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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

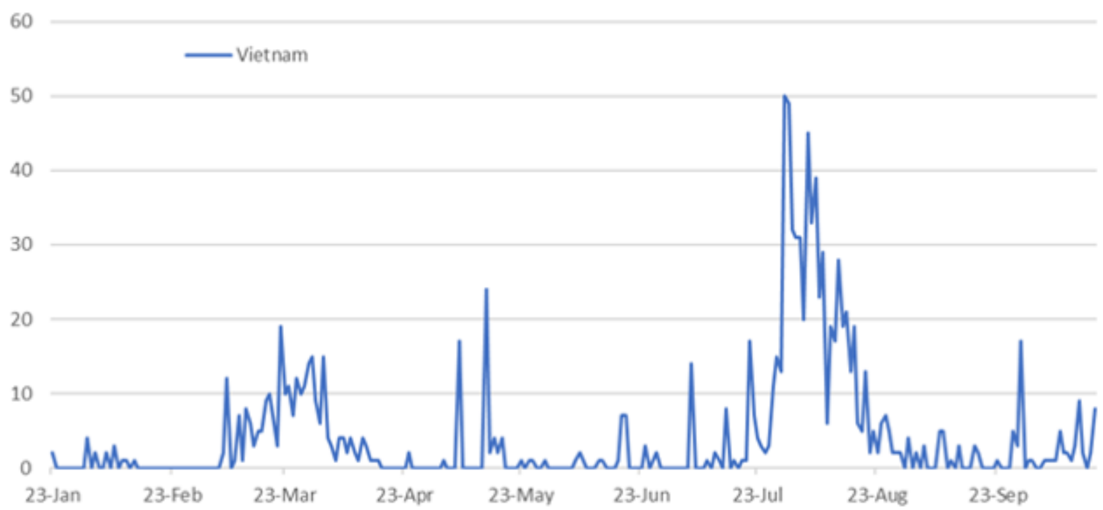
OCTOBER 2020

Over the past few years, we have written extensively about the changing landscape in emerging markets (EM), which has been centered around innovation and the growth of domestic demand. This has marked a shift from the days when EM was thought of as an export-dependent cyclical asset class that ebbed and flowed with the global economy.

The increasingly inward-looking nature of EM, whether captured in local consumer brands, domestic supply chains, or innovative areas like technology and health care, has helped reduce the degree of sensitivity of the asset class to global economic growth. Thus, as COVID-19 spread throughout the world, causing global growth to collapse, it was perhaps unsurprising that North Asian economies, through their technology prowess, as well as their rapid response to the disease, delivered better economic growth and equity market performance than much of the rest of the world.

Outside of North Asia, Vietnam has been a less talked about, but standout economy. Having suppressed multiple waves of COVID-19, with a maximum of only 50 new daily cases over the course of the year, Vietnam has been one of the success stories on this front (Exhibit 1).

Exhibit 1. Vietnam New Daily Coronavirus Cases



Source: Johns Hopkins, Renaissance Capital

Further, Vietnam has generated positive gross domestic product (GDP) growth during every quarter of 2020, dipping to a low of 0.4% in the second quarter, but recovering nicely to 2.6% growth in the third quarter. This is despite having to resort to a strict lockdown of tourist attraction Danang, and consequently curtailing the tourism industry, which accounts for 12% of GDP. The ongoing growth of the digital economy has helped to offset the hit from tourism, and the government aims for this industry to contribute 20% to total GDP in the next five years.

Despite performing roughly in-line with the MSCI Emerging Markets Index year-to-date, Vietnam's equity market has outperformed EM by 70 percentage points over the last 10 years, and according to IMF data, Vietnam's economy may surpass regional counterparts Singapore and Malaysia in size this year.

Still technically a frontier market, Vietnam aims to achieve GDP growth of 6.5-7.0% per year, reaching per capita GDP of $5,000 by 2025. In tandem, Vietnam's middle class, which currently accounts for roughly 18% of the population, is projected to grow to 26% over the same time frame.

While the digital economy and the growth of tourism have been supportive developments in recent years, the growth engine for Vietnam's economy has been exports, as Vietnam has been the prime beneficiary of the relocation of manufacturing capacity outside of China.

Vietnam's large, well-educated workforce has attracted a number of multinational companies, leading them to set up regional production hubs in the country. Further, minimum wages in Vietnam are 6% lower than Malaysia and Indonesia, 28% lower than Thailand and 15% lower than Cambodia. Vietnam has a 20% corporate tax rate, comparing favorably to Malaysia's 24%, Indonesia's 25%, and Philippines' 30%.

The Vietnamese government has been proactive in signing free trade agreements, with 13 currently in effect and three more under negotiation. The European Union-Vietnam Free Trade Agreement (EVFTA), which took effect on August 1, 2020 after ten years of negotiations, eliminates almost 99% of customs duties between the EU and Vietnam and has the potential to be a game-changer.

Vietnam's growth in foreign direct investment (FDI) is not just a result of the recent US-China trade tensions, but rather a natural progression as China's working age population peaked in the early 2010s. As wages rose, China's position in lower end manufacturing became less competitive, and Vietnam attracted increasing amounts of FDI.

More recently, large technology companies have made investments in manufacturing capacity in Vietnam. Specifically, Korea has been developing a close supply chain partnership with Vietnam, focused on consumer electronics. Vietnam's structural shift from low productivity industries such as agriculture to higher productivity manufacturing and services has in turn supported labor markets and consumption.

For years, Vietnam has been among the best macro stories in the developing world, but many foreign investors have been frustrated by the rigidities and inconsistent performance profile of the local equity market. The Vietnam capital market authorities have published a draft guidance of a new securities law which will take effect in 2021.

The main issue holding back investment in Vietnam is foreign ownership limits, which stand at 30% for banks and 49% for other companies. Once a stock hits its foreign ownership limit, a foreign investor must buy from another foreign investor, often at a large premium to the market price. The new draft allows the government to decide on specific foreign ownership limits, conditions, and procedures, which provides some clarity to the existing regulation surrounding foreign ownership limits.

The potential game changer for foreign investment into Vietnam would be the introduction of non-voting depository receipts (NVDRs), which would provide foreign investors with same economic benefits as those investing directly in a company's ordinary shares, only without voting rights. This model has been successfully utilized in Thailand for the last 20 years. Today, foreigners own roughly $160 billion worth of Thai equities, representing 30% of the stock market, compared to $36 billion of equities in Vietnam, or 19% of the stock market. Thailand's market capitalization as a percentage of GDP is around 100%, while Vietnam stands at 72% on the same measure.

Unfortunately, recent comments from Vietnam's State Securities Commission suggest that NVDRs are unlikely to materialize in the near-term. While this is a disappointment, Vietnamese authorities display a strong understanding of the role of capital markets in the country's development, and are intently focused on improving investors' access to the market.

If Vietnam is able to successfully address the issues surrounding foreign ownership limits, we believe its equity market has the potential to generate significant outperformance. The strategy currently holds a 4.5% position in Vietnam, while additional holdings are benefiting from the shift of manufacturing capacity to the country.

The strategy's top holding in Vietnam is an information technology (IT) services company, whose digital transformation revenue grew by 65% in the first half of 2020. With a young, highly educated population, Vietnam graduates 40,000 technical engineers from its universities each year and has become a growing location for IT outsourcing. Despite consensus expectations for the company's earnings to grow at 18% per year over the next three years, along with a 22% return on equity, the company trades at only 11.5x price/earnings, a fraction of the 25-50x multiples commonly found among comparable EM companies. This is emblematic of the type of value unlocking that could be found in Vietnam, should the foreign ownership regulation be appropriately clarified.

Similarly, the strategy's two bank holdings in Vietnam trade at 1.0-1.5x price/book, depsite generating 17-20% return on equity. Following a lengthy cleanup of the banking sector after the bursting of an asset price bubble in 2008, Vietnam's banking sector has been on stable footing in recent years, and a fragmented sector will yield opportunities for leading players to take market share in the coming years. With one of the fastest growing consumer markets in all of Asia, we see scope for Vietnam's banks to generate strong growth in the attractive retail market, boosting margins and returns.

Within the textile industry, the EVFTA should bring new outsourcing opportunities from EU clients. Vietnamese textile exporters had previously faced tariffs of roughly 10% on exports to the EU. Since the tariff is now removed, we believe that EU vendors will increasingly source products from Vietnam. The strategy owns a position in a Taiwanese textile manufacturer with 40% of its capacity located in Vietnam, positioning the company as a prime beneficiary of the free trade agreement.

Vietnam maintains a multi-faceted economy, with strong underpinnings in manufacturing, tourism, and the digital economy. Boasting one of the world's best macro stories, we see scope for capital market liberalization to unlock significant value in Vietnam's equity market in the years ahead, placing Vietnam among the ranks of the most attractive investment destinations in the world.

Performance Review

At the sector level, the most significant contributors to returns were consumer discretionary and health care. Communication services and consumer staples detracted the most value. At the country level, China and India contributed most to performance for the month, while Brazil and Poland were notable detractors from performance.

Positioning and Outlook

As noted above and discussed in past commentaries, North Asia has been the standout region within EM throughout 2020, due to the influence of the rapidly growing technology sector within this region, as well as a rapid response to the initial outbreak of COVID-19.

More recently, our investment philosophy, which focuses on inflection points and second derivative changes, has increasingly led us to two countries that struggled to contain COVID-19 for much of the year, but have recently seen an improvement in the progression of the virus – Brazil and India (Exhibits 2 and 3).

Exhibit 2. Brazil New Daily Coronavirus Cases

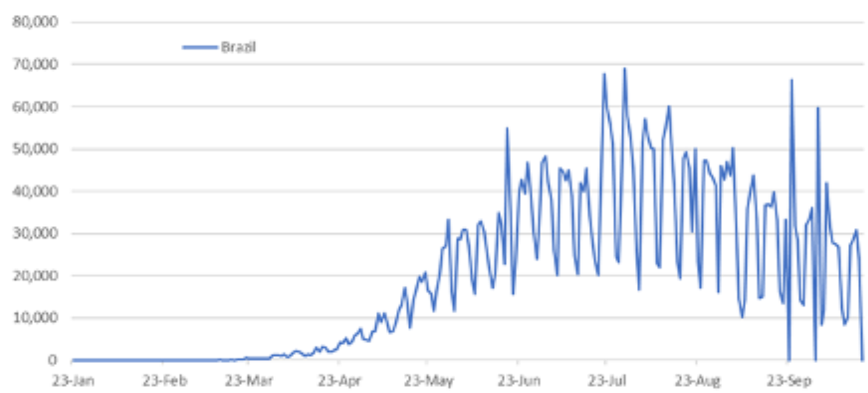


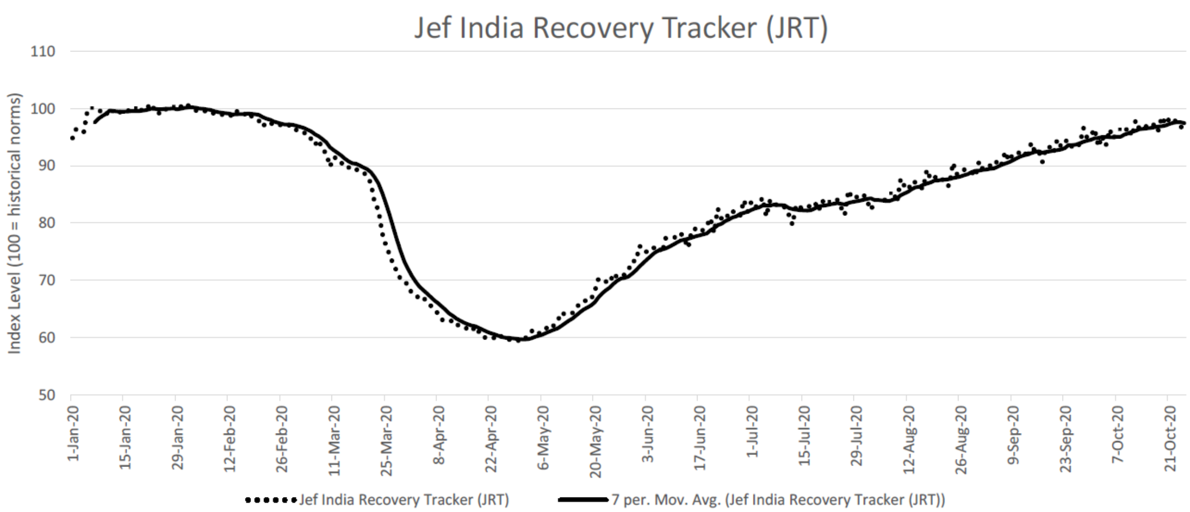
Exhibit 3. India New Daily Coronavirus Cases

Source: Johns Hopkins, Renaissance Capital

While the investment case for these countries is not predicated on COVID-19 progression alone, the implications of declining new case data for growth, as well as a stabilization in banks' asset quality, should help support asset prices, in our view. With a wide slate of recovery growth opportunities, Brazil and India provide diversification from the dynamic growth companies in North Asia that have had a high weighting in the portfolio and performed well year-to-date.

In India, we continue to find a strong opportunity set in agrochemicals, health care, and the localization of manufacturing. This month, India announced that the country will no longer import air conditioners with refrigerants, opening the door to increased local production of air conditioners and directly benefiting two of the strategy's holdings. At the margin, we expect improvements in Indian banks' asset quality, as the rural economy has been well supported by stimulus, while activity is carrying on in large metros, despite the threat of COVID-19. Interestingly, Jefferies' India Economic Activity Index is back to pre-COVID-19 levels, painting a positive picture for domestic cyclicals (Exhibit 4).

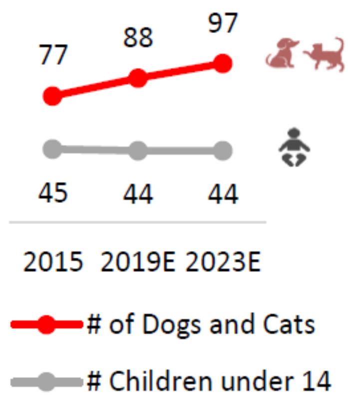
Exhibit 4. Jefferies India Economic Activity Index



Source: Jeffries

Brazil has responded to COVID-19 with a continuation of the sharp interest rate cuts we have seen over the past few years. While the reform initiatives touted at the onset of the Bolsonaro administration have given way to a rising fiscal spend to support COVID-19 recovery efforts, this has also led to a cyclically better backdrop for companies in the steel and industrial equipment industries. Further, Brazil's retail sector holds recovery potential as COVID-19 case progression improves. The strategy added a recent listing in the retail space which operates pet stores, maintaining a 36% return on invested capital in a highly fragmented segment of the sector where they are the leading player with only 4% market share. Fun fact, Brazil has the world's third largest pet population, and the cumulative growth of pets was 14% over the last four years, with the number of pets far exceeding the number of children (Exhibit 5).

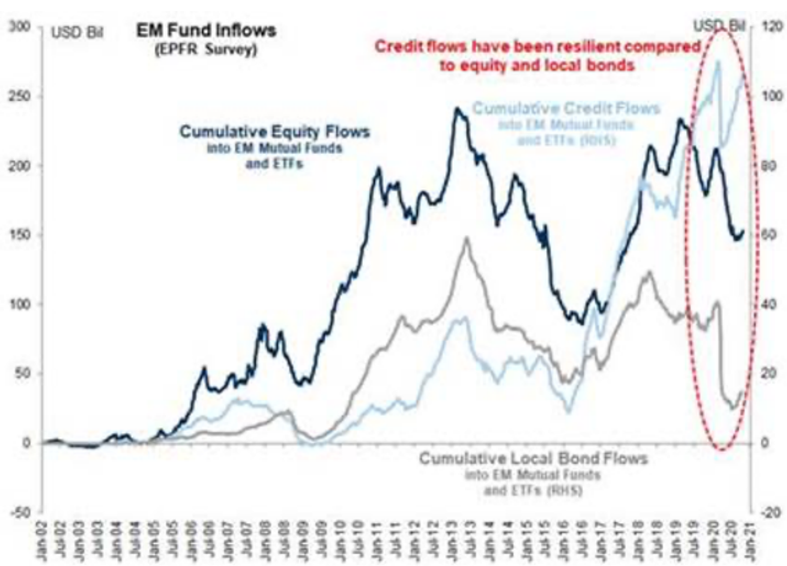
Exhibit 5. Brazil Pet Population vs. Children Under 14 (millions)



Source: Santander

Since global equity markets peaked in August, the path forward has been increasingly volatile, as a result of factors including US-China tensions, questions over regulation of the US technology sector, and uncertainties related to the US elections. We avoid sweeping views on inherently difficult to predict geopolitical events, but rather respond nimbly to new information. That said, it is notable that investors have reduced positions in EM equities and local fixed income since inflows peaked in 2018 (Exhibit 6).

Exhibit 6. EM Fund Flows



Source: Goldman Sachs, EPFR

With EM equities showing nascent outperformance relative to US equities, any post-election clarity, particularly if accompanied by growing views of a weakening trend for the US dollar, could lead investors to close these underweight positions and allocate more capital to emerging markets. Irrespective of the short-term volatility associated with these geopolitical developments, we see a strong earnings trajectory and broadening out of performance trends as we head into the final months of 2020.

Until next month,

Chad Cleaver, Lead Portfolio Manager
Driehaus Emerging Markets Small Cap Equity Strategy