

## The Emerging Markets Consumer



### Evolution and Premiumisation

Of the world's 7.7 billion people, almost 7 billion live in emerging and frontier countries. Between now and 2030, the United Nations expects them to account for almost all of the additional 800 million, while 90% of the new entrants into middle class status around the world will come from emerging Asia<sup>1</sup>.

Some of these economies are growing rapidly. India's economy, as measured by wealth per adult, has expanded fourfold in the last 18 years. This is impressive, but pales by comparison to China, where the same metric has increased a staggering 11-fold. Private consumption is the largest component of most economies, usually by some distance. In most cases, the

share of consumption rises as they become wealthier, with the move from agriculture to manufacturing and then to services. This pivot towards domestic demand means that these countries are less affected by a slowdown in global trade than would have been the case in the past. As economies develop, consumption patterns will change.

<sup>1</sup> Source: Fiera Capital; International Monetary Fund, World Economic Forum, regional and country demographics retrieved from the IMF DataMapper, as of end December 2018 and Caixa Bank Research.

### China in The 1980s



### The Pace of Growth...

On our early visits to China, the streets were full of bicycles. In much of southern Asia, the urban soundtrack is that of a motorbike engine. In wealthier countries, the streets are clogged with cars. Each shift – from bicycle to motorbike, from motorbike to automobile – means higher ticket prices but also different accessories and a substantially higher insurance premium. The emerging landscape is continuously shifting.

### Modern Day China



Three decades ago, the equity benchmarks were dominated by the resource-rich economies of Mexico and Malaysia. They are now dominated by the four Asian giants – China, India, Korea and Taiwan. However, these latter two are now at per capita income levels of developed economies. The five countries in the world with the largest growth in working population are all either emerging or frontier markets. India, Pakistan, Nigeria, DR Congo and Ethiopia are together expected to add almost a billion people to their populations between 2015 and 2050.

Not all of these economies will succeed, but it is possible that in three decades countries such as these, as well as Vietnam and Bangladesh, will be an integral part of the emerging markets opportunity set.

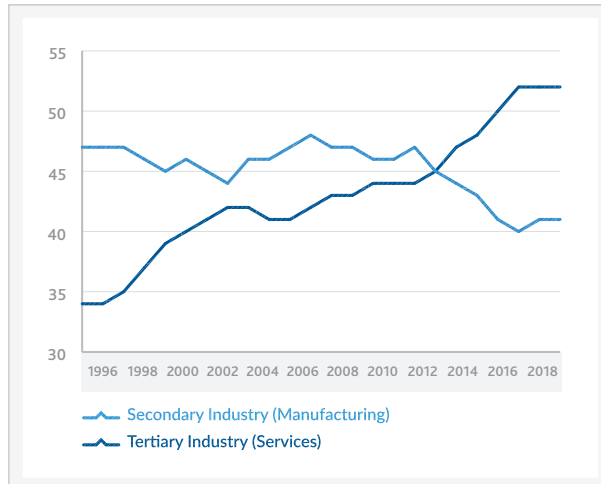
**This Insight looks at the boom in emerging market consumption, a trend that sees those at the lower end of the wealth pyramid having discretionary income for the first time and richer folk spending more of their income on premium goods and services. We expect this to be with us for many years to come. Opportunities abound everywhere, but any analysis of these consumer trends has to start in China.**

### China – People Want Better and Different, not Just More.

As the world's most populous country and (adjusted for spending power) its largest economy, China merits special attention. The economy has grown at an average of over 9% per annum over the last 25 years; while this rate has moderated recently, it is likely to continue at a 4-6% rate for the coming years, over twice that of the developed world. The Yangtze River delta area, including cities such as Shanghai and Nanjing, is a USD 2.6 trillion economy, larger than Italy's. Further south, the economy of the Pearl River delta (Hong Kong, Guangzhou & Shenzhen) is bigger than Canada's. While there is some scepticism about the accuracy of China's GDP numbers, the sectors we focus on here tend to be less sensitive to investment, stimulus and overall growth courtesy of their structural drivers.

As with Japan in the 1970s and Korea in the 1990s, China is now at a stage in its development at which 'premiumisation' is a key consumption theme. People want better and different, not just more. Premiumisation covers a wide range of sectors, from financial services to healthcare, from travel to education. Meanwhile, e-commerce is at the heart of almost all of these. Without strong legacy incumbents, leading Chinese internet companies, and companies with strong online presence are able to dominate. Alibaba is, in our view, the best example. In the 12 months to August 2018, it added 200 million new users to its payment platform, to reach over 700 million. The company is especially optimistic on growth in lower-tier cities, with currently around 500 million consumers and USD 2.5 trillion in consumption, a figure forecast to triple in the next decade. Goldman Sachs estimates that China's online retail market will double between 2016 and 2020, to USD 1.7 trillion.

### China's Economic Rebalancing (% of GDP)



Source: Source: National Bureau of Statistics of China, Jefferies as at 25 July 2019

The expansion in the market for luxury goods is a prime example of premiumisation. A McKinsey survey estimates that, having risen from RMB 334 billion to RMB 770 billion between 2012 and 2018 – an additional RMB 436 billion or 130% - this will expand by another RMB 457 billion by 2025. China accounts for 40% of global luxury goods consumption, and is expected to provide 65% of global growth in this category by 2025. This is driven by younger people. Already over half of total spending by Chinese on luxury items is by people born since 1980, and almost a quarter by those born in the 1990s. Of the latter group, 50% only started buying luxury within the last year, and over 90% in the last three years. Consumers are changing what they buy: while those born between 1965 and 1970 are only interested in foreign brands, younger people are more favourable towards top-end domestic brands. No longer is luxury synonymous only with names such as Prada, Gucci and Burberry. Instead of considering brand legacies and their historical significance, these young consumers are more influenced by contemporary trends.

One consequence of increased preference for domestic brands is that luxury spending within China is growing at twice the pace of spending by Chinese abroad. A beneficiary of this is JNBY, a luxury local clothing brand. Much of its success is down to the repeat business provided by its membership programme, which now totals 3.1 million

loyal customers. Social media is playing an increasing role in influencing people's decision-making: the survey suggests that only a third of older consumers take much notice of internet commentary, compared to over half of those born in or after the 1980s. One indicator: Mini Yang, a KOL (key opinion leader), has over 100 million followers on Weibo, the microblogging site. As an aside, at a time of increasing concern about the environmental impact of the textile industry, JNBY has launched an entire brand, named Reverb, based on recycled material.



Source: Source: JNBY annual report as at 31 Mar 2019

Another high end domestic product is premium baiju, a traditional Chinese liquor. This has the equivalent status in the local market of a single malt whisky or a good cognac. A standard bottle of Wuliangye's baiju sells for USD 160, while some of their brands retail for a multiple of this. Revenues of ultra-premium Baiju are expected to more than double between 2017 and 2022. Away from the glamour of luxury brands, the humble beer market also paints a picture of the trend towards premiumisation. While overall beer volumes in China are expected to decline between 2013 and 2023, the value of premium beers is forecast to rise by a compound rate of more than 10% to USD 63 billion. In India, albeit from a tiny base, it is predicted to rise from just USD 0.4 billion to USD 2.7 billion, almost a seven-fold increase. Even in Korea, a much more mature market, it is expected to increase over 4 times in that period.

In financial services, an innovative business model is seen in China's leading private insurers such as Ping An. They are using technology including facial recognition software, so that their well-travelled salespeople can immediately see on their tablets which existing products somebody has, and what may be of interest from a whole roster of Ping An's offerings, tailored to that customer. In our view, Ping An's potential is only at the early stages of being understood by investors.

China's outbound tourism is having a major impact on the country's balance of payments. The trade balance is little changed as a percentage of GDP over the last seven years (3%). However, the explosion of tourism has resulted in the overall current account surplus all but disappearing. The country's services deficit is 2% of GDP, largely due to tourism. We recall the decade from 1985 when outbound Japanese tourist numbers tripled and are unsurprised to see the same story being played out from China. By 2016, Chinese tourists already outspent their US counterparts by a factor of 2 to 1, even though only 7% of Chinese have a passport, compared to 40% of Americans. Beneficiaries of this include CTrip, the online travel agent, and the hotel and casino operators in Macau, such as Wynn Macau and Sands China.

### The Wider Healthcare Sector

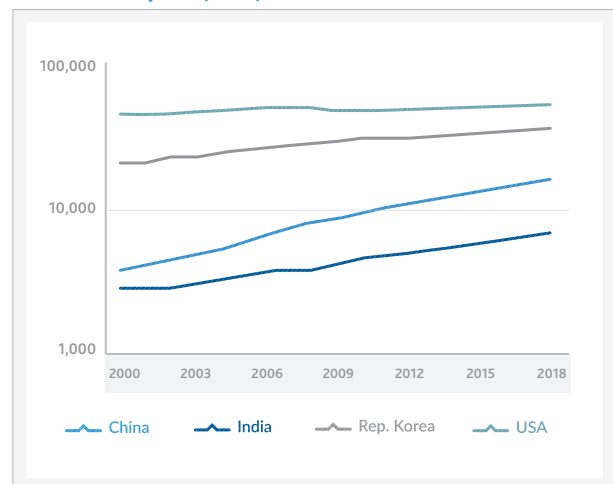
Healthcare is another expanding area. China's healthcare market is expected to rise at a compound 14% to RMB 8 trillion between 2015 and 2020. This is partly due to its aging society. Looking at the wider world, emerging market healthcare expenditure is expected to grow by 11% annually, compared to 4% in developed economies. One beneficiary of this trend is the UAE-based hospital operator, NMC, which is expanding through the Middle East and is improving efficiency of its hospitals through higher capacity utilization. NMC benefits from government policy, which is imposing mandatory health insurance as it seeks to reduce the burden on the state.

A different type of consolidator in the healthcare space is South Africa's pharmaceutical retailer, Dis-Chem. Ageing populations are a clear growth booster and we have observed that other EM pharmacies – such as Brazil's Raia Drogasil – maintain resilient growth of 20% and more each year even through tough economic conditions such as Brazil's worst ever recession. Dis-Chem has competitive advantages from scale in terms of buying and distributing drugs, building their brand name, customer loyalty and trust and buying up smaller, 'mom and pop,' shops.

### Don't Forget India

India is at an earlier stage in its development than China, with per capita income adjusted for living costs of around USD 8,000, compared to China's USD 18,000. As a result, the drivers of consumption growth may be different. One illustration of where India may be heading: in 2000, only 7% of China's population had net wealth of more than USD 10,000. This figure is now 67%. By contrast, in India, this figure has risen from 2% to 9%. Mortgage penetration is only 10% of GDP, compared to 26% for China and almost 90% for both the US and the UK. Automobile sales are also much lower, at only 4 million per annum compared with 23 million for China. Adjusting for GDP, this suggests a strong outlook for Indian car sales. There are serious environmental challenges associated with economic progress. Seven of the ten most polluted cities in the world are in India. However, developments in clean energy and electric vehicles mean that India, like China, has the potential to leapfrog legacy technologies and provide environmentally-friendly solutions. China already has over 420,000 electric buses, compared to 300 in the US. It is likely that India will out of necessity follow suit.

### GDP Per Capita (PPP) in USD

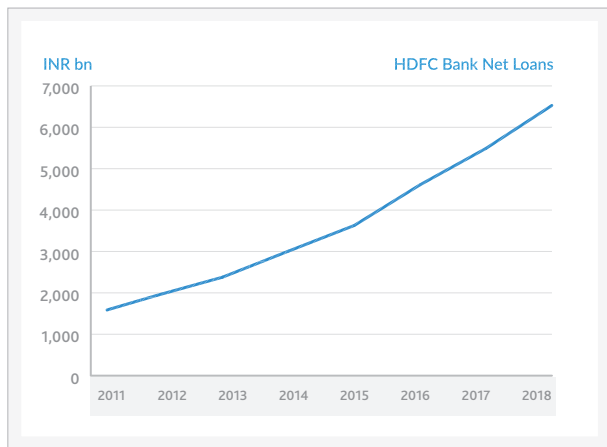


Source: Source: Fiera Capital, World Bank as at 31 Dec 2018

Some investments are predicated on relatively simple, structural growth stories. As India’s population grows, urbanizes, shifts to formal employment, and reaches the foothills of the middle class, annual demand for new homes could reach ten million per year. Banks that have compounded earnings by 20% per year over the past decade should, in our view, be able to sustain this rate of expansion over the next decade as many Indians get their first bank accounts and mortgages.

Our preference is for private banks, such as HDFC and Kotak Mahindra, which grow with a keen eye on returns, liquidity and profitability (state-owned banks in India have problems including asset quality).

### The Growth In HDFC’s Loan Business



Source: Source: Fiera Capital, World Bank as at 31 Dec 2018

Selected banks are also attractive in other countries in which low household debt to GDP ratios can provide a multi-year runway of growth.

These include Mexico, Russia, Peru and Indonesia. This applies to the first two despite relatively sluggish performance of their underlying economies. Indonesia, by contrast, is a country with a potential for rapid evolution in the coming years, with per capita income around half way between those of India and China. However, retail sales of sportswear per capita is only 15% of that of China (and 3% of Japan’s), suggesting room for expansion. Indonesians are also far more likely than just a year ago to buy items such as fashion clothing, cosmetics and perfume. 16% of the population plans to buy a car in the next year, compared to only 10% a year earlier. Even in Thailand, which is one of the wealthier emerging economies, only 14% of adults have credit cards.

In our view the emerging markets consumer story is far from over. Each country is different, at differing stages of development and with varying standards of economic and corporate governance. But there are some common strands. It is broadly a story of new consumers for economies with lower income levels; and of premiumisation at the middle to upper levels. This has a long way to run, providing a wealth of investment opportunities for the astute stock picker.

— Ian Simmons and Julian Mayo

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