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Valuations in Emerging Markets

More Than a Multiple: Focusing on Valuations Over "Value vs. Growth"

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Key Terms

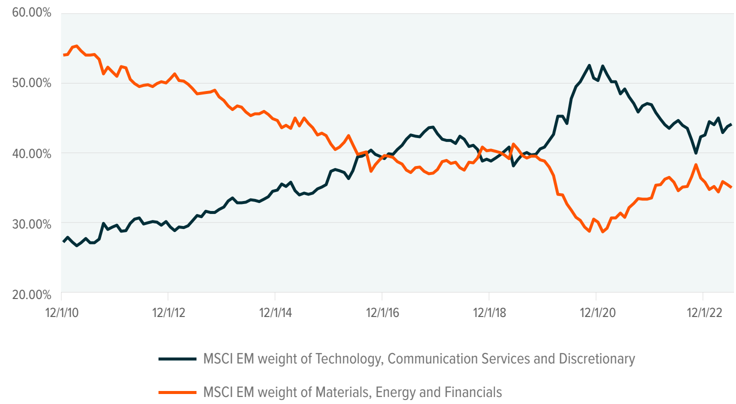
Growth investing: *an investment strategy that involves finding stocks that are expected to grow at above-average rates compared to the broader market.*

Value investing: *traditionally known as an investment strategy that involves picking stocks that appear to be trading for less than their intrinsic or book value.*

With headlines constantly comparing "growth" versus "value" investing in the global equity markets, we have received questions about how our team thinks about valuations across Emerging Market (EM) equities. While it is simple and intuitively appealing to think about the market in "growth" or "value" paradigms, we believe that such categorizations do not tell the whole story of our research and portfolio construction capabilities. As active stewards of capital for our investors' wealth, our goal is to outperform a broad benchmark across a long-term investment horizon in any market environment. We believe we can find value in different market environments across high growth companies, cyclicals, turnaround stories, asset plays, and more, within our investment process.

MSCI EM INDEX SECTOR WEIGHT BETWEEN GROWTH AND VALUE

Source: Factset. As of June 30, 2023.



Note: In 2016, Real Estate sector broke out from Financials. In 2018, the MSCI Telecommunications sector became Communications Services and many IT companies were moved into the new Communications Services sector.

WHERE DOES EM FIT IN?

With a low base of earnings, unmatched natural resources, and attractive demographics, EM, in general, could be considered a growth basis asset class. Simultaneously, though, due to commodity and U.S. dollar (USD) exposure, EM is inherently cyclical and can behave similarly to traditional "value" investments potentially benefitting from discounted multiples, global demand growth, and a weaker USD environment. Thus, EM is a dynamic asset class displaying aspects of both structural growth and cyclicality.

A DYNAMIC ASSET CLASS

Historically, EM economies centered on manufacturing and commodities, and were broadly reliant on cheap exports of natural resources to developed markets (DM). Over the last decade, the asset class has evolved towards services, creating new opportunities for growth in healthcare, education, entertainment, housing, financial services, discretionary spending, and more. The advent of new technologies has enabled these service businesses to grow rapidly and helped generate better earnings growth and return profiles versus the historical asset-heavy, low-return business models of emerging markets — thus keeping valuations attractive.

WHAT IS VALUE?

One of our general goals of investing is to find a company trading below what we deem as its intrinsic value. Nobody looks to buy overvalued companies. The question is, how do you define intrinsic value? We believe that focusing solely on low absolute multiples in EM can be an unsafe strategy. A company is more than a multiple, and there are various examples of companies trading at cheap multiples that remain depressed for good reasons. EM is largely represented by either asset-heavy highly cyclical commodity or manufacturing businesses, state-owned enterprises (SOEs), or both. The combination of these traits within a cyclical asset class could lead to a "value trap." While many goods and services are pure substitutes, other goods and services are not. Would you buy any bike helmet, a piece of fish, or a fire extinguisher just because it is "cheap"? Of course not.

At the same time, growth alone is not helpful either. You wouldn't want to pay up for growth if earnings were being reinvested in dilutive projects. Growth creates value when the business model boasts a difference between its economic returns and its cost of capital. The larger the spread, the more sensitive to changes in expected growth rates. Bottom line, we believe that one has to balance valuation multiples with the company's prospects for both earnings growth and reinvestment rates.

ADVANTAGES AND DISADVANTAGES OF VALUATION MULTIPLES

Advantages	Disadvantages
Useful - Multiples can be robust tools that provide useful information about relative value.	**Simplistic** - Combines many value drivers into a point estimate. Difficult to disaggregate the effect of different value drivers.
Simple - Ease of calculation and wide availability of data make multiples an appealing method for assessing value.	**Static** - Multiples measure value at a single point in time and do not fully capture the dynamic nature of business and competition.
Relevant - Multiples are based on key statistics that investors use.	**Difficult to compare** - Multiples differ for many reasons, not all relating to true differences in value. This can result in misleading “apples-to-oranges” comparisons among multiples.

IN PRACTICE

When assessing a company’s intrinsic value, we look at various multiples, including Price-to-Book (P/B), Price-to-Earnings (P/E), and Enterprise Value-to-EBITDA (EV/EBITDA). It is important to look at current multiples versus historical averages (taking new environments into account) and against peers, but it is also necessary to see how they stand up against their theoretical targets.

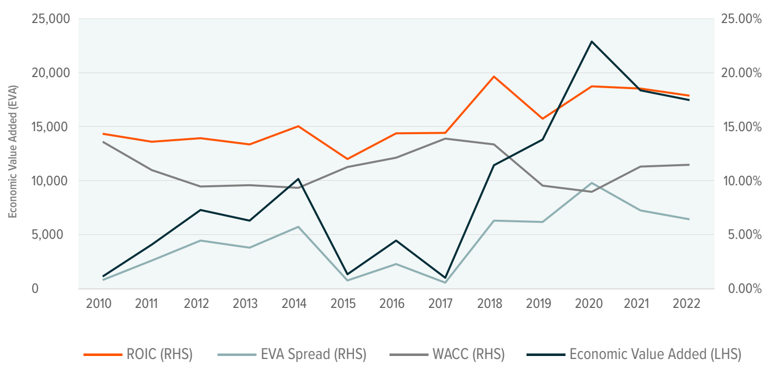
From a P/B Perspective, we look at	From a P/E Perspective, we look at	From a EV/EBITDA Perspective, we look at
$\dfrac{\text{ROE} - \text{Growth}}{\text{Cost of Equity} - \text{Growth}}$	$\dfrac{\text{ROE} - \text{Growth}}{\text{ROE} \times (\text{Cost of Equity} - \text{Growth})}$	$\dfrac{(\text{ROIC} - \text{Growth}) \times (1 - \text{Tax Rate}) \times (1 - \text{Depreciation Rate})}{\text{ROIC} \times (\text{WACC} - \text{Growth})}$

In all of the above examples, one can see that return profiles, earnings growth, and cost of capital are all useful in determining the fair multiple for a company. For a long-term investor, finding a company that can continue showing higher incremental returns should result in a virtuous cycle of improvement in the earnings base, the cash flows, and leverage ratios over time, resulting in ongoing value creation. We believe that stock prices follow both earnings and earnings expectations. At some point in time, share prices should reflect the economic value of the business. We look to find quality business models at attractive prices balanced against the long-term fundamental business outlook.

We find the Discounted Cash Flow (DCF) model useful in finding value for companies deriving value from long-term cash flow expectations. That said, we also acknowledge that the longer the forecast, the lower the conviction, so it can be dangerous to focus solely on a DCF-derived price target. Conversely, the DCF model can be advantageous to stress test one’s assumptions by altering inputs (ex: raising the cost of capital and lowering the terminal growth rate) to pessimistic yet reasonable levels. Long-term macro inputs are subjective, especially in EM, so we find it more beneficial to take a conservative path in testing the downside case.

COMPANY EXAMPLE: WALMEX

Source: Bloomberg as of 7/14/23.



Note: The above chart shows how a company generates economic value, as shown by economic value added (EVA), as the spread between returns, ROIC, and cost of capital, WACC, widens.

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CONCLUSION

In EM, the distinctions between "growth" and "value" are important to examine, understand, and appreciate. A low base of earnings and a longer/faster runway for future growth are key pillars in the investment case for the asset class. At the same time, EM carries many cyclical tendencies and typically trades at a deep discount to global equities. We stress that thorough research and diligent processes involve much more than looking at a static multiple to drive investment decisions. At the end of the day, we ask "what are you paying for?" In addition to sound balance sheets, quality management teams, and economic moats, we look for companies with return profiles above their cost of capital that trade at attractive multiples relative to earnings growth.

DEFINITIONS

Cost of equity is the return a company requires to decide if an investment meets capital return requirements. It represents the compensation the market demands in exchange for owning the asset and bearing the risk of ownership.

EBITDA (Earnings before interest, taxes, depreciation, and amortization) measures a company's overall financial performance and profitability.

Earnings Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability.

Economic Moat is a distinct advantage a company has over its competitors, which allows it to protect its market share and profitability.

Economic Value Added (EVA) is a measure of a company's financial performance based on the residual wealth calculated by deducting its cost of capital from its operating profit, adjusted for taxes on a cash basis.

Enterprise value (EV) is a measure of a company's total value, which includes the market capitalization of a company, short-term and long-term debt as well as any cash on the company's balance sheet.

Intrinsic value is a measure of what an asset is worth and refers to some fundamental, objective value contained in a financial asset.

Price-to-Book (P/B) Ratio measures the market's valuation of a company relative to its book value.

Price-to-Earnings (P/E) Ratio measures the company's current share price relative to its per-share earnings.

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.

Return on invested capital (ROIC) is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments.

Spread refers to the difference between two prices, rates or yields.

Value is the monetary, material, or assessed worth of an asset, good, or service.

Value Trap is a stock that appears to be cheaply priced because it has been trading at low valuation metrics for an extended time period. The danger of a value trap presents itself when the stock continues to languish or drop further after an investor buys into the company.

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