Growth and Income Investing in Emerging Markets

August 2018

Developments in corporate governance, maturing economies and changing demographics are leading to companies in emerging markets (EMs) paying out higher dividends to shareholders. As bottom up investors looking for growth in these markets, we believe that companies that generate sufficient cash both to reinvest in the future growth of their businesses and return what remains to shareholders as dividends are preferable to those that hoard excessive cash and those low growth companies that lack reinvestment opportunities. In addition, we look for management teams who regard the company assets as belonging to all shareholders, not just to some, e.g. the founding family, the state or management itself.

Whereas 20 years ago EMs were characterised by generally poor governance, over the last two decades there have been gradual but widespread improvements. One catalyst to this was the Asian financial crisis of 1997-8, which discredited a model in which controlling shareholders – whether families or governments – were often able to do more or less as they pleased with assets which belonged to all shareholders. They had hitherto got away with it due to the rapid growth in these economies in the booming period of the mid-1990s. Following this crisis, foreign investors became more aware of the benefits which could accrue from improved governance and started to exert pressure on companies.

Over this period, the growth rate of many countries has slowed as they became wealthier. For example, Korea and Taiwan (the second and third largest EMs by market capitalisation) were growing at 6-8% prior to the Asian crisis, but are now growing at closer to 3%. At the same time, population growth in most countries is falling, in some cases sharply. As a result, the high capital spending, debt-fuelled corporate model, which aims to capture or at least maintain market share in a rapidly-expanding economy, is no longer appropriate for most firms. It has broadly been replaced with one focusing more on cash flows and financial prudence.

An example of this dynamic is Samsung Electronics, one of the very largest EM companies. For decades this was seen as a high growth company, generating returns but ploughing them back into the business. The last few years there have been four factors at play which have led to a very different approach. Firstly, the growth rate of its core businesses – notably, mobile phones – has slowed. Secondly, the company's shareholders are largely foreigners, many of whom (including ourselves) have spoken to management about the need to improve returns. Thirdly, the Samsung group is undergoing a restructuring due partly to generational asset transfer issues. Finally, there is increasing pressure from domestic stakeholders, from local shareholders to President Moon Jae-In, who recognise that increased dividend payouts will help longer term funding for pensioners in Korea.

The table below shows how Samsung's dividends have increased in recent years:

Year	Dividend Amount Payable (Korean Won)	
2018	₩	1,138.00
2017	₩	970.00
2016	₩	420.00
2015	₩	410.00
2014	₩	286.00
2013	₩	160.00
2012	₩	110.00

Source: Morningstar and Fiera Capital

The consequence has been a fall in the capex/sales ratios in most economies, including the five largest markets. Furthermore, an increasing part of the returns from equity investing in EM is coming from dividends as opposed to capital gains. As the chart below shows, a quarter of the returns in the last decade have come in the form of dividends paid to shareholders, a ratio which has widened over the last six or seven years.

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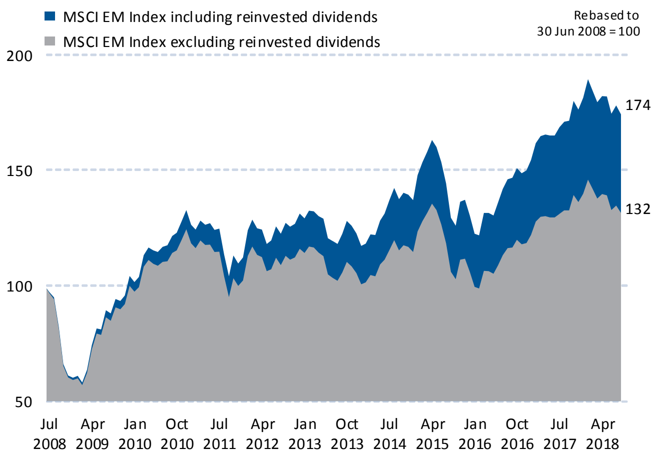

Source: MSCI and Fiera Capital

In our view, a portfolio investing in high quality, growing companies who treat the company as belonging to all shareholders and who provide them with a consistently rising income stream should produce strong compounding returns over time. Companies of this nature are increasingly to be found in emerging markets.

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The opinions expressed in this document are those of the author.

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