BlueOrchard Academy

The relative value of emerging markets

November 2022

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Executive summary

Over the past decades, emerging markets* have significantly grown their share of global GDP, improved policies and regulatory frameworks, and have become more resilient as a result. Despite this progress, investors' risk aversion with respect to emerging markets has jumped as the US Fed started hiking interest rates, as witnessed by increasing spreads, equity outflows and discounted valuations compared to developed markets.

The situation of most emerging markets – in particular relative to developed markets – does not seem to warrant such a reaction:

- While debt levels have grown since the global financial crisis, they remain lower and structurally much sounder than 20 years ago.

- For the first time in 40 years, inflation in G7 economies matches the inflation in emerging markets while G7 debt levels are much higher and interest rates much lower.

Against this backdrop and the track record of historically faster recoveries in emerging markets, we have strong conviction that emerging markets offer significant opportunity.

Private equity strategies in financial inclusion may be particularly well positioned, as the sector is particularly exposed to the factors of fundamental growth, improved resilience, and increasingly attractive valuations.

*In this paper we will use the term "emerging markets" for the countries included in the DAC list of ODA countries.
All tables in this report exclude data from China.

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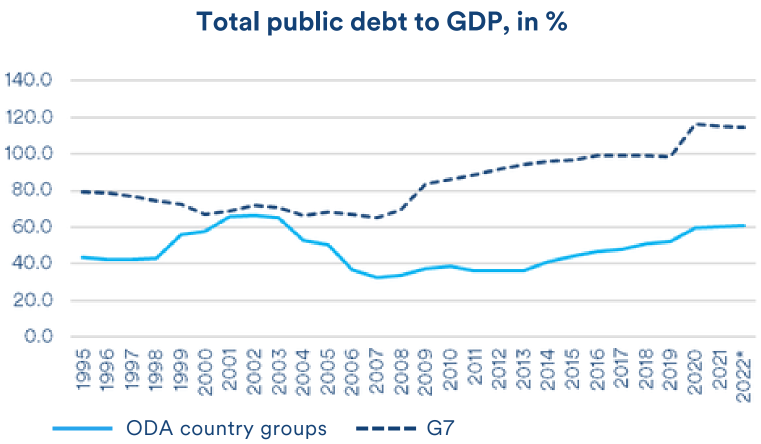
The economic outperformance of emerging markets

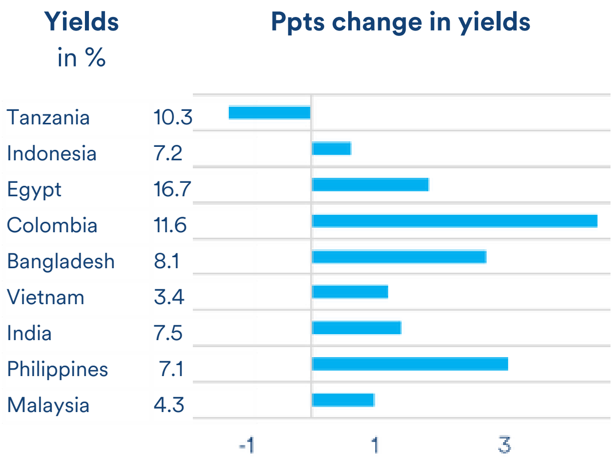
Emerging market economies have been a success story since the middle of the 1990's. Growing their GDP by 5.5% p.a. as a group, they have consistently grown their share of global GDP. In parallel, emerging market countries reduced their aggregate debt to GDP to less than 40.0% by 2006 as highlighted below, driven by a mostly benign environment of increasing prices for natural resources, increased trade harmonization, and several initiatives ease the external debt burdens of low-income countries.

When the US central bank stepped up its fight against inflation with meaningful rate hikes in Q2 2022, investors instinctively started fearing a return of emerging market debt and currency crises, as has happened in the past.

This resulted in large negative portfolio flows, particularly on the equity side, and currency depreciation against the USD. The change in treasury yields for the top ten economies in terms of GDP growth are an indicator for the increased risk aversion of investors.



Source: IHS Markit



Source: Preqin

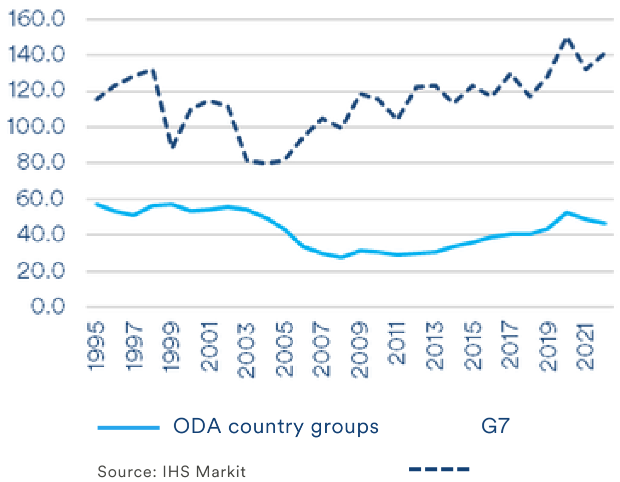
The global financial crisis marked the first turning point when sovereign debt levels ceased to fall and started increasing again. More than a decade on, this was accelerated by the Covid-19 pandemic, leading to a further jump in debt as economies suffered from prolonged lockdowns, resulting in declines in corporate and government revenues.

Emerging markets have improved structurally

Against this backdrop, it is worth having a look at how emerging markets have evolved since past crises. Since the 1990s, emerging markets have become more self-contained and represent a higher percentage of global GDP.

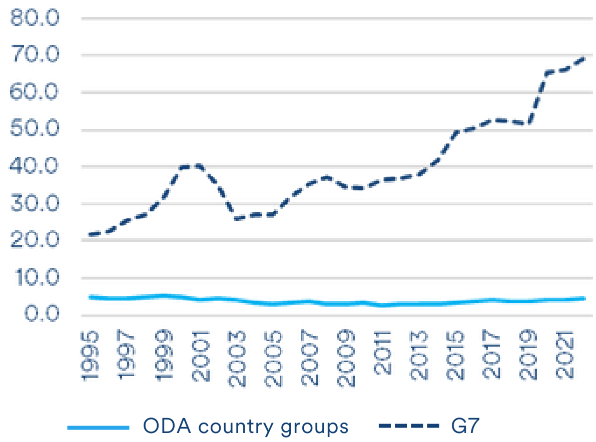
While debt levels in emerging markets have grown significantly since 2008, they are still below the level seen at the beginning of the millennium and far below that of the G7 countries.

Total external debt to GDP
in %



Source: IHS Markit

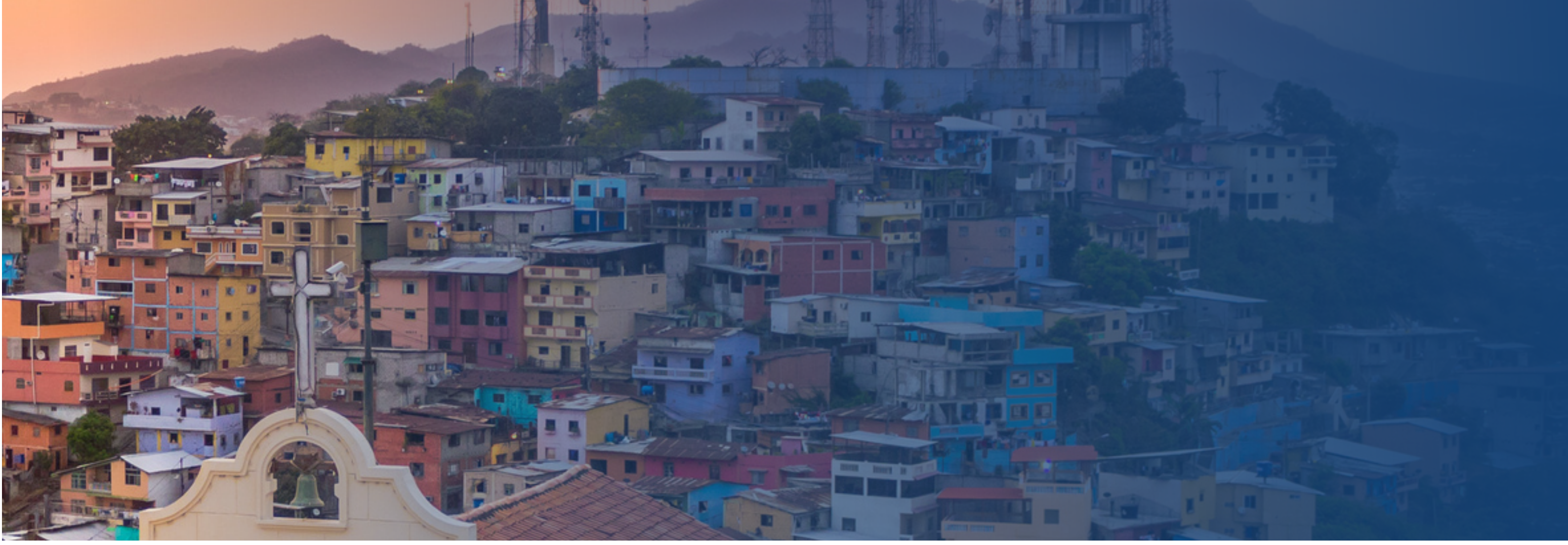
Total short-term debt to GDP
in %



Source: IHS Markit

They have improved policies and built-up buffers which might position them relatively well compared to more developed economies. This includes international currency reserves that are strong by historical standards.

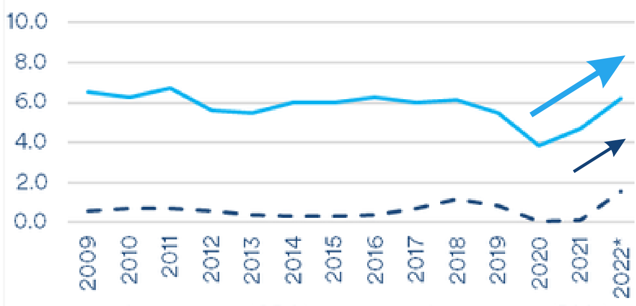
In addition, compared to previous crises, emerging markets have reduced their external vulnerabilities. As an example, emerging markets have reduced their proportion of debt funded externally. These economies also rely much more on local banks than they have in the past.



In both the G7 countries and emerging markets, fiscal deficits post-Covid remain elevated and will need to be curbed in the near term – and rising interest rates increasingly make this reduction an urgent matter; however, central banks in emerging markets were notably faster than their G7 peers in increasing policy rates.

This head start may allow emerging market central banks to halt interest rate increases sooner than developed economies. Notably, the near parity of inflation between emerging markets and G7 economies is unique in the last forty years.

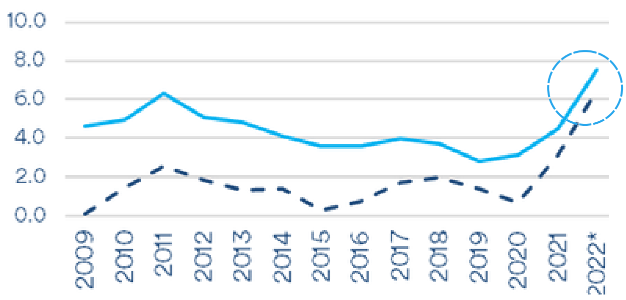
Interest rate
in %



Interest rate (ODA) ---- Interest rate (DMs)

Source: IHS Markit

CPI inflation
%



CPI inflation (ODA) ---- CPI inflation (DMs)

Source: IHS Markit

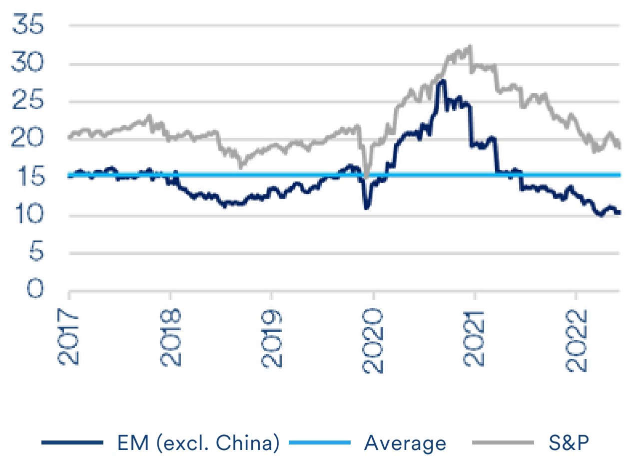
Emerging market equities offer attractive longer-term relative value.

Relative value

Despite the emerging markets' favourable positioning relative to prior crises, emerging markets have experienced significant capital outflows as investors have looked for safety in developed economies. This outflow has had a significant impact on emerging market equities. The MSCI index for emerging markets (excluding China) is trading at its lowest private equity multiple in more than five years and is now trading at a 47.0% discount to the equivalent DM multiple, as can be seen in the chart below.

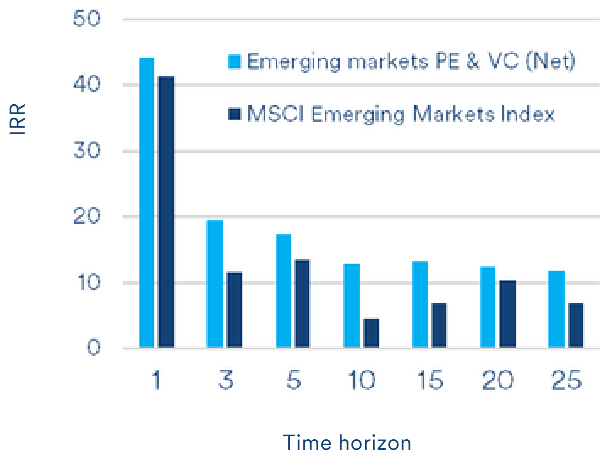
We are also seeing a similar valuation trend in private markets, with emerging market transactions taking place at significant discounts to their emerging market peers. Furthermore, many of the emerging market financial markets have matured considerably over the last ten years and provide for a much more attractive exit environment for private investors.

MSCI - P/E ratio



Source: Bloomberg

Pooled private equity & venture capital returns vs MSCI EM



Source: Cambridge Associates

This represents a significant increase in the pre-Covid spread. Given this discount along with the higher long term growth prospects of emerging markets we believe that emerging market equities offer attractive longer-term relative value.

Given these characteristics, we believe that Emerging Market private equity will continue to outperform public markets, as it has done over the last 25 years.

Why financial inclusion, why now?

Companies active in financial inclusion have grown strongly in the past decades. The fundamental basis of this fast growth remains intact: A large number of unserved and underserved individuals and businesses in growing economies. Much like emerging markets, financial institutions can be expected to weather the current storms well. Banks and insurers in emerging markets are well-regulated and, following regulatory changes over the last five years, are well capitalised. In addition, management teams tend to be quite adept at managing challenging macroeconomic environments.

In some cases, inflation and increasing interest rates may result in muted growth, higher claims and loss ratios in the short-term. In the mid-term, as these effects on income fade out, we expect higher interest rates to drive profitability through growing investment income and margins. Against the backdrop of the improved resilience of emerging markets, the fundamental growth case for financial inclusion, and increasingly attractive valuations, a case for positive private equity vintage years ahead can be made.

Case study

One example of the resilience of financial services in emerging markets is BlueOrchard’s private equity investment in Ghana, Vanguard Assurance.

The company continues to grow premiums at more than 30.0% annually despite a challenging macro environment. This growth is largely driven by unserved and underserved individuals entering the insurance market. Insurance penetration is 0.6% of GDP, which is light years behind the OECD average of 9.4%.* As more people enter the middle-class, they look to gain access to traditional financial services, which is fuelling growth in insurance. In addition to this, technology and business model innovations help to distribute financial services to low-income populations more effectively leading to exponential growth on the micro-insurance side of the market. Vanguard recently entered into a partnership with the largest mobile network operator in Ghana to distribute insurance on their mobile money platform, giving Vanguard access to millions of customers whose insurance needs currently are not met.

* Source: OECD.org.

Conclusion

Given the growing significance of emerging markets in the global economy we believe that that emerging market private equity will similarly continue to grow its relevance.

While the current tapering cycle has already had a pronounced effect on emerging market capital flows, previous cycles have shown that any underperformance in emerging market economies tends to be short lived. Furthermore, emerging markets have come into this cycle in far better condition than previous cycles – including relative to developed markets.

Currently markets are offering a significant discount for emerging market private equity investments, and we believe that this will lead to outperformance of the asset class as this discount reverts to historical levels.

About the authors

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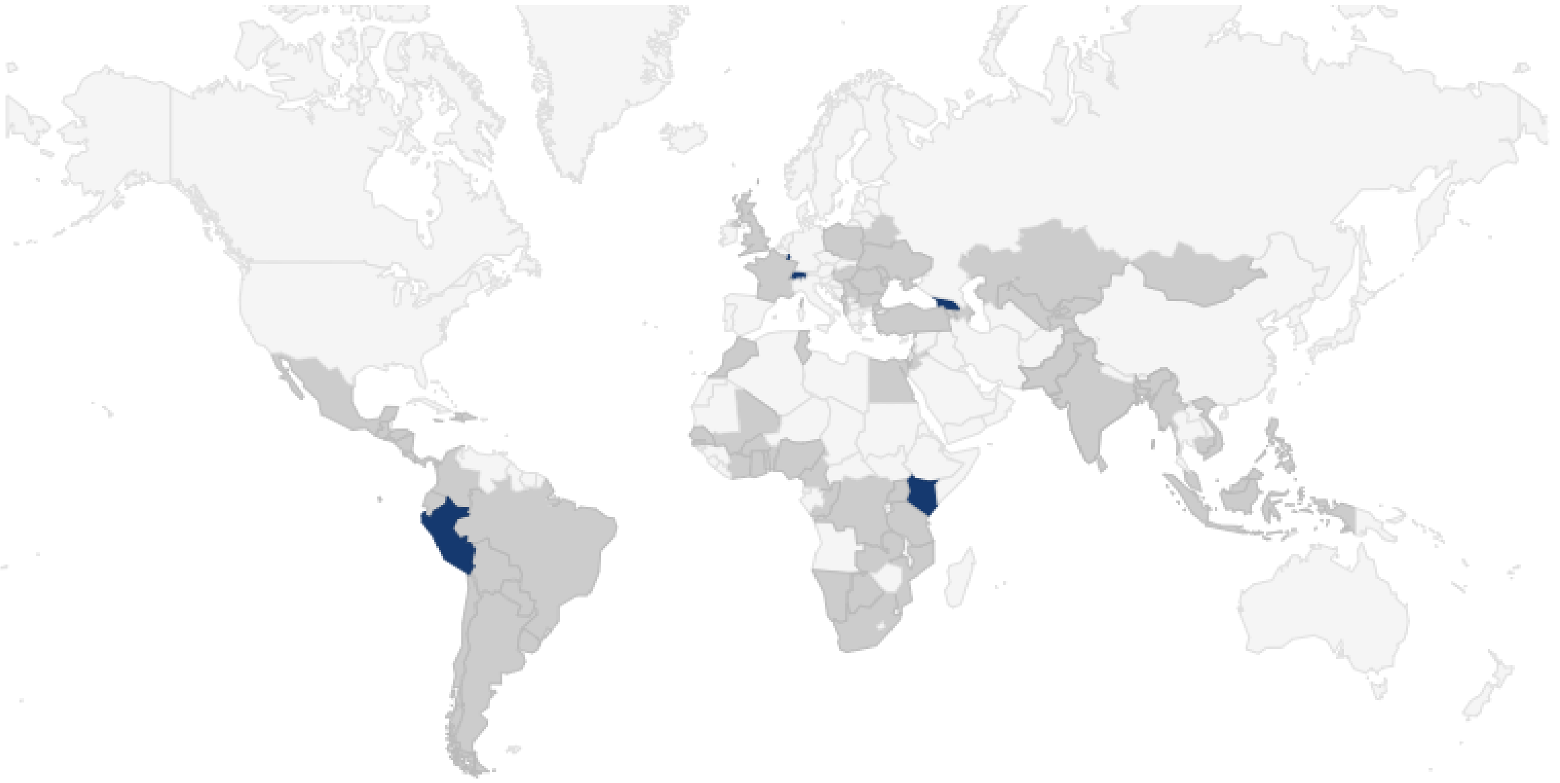

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