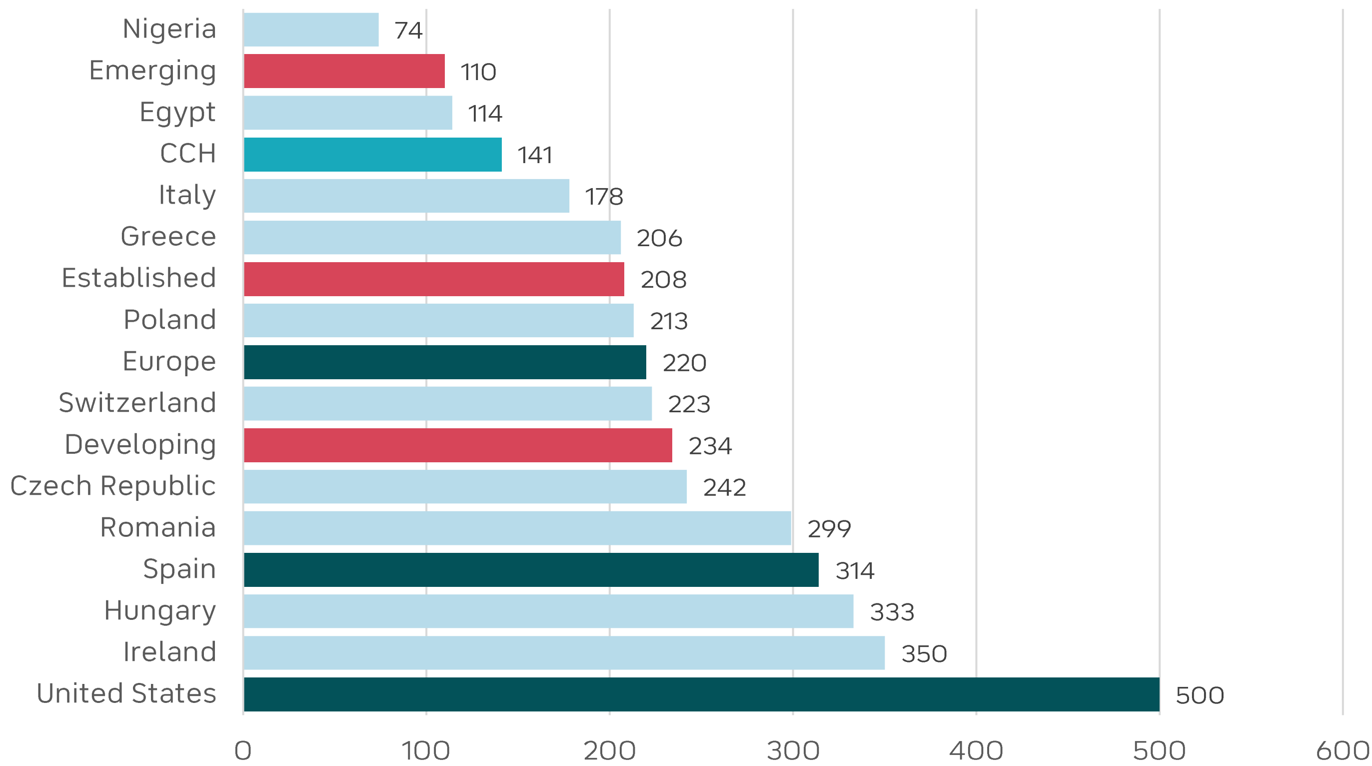

Figure 3. Per capita consumption in Coca-Cola HBC's territories.

Emerging global brands and local leaders: The process of bottling and distributing sparkling beverages may not have the intuitive kerb-appeal of a technology business or luxury goods company, but their ability to grow and compound revenues and profits for the long term make them exciting long-term investments. These businesses combine attributes that we prize – alignment, pricing power and resilient growth. The Coca-Cola Company, headquartered in Atlanta, owns and manages a portfolio of brands. It is a global leader in consumer brand management and has 30 brands that generate over a billion dollars in revenues each. The bottlers benefit from customer captivity through the brand's pricing power and pervasive consumption habits. Consumers around the world associate Coca-Cola with quality, consistency and refreshment, and this entrenched brand loyalty makes switching to a competitor difficult, especially in impulse-driven purchases (e.g. vending machines, corner stores, restaurants). And, just as important, bottlers control the route-to-market infrastructure, which forms the backbone of customer captivity. Over decades, they have built intimate, hard-to-replicate relationships with local retailers, kiosks, restaurants and supermarkets.

These relationships are not just about delivering crates – they involve inventory management, equipment placement (e.g. coolers, dispensers), credit terms and tailored promotional activity. This deep customer integration acts as a switching cost, both for retailers and for Coca-Cola itself. It would be extremely costly and risky for any new entrant – or even the parent company – to replicate these capabilities at a local level, which ensures exceptionally strong alignment between the Coca-Cola Company and its bottlers.

Bottlers like **Coca-Cola HBC** and **Coke FEMSA**, which are owned in our strategies, also benefit from their emerging and frontier market footprints, which are often underpenetrated in terms of per capita consumption of non-alcoholic beverages. As incomes rise and modern retail expands, volume growth follows. These companies are poised to benefit from both premiumisation and market expansion. Furthermore, their geographic diversification allows them to offset volatility in any single market. For example, Coca-Cola HBC's exposure to Nigeria (a long-term growth story) is balanced by stable cash flows from central and eastern Europe. The long-term growth opportunity is a significant one. Per capita consumption of soft drinks in Nigeria remains the lowest out of all of HBC's 28 territories[7], as can be seen above in figure 3.

We view Coca-Cola bottlers not as commodity beverage producers but as regional monopolies with entrenched customer relationships, scale-driven cost advantages and deep operational moats. Their success is not driven by disruption, but by strategic execution within protected zones of competition, and this should both protect and sustain long-term profit growth and investment returns.

An emerging industrial leader: WEG was founded in 1961 in Brazil and takes its name from the initials of its three founders, whose families still control the business. WEG is one of the world's leading producers of electric motors, which are used in everything from a small electric fan to a large high-voltage power turbine. Low cost was important in WEG's early days but its long-term success in this field was forged by building customer trust in its products. Over the years, WEG's engineering proficiency has led to continuous improvements in the energy efficiency of its motors and enabled the company to move into adjacent markets such as transformers for power distribution. In recent years, their knowledge leadership in electric motors and power transmission has given them an early-mover advantage in several exciting new renewable energy-related product segments, including electric vehicle charging, energy storage solutions, solar equipment and wind turbines.

WEG has an engineering-led culture that strives to provide the best products in a particular niche. A reputation for reliability and a culture built on partnership with its network of distributors and customers have allowed its firms to become leaders in new growth markets.

Success has not been the result of undercutting rivals; instead, it has been about creating a loyal customer base that meant they themselves weren't undercut and has led to increased market share in the low-voltage AC motor segment. WEG is seen as an emerging competitor to the likes of ABB and Schneider Electric. Across the emerging market space, there are many low-cost leaders. We continue to search for those that, like WEG, can take the next step by turning a low-cost opportunity into a long-term sustainable competitive advantage.

SKATING TO WHERE THE PUCK IS GOING

This paper does not have space to do justice to the opportunity that we see ahead of us. In many ways, that's what the portfolio is for. It is also important to point out that we have purposely not singled out areas where the developing world already has clear global leadership. For example, **TSMC** is the poster-child of what a founder-led business that focuses on innovation and a deep commitment to through-the-cycle capital investment can achieve. It dominates the global semiconductor foundry market with a market share six times greater than its nearest competitor Samsung[8] and it has been a rewarding investment for its equity holders. Importantly, we believe that TSMC is at the vanguard of a journey that other emerging leading businesses will follow and that global asset owners and investors will come to appreciate.

In many ways these businesses and their valuations have been overshadowed by the sheer might of the US equity market. There is now a distinct possibility, however, that the puck is travelling in a different direction. It is unlikely to be a simple or straightforward journey, but it should be a rewarding one and we recommend having the patience to invest with optimism in the developing world.

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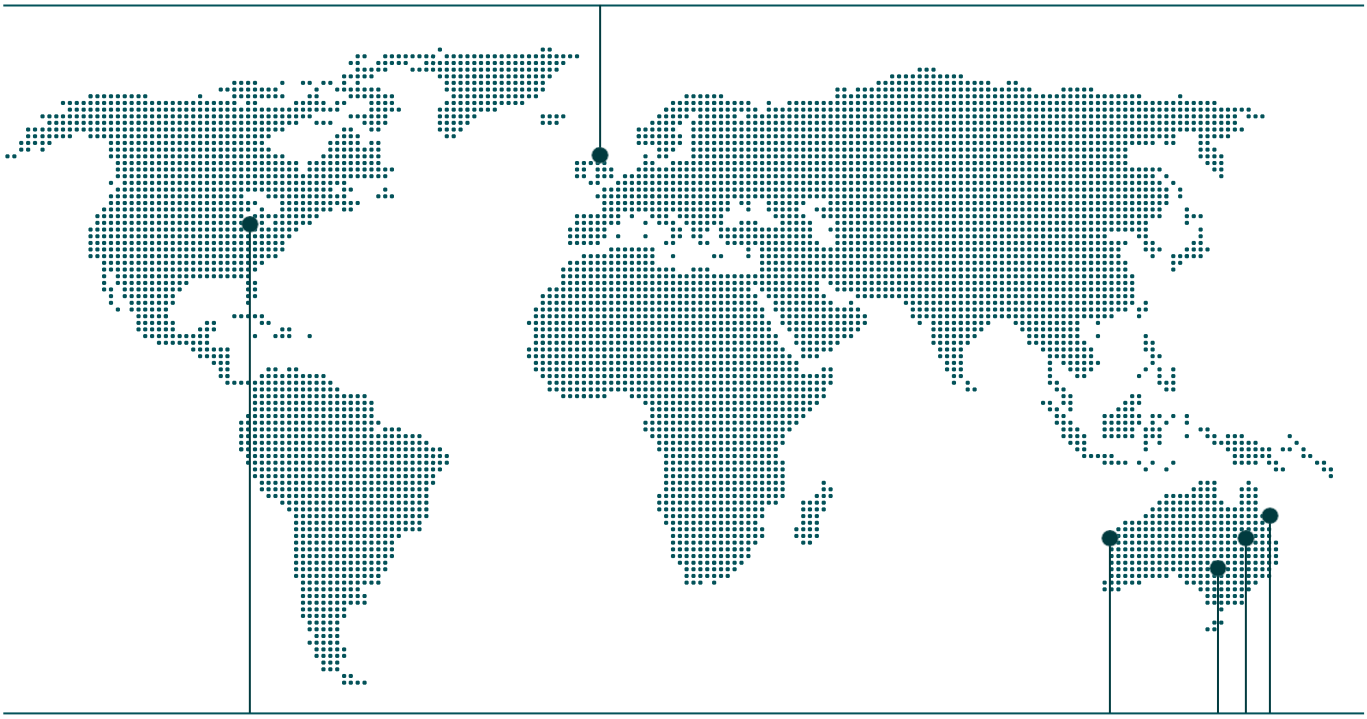

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