DRIEHAUS
CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

MAY 2024

Over time, one of our key messages to investors in emerging markets (EM) has been that passive indices tend to be inefficiently constructed expressions of the opportunities within the asset class. Consequently, we are comfortable undertaking what can be at times meaningful deviations from the benchmark, including investments in countries which are not represented at all in the MSCI Emerging Markets Small Cap Index. Argentina is an example of one such investment.

The legacy of Argentina's economy is that of boom to bust. Endowed with substantial natural resources, the country grew to be among the wealthiest in the world in the early 20th century, ranking among the top 10 in per capita income. However, the onset of political instability in the 1930s served as a precursor to things going horribly awry in the economy, and Argentina's modern day legacy is that of hyperinflation and default.

The strategy has been invested in Argentina since late 2022, and during this period, Argentina has been a key contributor to relative performance. The election of outspoken president Javier Milei in November 2023 ushered in expectations of economic reforms rooted in free market principles and fiscal discipline, with an aggressive approach that Milei brands as "shock therapy." While we are still in the early days of Milei's policy implementation, initial signs of a turnaround in Argentina's economic woes are more palpable than any other period of my 20-year career in EM.

While a full compendium of Argentine economic history is far too lengthy for this commentary, the condensed version is that much of the country's deep economic malaise is a function of populist policies and heightened fiscal spending, accompanied by significant monetary expansion, spanning several decades under the leadership of the likes of Juan Peron, Nestor Kirchner, and Cristina Fernandez de Kirchner. These policies led to a series of defaults and debt restructurings under IMF programs, culminating in hyperinflation and the imposition of capital controls.

The centerpiece of Milei's shock therapy plan in the short-term is to correct macro imbalances through a swift fiscal adjustment, FX devaluation, and increase in energy prices, engineering a recession that is designed to result in a large current account surplus and accumulation of international reserves. This is a relatively standard playbook for an EM economy facing this type of crisis. However, this is only a short-term fix. Ultimately, structural reforms, including a credible longer-term fiscal consolidation, will be necessary, as will the elimination of capital controls, if Argentina is to emerge more sustainably from its deep economic downturn.

While we are still in the early days of the Milei administration, thus far we are seeing progress on multiple fronts. Bradesco estimates that Argentina is on track to achieve a primary budget surplus equivalent to 1.4% of GDP in 2024. Headline inflation in April was up 8.8% month-over-month, still unacceptably high, but having slowed significantly from the peak of 25.5% in December 2023.

Central to a sustained economic recovery is Argentina's energy policy. One of the reasons we had the conviction to invest in Argentina ahead of the 2023 elections, despite the inherently unpredictable nature of local politics, is that the country desperately needs hard currency, and we believed that all candidates for president would support policies to unlock the vast oil reserves found in Argentina's Vaca Muerta shale formation.

The Vaca Muerta is estimated by the US Energy Information Administration to contain 16 billion barrels of oil and 308 trillion cubic feet of natural gas resources, representing one of the largest unconventional energy resources in the world.

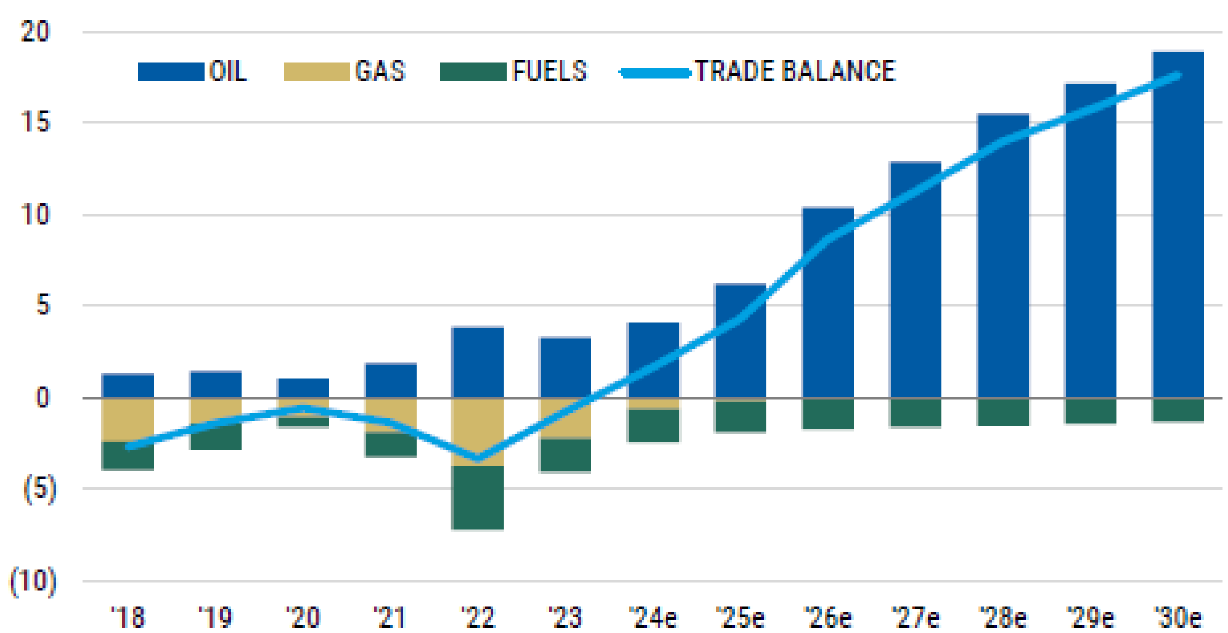
Not only does oil represent a potential source of exports for Argentina's economy, but the country is increasingly in need of the shale gas from the Vaca Muerta, as its key sources of regional imports are deteriorating. The energy sector represents 11% of Argentina's GDP, and the Ministry of Economy expects this to grow to 19% of GDP by 2030.

Shale reached an initial inflection point in Argentina in 2013, and activity accelerated from 2016, as Argentina was able to skip the trial-and-error phase that the US experienced, while benefiting from advances in technology and well design.

Following the FX devaluation, fuel retailers have announced a series of price increases that reduced the gap in domestic prices relative to import parity. As a result, the energy trade balance has shrunk significantly, and authorities look to the Vaca Muerta as a driver of meaningful trade surpluses in the years ahead, cementing its status at the core of Argentina's macro stabilization plan (Exhibit 1).

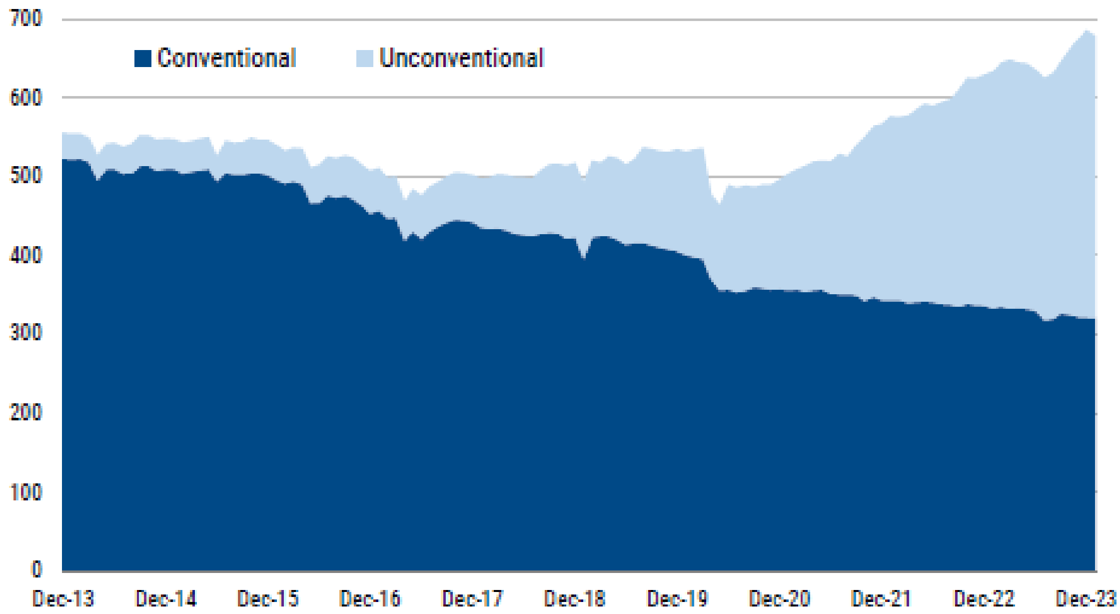
Key to this strategy is increasing pipeline capacity expansion, as several new pipelines are set to come online in the coming years, nearly doubling overall capacity by the end of the decade, and supporting the growth of the energy sector (Exhibit 2).

Exhibit 1. Argentina Oil & Gas Trade Balance ($B)



Source: Secretaria de Energia, Morgan Stanley Research estimates

Exhibit 2. Argentina Oil Production (kbd)



Source: RystadEnergy, Morgan Stanley Research

While the near-term picture for Argentina has been looking more promising, reforms in EM are notoriously difficult to pull off, and there is a particularly challenging backdrop to Argentina's reforms.

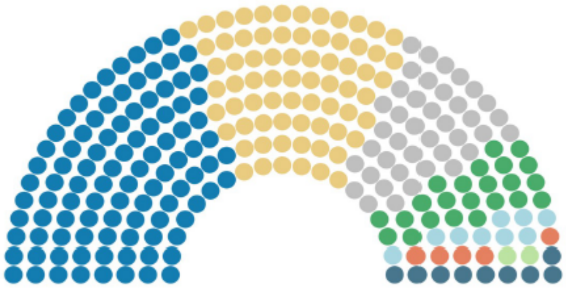
The main risk to the fiscal consolidation is a larger than expected decline in tax revenues as economic activity deteriorates. While Milei is popular, he is prescribing a painful cure for Argentina's economic woes, and a prolonged downturn risks weighing on his popularity and political capital.

A potential reversal of fiscal savings from a recently passed pension indexation formula also poses a risk, as opposition lawmakers demand a more favorable outcome for pensioners. This underscores the fact that Milei does not have an overwhelming mandate, or even a majority, as Kirchner affiliates hold 33 out of the 72 Senate seats, and the Lower House is similarly divided (Exhibit 3).

The central question is whether Milei will maintain the political capital, and whether the Argentine populace will maintain the patience necessary to carry out the reforms without diluting or otherwise undermining what Milei has sought to achieve with his shock therapy.

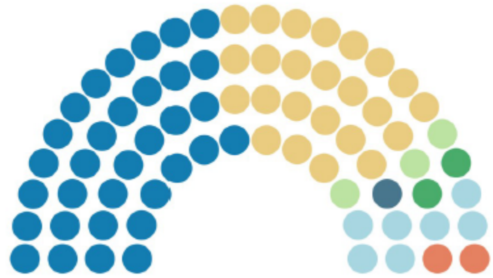
Exhibit 3. Argentina Congress Composition

Lower House



	Seats
Unión por la Patria y aliados	99
Juntos por el Cambio	71
La Libertad Avanza	40
Hacemos Cambio Federal	23
Innovación Federal	9
Frente de Izquierda	5
Ser	2
Others	9

Senate



	Seats
Unión por la Patria y aliados	33
Juntos por el Cambio	24
La Libertad Avanza	7
Unidad Federal	3
Por Santa Cruz	2
Innovación Federal	2
Juntos Somos Río Negro	1

Source: Morgan Stanley Latam Economics

The strategy currently holds four Argentine stocks, mostly focused on the energy sector. Our core holding in the country is a leading independent oil exploration and production (E&P) company with a prime acreage position in the Vaca Muerta.

The company holds a deep inventory of wells, which have seen improvements in profitability from the combination of higher oil prices and FX devaluation. Over the next three years, simply drilling down this inventory will result in a doubling of production, and a recently added high specification rig will generate strong operating efficiency. This company carries optionality to Milei's reform agenda, as a dismantling of capital controls would make it likely that another round of investment from international oil service companies would follow, allowing for the upside case in the resource base to be unlocked.

We also hold a position in the leading shale gas company in the Vaca Muerta, which is addressing Argentina's domestic gas demand by accelerating its production. Similar to the oil E&P, this company carries option value to the reform agenda, as liquefied natural gas (LNG) exports could be a possibility down the road if Milei succeeds in turning around the economy.

Lastly within the energy sector, we hold a position in a state affiliated company that is the leading integrated energy producer in Argentina. This company has benefited directly from the change in pricing policy for gasoline and diesel, shifting closer to import parity, while FX devaluations have also supported profitability. An idiosyncratic driver is the company's recently released "4x4 plan," aiming to multiply the company's value by four times in the next four years through various operational improvements and divestitures.

Outside of the energy sector, we hold a position in one of Argentina's leading commercial banks. While small, the Argentine banking system is well capitalized and highly profitable. Moreover, credit penetration is at one of the lowest levels in the world, at only 10%, which provides significant long-term growth potential.

The case of Argentina is emblematic of a trend we have seen across a number of EM economies in the post-pandemic era. While the developed world engaged in fiscal and monetary largesse amid the pandemic and was slow to extract itself from these extraordinary policies, EM economies are increasingly addressing longer-standing fiscal, monetary, and regulatory risks through bold policy moves.

Argentina is not alone in this regard, as Turkey recently hiked interest rates by 500 basis points in one fell swoop, while China has sought to reduce the tail risks associated with its overreliance on the property sector, and Brazil was one of the first central banks to aggressively raise interest rates to ward off inflation at the same time the Federal Reserve deemed inflationary pressures to be nothing more than transitory.

While investing in a reform story like Argentina carries many risks, we have already seen outsized returns in the country, and in our view, the implementation of Milei's shock therapy could yield substantial future gains for beneficiaries in the energy and financial sectors.

Until next month,

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