DRIEHAUS
CAPITAL MANAGEMENT

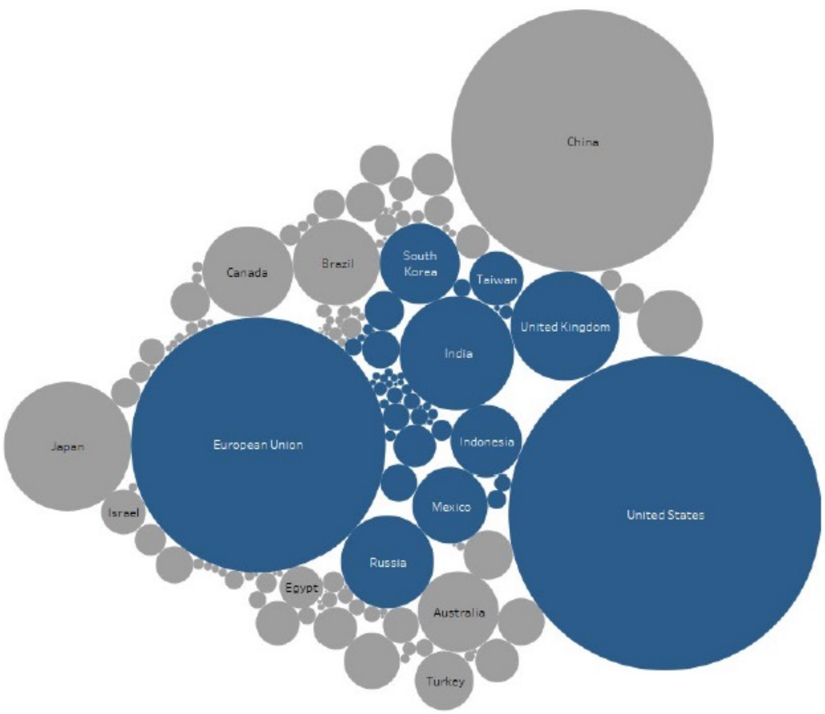
Driehaus Emerging Markets Small Cap Equity Strategy Summary

JULY 2024

This month's commentary presents our favorite charts across emerging markets (EM), showing the themes represented in the portfolio.

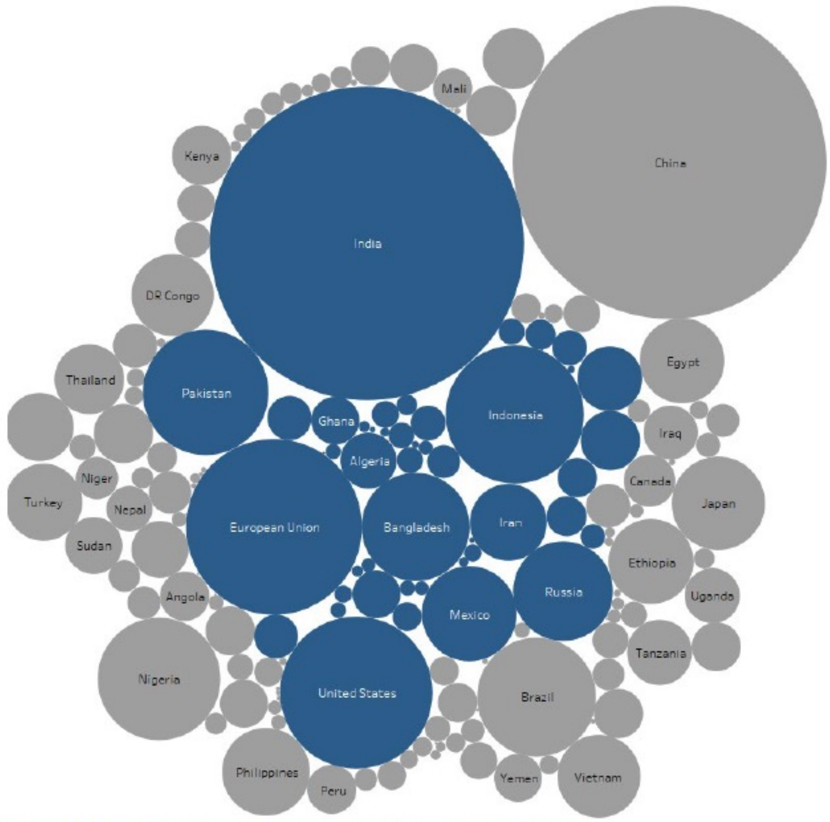
On the political front, this year features a particularly heavy election calendar. In 2024 elections are taking place in countries which account for 60% of the world's GDP and 40% of the world's population (Exhibits 1-2). While we do not attempt to make sweeping predictions about politics or position our portfolio around such inherently difficult to predict events, we have already begun to see unexpected volatility associated with recent political events in Europe, as well as the Mexican Congressional elections. Arguably, the most impactful election as it relates to EM looms ahead in November, as the US heads to the ballot boxes.

Exhibit 1. Countries With Elections in 2024 (% Share of World GDP)



Source: BofA Global Research (blue = holding elections in '24, grey = not holding elections)

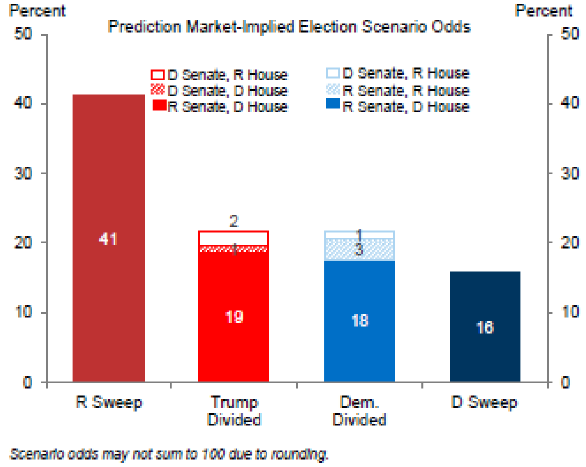
Exhibit 2. Countries With Elections in 2024 (% Share of World Population)



Source: BofA Global Research (blue = holding elections in '24, grey = not holding elections)

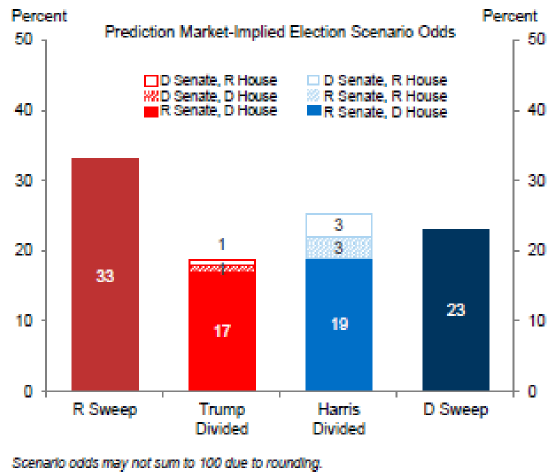
The US election outcomes and implications remain highly fluid, as illustrated on the following charts, which show the rapid changes in implied odds of various scenarios in just over one a week span in late July (Exhibits 3-4).

Exhibit 3. Prediction Market-Implied Election Scenario Odds, July 21



Source: Polymarket, PredictIt, Goldman Sachs Global Investment Research

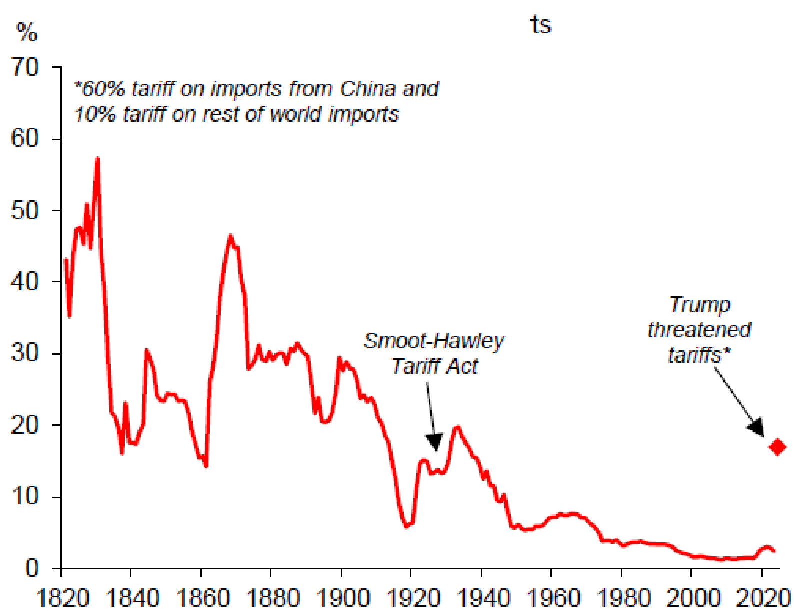
Exhibit 4. Prediction Market-Implied Election Scenario Odds, July 29



Source: Polymarket, PredictIt, Goldman Sachs Global Investment Research

In recent months, former President Trump has indicated that he is considering a plan to impose tariffs of 60% or higher on Chinese goods in his potential second term. Beyond China, Trump has said he would impose a blanket 10% tariff on all US imports. Taken at face value, this would mark a radical departure from US trade policy over the last several decades, bringing the tariff share of US goods imports to levels not seen since the Smoot-Hawley Tariff Act was implemented in 1930 (Exhibit 5). That said, policy to contain the growth of China has become entrenched on both sides of the aisle, and we do not anticipate any major U-turns in the aftermath of the US election.

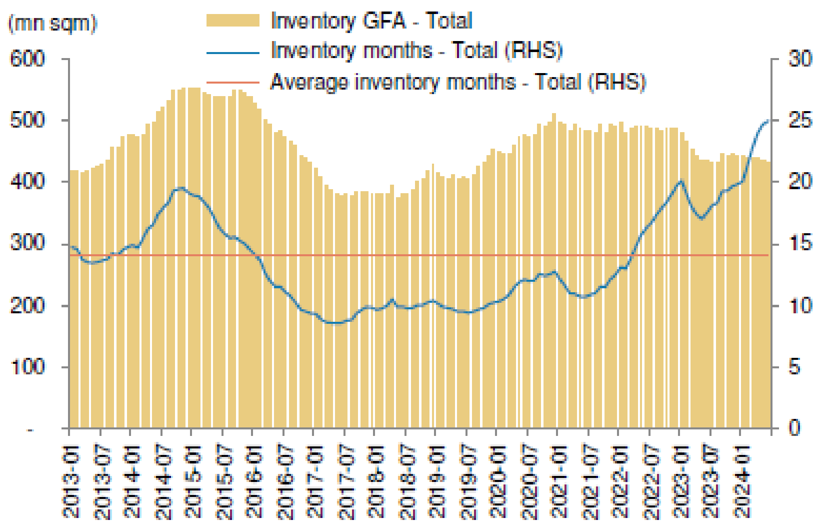
Exhibit 5. US Average Tariff Rates (Share of Goods Imports)



Source: US Census Bureau, BEA, Macrobond, Macquarie

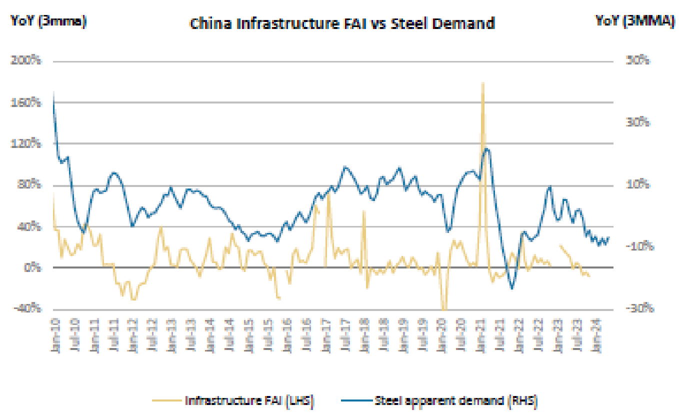
Meanwhile, China has largely stayed the course with its restrictive property policy introduced in late 2020, while refraining from major economic stimulus. Consequently, property inventories are at all-time highs, in terms of months of sales, while steel demand and fixed asset investment in infrastructure are contracting on a year-over-year basis (Exhibits 6-7).

Exhibit 6. China Property – Total Inventory Months



Source: CREIS, Morgan Stanley Research

Exhibit 7. China Infrastructure Fixed Asset Investment and Steel Demand



Source: CEIC, Morgan Stanley Research

The strategy has maintained an underweight position in China throughout the year, while also being underweight the materials sector, as the lack of cyclical impulse in China has created a weak backdrop for earnings.

That said, China remains a low weighting in the MSCI EM Small Cap Index, at 7.2%, and in our view, this relatively low exposure is a positive characteristic of the small cap segment of the EM equity asset class.

As we have noted several times in the past, China's loss has been India's gain in recent years, as India's weighting in the index is now 30%, while vast improvements in infrastructure and favorable demographics increasingly point to the emergence of a domestic manufacturing base.

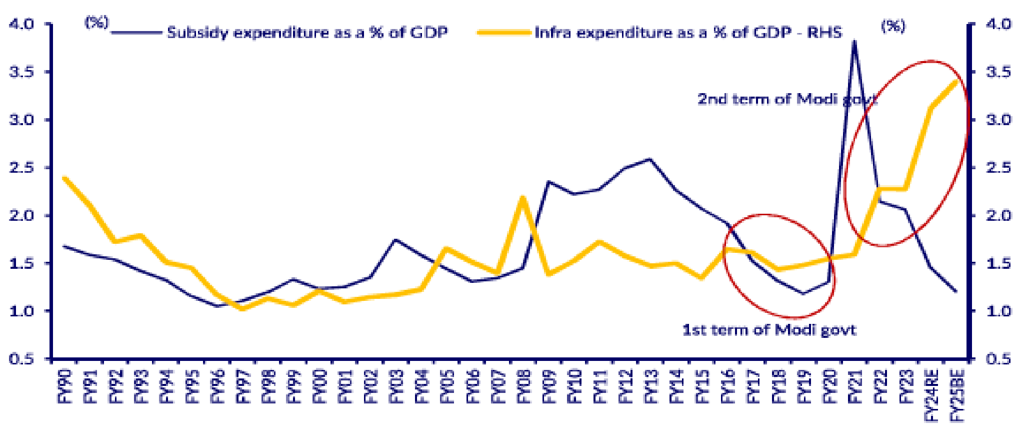
Virtually every area of Indian infrastructure is inflecting or accelerating, including ports, airports, roads, rail, defense, and power, and the strategy has exposure across all of these verticals.

Infrastructure is a critical backbone of sustainable economic growth, and India's government has promoted infrastructure investment over the last decade, improving the country's logistics and ease of doing business. During that period, central government capex as a percentage of GDP has increased from 1.7% to 3.2%.

After recently being elected to a third term, Prime Minister Narendra Modi has hit the ground running, behind an ambitious budget centered around continued infrastructure spending, alongside asset monetization plans to improve funding visibility.

An embodiment of the Modi era can be found in the chart below, showing the marked increase in infrastructure spending as a percentage of GDP. Notably, with the exception of extraordinary spending during the pandemic, Modi has simultaneously reduced spending on subsidies, which had moved meaningfully higher in the years preceding his first term in 2014 (Exhibit 8).

Exhibit 8. Indian Central Government Infrastructure Capex and Subsidies (% of GDP)



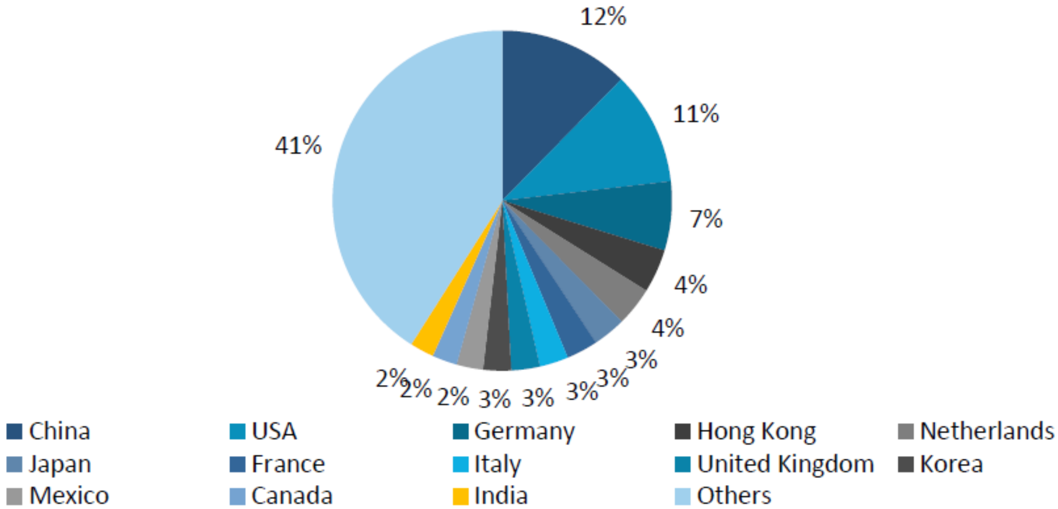
Source: CLSA, CMIE (Centre for Monitoring Indian Economy)

India's merchandise trade is relatively small as a percentage of the global pie, particularly considering the size of the country's population and the fact that it is the 5th largest economy in the world (Exhibit 9).

That said, India's trade volumes are growing at twice the rate of global trade volumes, and an increasing proportion of manufacturing should lend further support to trade in the years ahead (Exhibit 10). The strategy holds a position in one of India's largest container port operators, which continues to expand capacity and is in an advantageous position to capture market share in this growing segment.

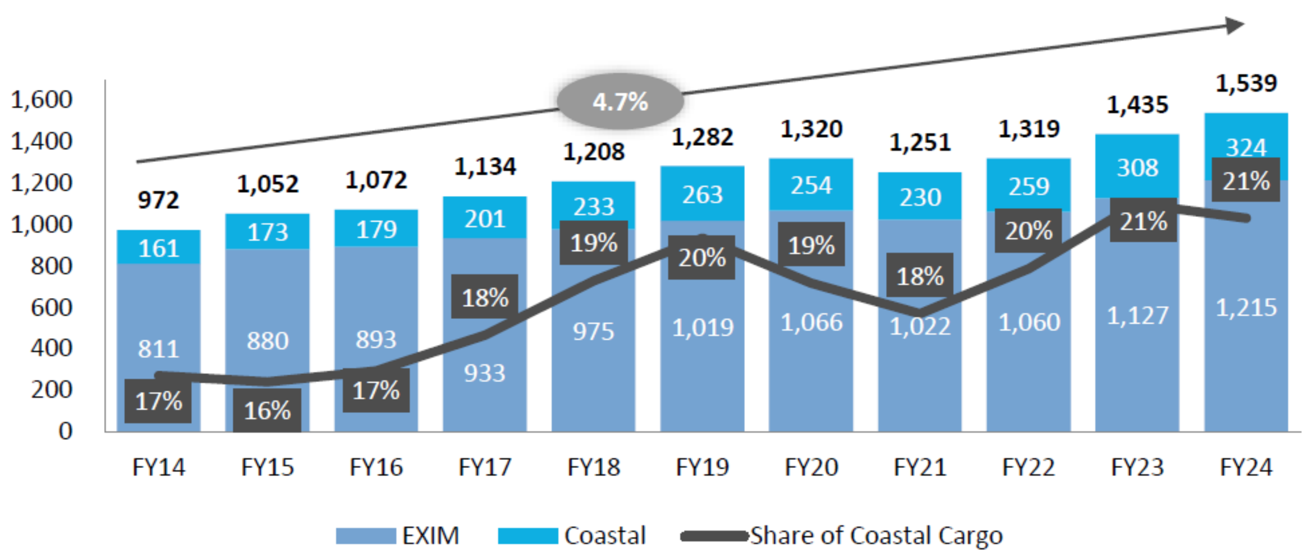
Exhibit 9. World Merchandise Trade

2023 ($ tn) - Total ~$48tn



Source: WTO, UNCTAD, Ministry of Ports Shipping and Waterways, Avendus Spark Research

Exhibit 10. India Cargo Handled in Ports (MT)

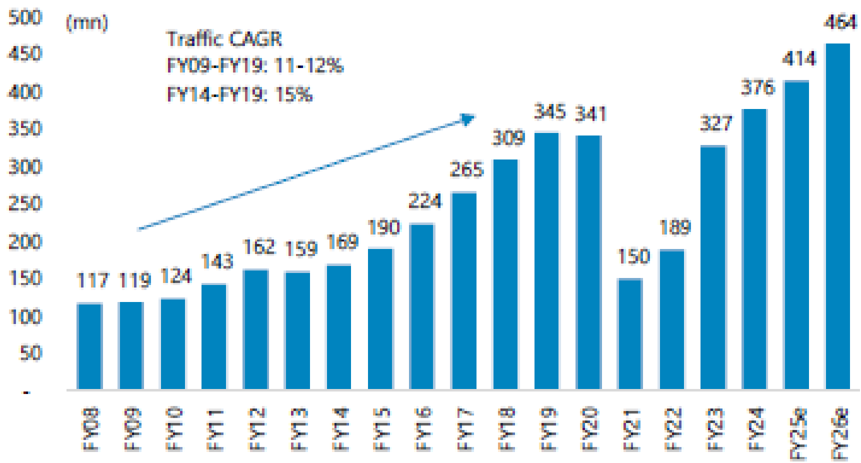


Source: Ministry of Ports Shipping and Waterways, Avendus Spark Research

As incomes improve in India, we have witnessed a rapid increase in demand for air travel, with volumes quickly recovering to pre-pandemic levels and continuing to accelerate (Exhibit 11). The strategy holds the leading airport operator in India, with 27% market share, led by the crown jewel asset, Delhi International Airport, the world's 10th largest by passenger traffic.

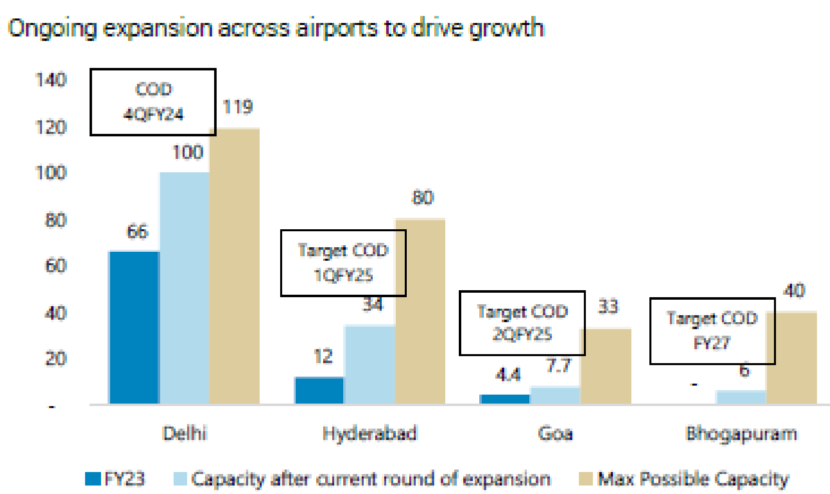
With additional airports in rapidly growing tier-2 cities and major expansions planned across each, the company should see a robust growth rate in passenger traffic (Exhibit 12). India's low penetration of duty-free spending, along with an expanding aspirational consumption dynamic in the country, augurs favorably for the higher margin revenue associated with the company's non-aeronautical segment.

Exhibit 11. India Airport Traffic



Source: AAI, Jefferies

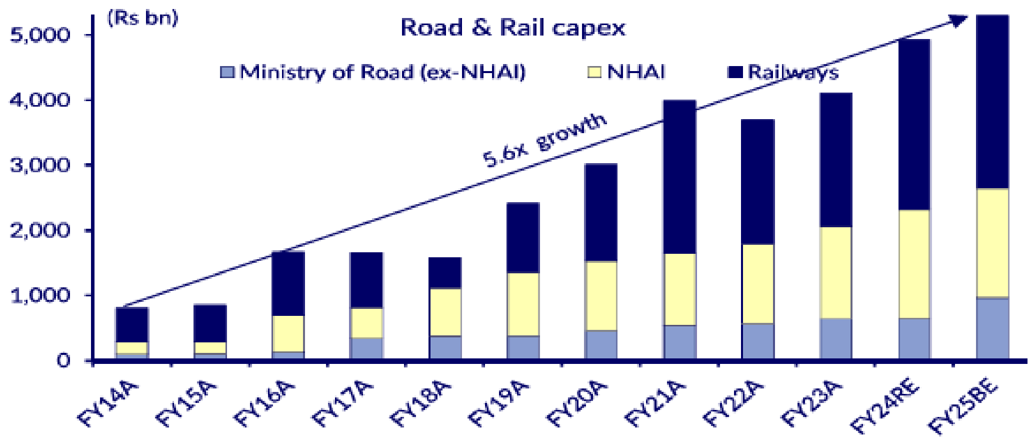
Exhibit 12. Airport Expansion Targets



Source: Company, Jefferies

Road and rail capex has grown by 5.6x during Modi's tenure, and the strategy owns leading players in both of these areas, with a position in a toll road operator and a manufacturer of railway wagons and passenger coaches (Exhibit 13). The rail infrastructure company is well positioned to gain from India's Vande Bharat initiative, a multi-year opportunity to modernize and expand India's passenger rail network. The Modi government seeks to lower logistics costs to high single digits as percentage of GDP, in line with developed countries, from the current mid-teens level, and vast improvements to road and rail infrastructure are at the forefront of this initiative.

Exhibit 13. India Road and Rail Capex



Source: CLSA, India Budget

India maintains both rapid power demand growth, as well as ambitious targets for renewable energy, having committed at the COP26 climate symposium to add 500GW of renewable energy capacity by 2030 (Exhibit 14).

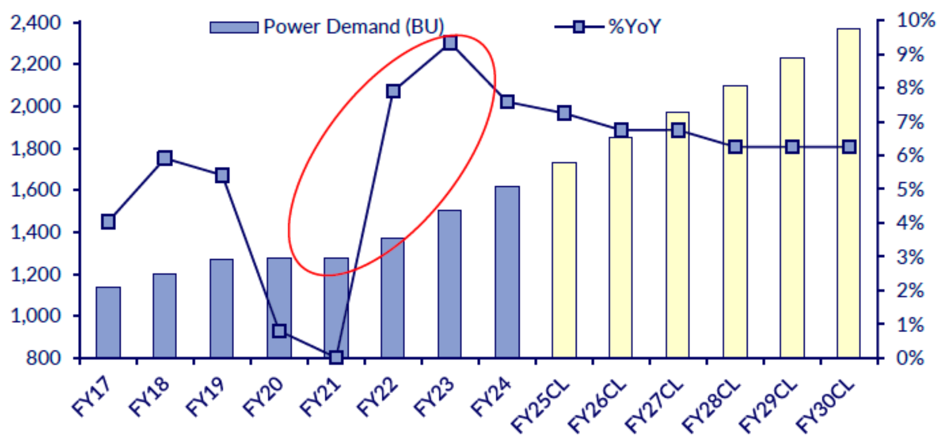
As of March 2024, India has installed capacity of 191GW of renewable energy, implying that 51GW need to be added per year through 2030 in order to meet the target. For context, India added 15GW of renewables in 2022 and 18GW in 2023. In all likelihood, these ambitious additions will not be met by 2030, but this does underscore that the pace of capacity additions in renewables is likely to speed up.

Along with the acceleration in installed generation capacity, the associated transmission and distribution infrastructure is increasingly in demand, as this is necessary to evacuate the power from the point of generation to the major demand centers.

On the storage front, while battery costs have been coming down, battery storage is not yet economical in India. Conversely, pumped hydro storage has been a scalable alternative to promote more efficient usage of renewable energy in the country. In order to improve the efficiency of power consumption in the country, the government is aggressively pushing smart meters.

The strategy owns positions in a wind turbine manufacturer, a pumped hydro storage provider, a smart meter manufacturer, and a transformer supplier, touching several different points of the power supply chain.

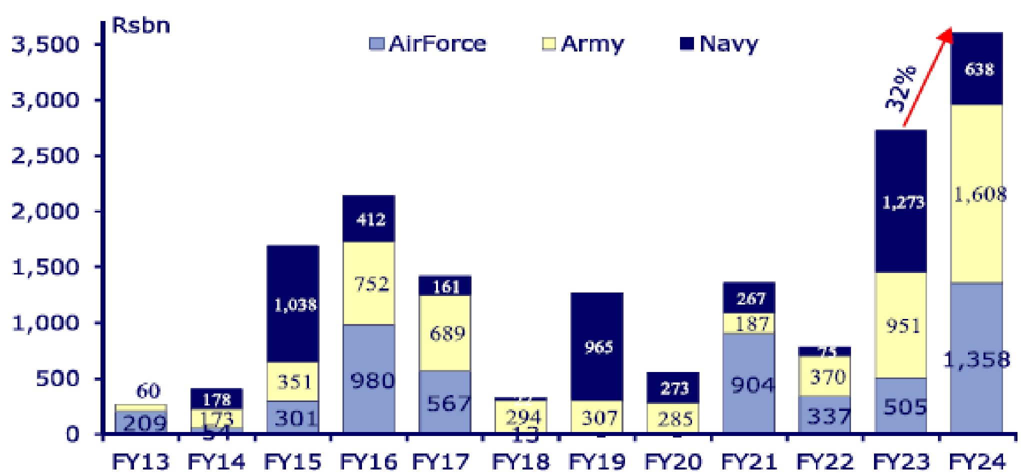
Exhibit 14. India Power Demand Growth



Source: CLSA, Ministry of Power

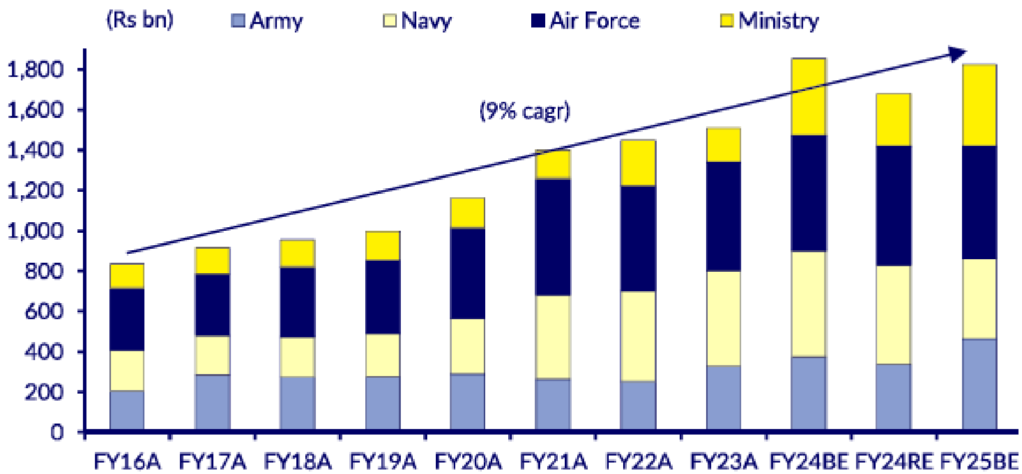
Defense capex has also grown sharply in recent years, as India continues to prioritize indigenous manufacturing and technology upgrades (Exhibits 15-16). The strategy owns a position in a leading shipyard in India, with expertise in building submarines for the Indian Navy. Maritime India Vision 2030 contains 150 initiatives to turn around ports, shipping, and waterways, including a large naval capex program. We expect this company to be a major participant, given its advanced capabilities and partnerships.

Exhibit 15. India Defense Acquisition Council Orders



Source: CLSA, PIB (Press Information Bureau)

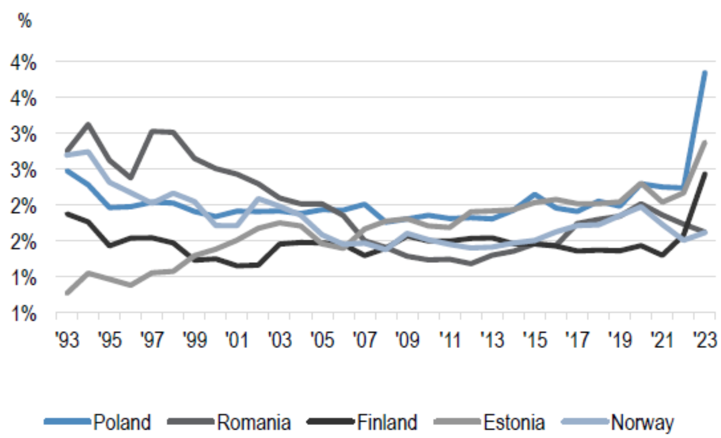
Exhibit 16. India Defense Capital Outlay



Source: CLSA, Budget

The trend of increased defense spending is being felt outside of India as well, creating opportunities for Korean defense companies, which are benefiting from their ability to provide comparable products to those widely accepted in the industry, but at a fraction of the cost. Moreover, as stockpiles have dwindled due to recent global conflicts, Korea's position within the supply chain stands out, as the leading companies have spare capacity and attractive price points, as economies that already faced fiscal constraints are now seeing aggressive step-ups in defense spending (Exhibit 17).

Exhibit 17. Defense Budgets (% of GDP)

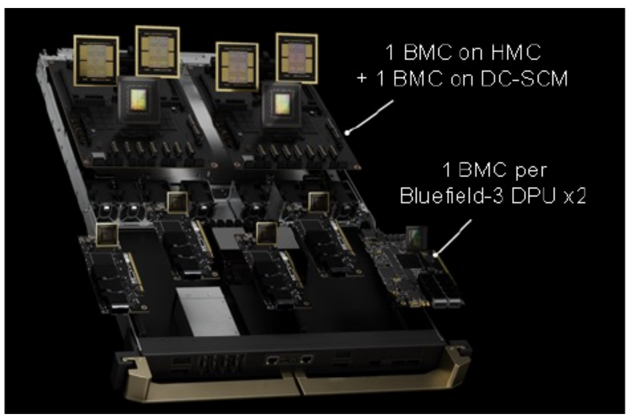


Source: SIPRI (Stockholm International Peace Research Institute)

Shifting gears, no summer chart pack would be complete without discussing the continually evolving trends around artificial intelligence (AI). In an EM context, Taiwan has provided strong exposure to the AI theme, and the strategy has owned companies with leading positions in servers and associated technologies such as liquid cooling. While we pared back a number of these exposures, having become more discerning as the market aggressively priced in the earnings for many of the associated companies, we remain optimistic on companies that have carved out leadership positions in the AI supply chain.

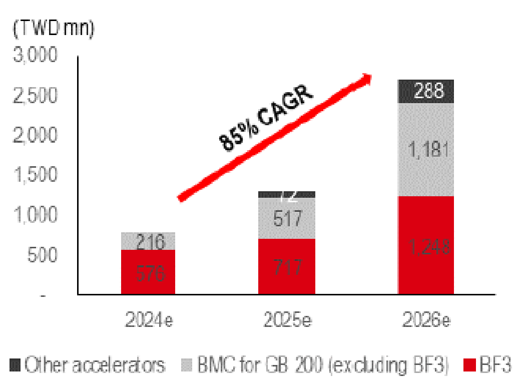
One such company that we continue to hold commands 90% market share of baseboard management controllers (BMCs) for AI servers. Nvidia's rollout of the new generation of AI graphics processors, the GB200, has represented a game changer for the company, as some analysts expect GB200 to comprise around half of total AI server GPUs next year (Exhibit 18). Moreover, the higher BMC content in GB200 bodes well for the company. This is a powerful near-term catalyst, while longer-term, more complex AI server systems are likely to drive even higher adoption of BMCs going forward (Exhibit 19).

Exhibit 18. Increasing BMC Adoption



Source: Company Data

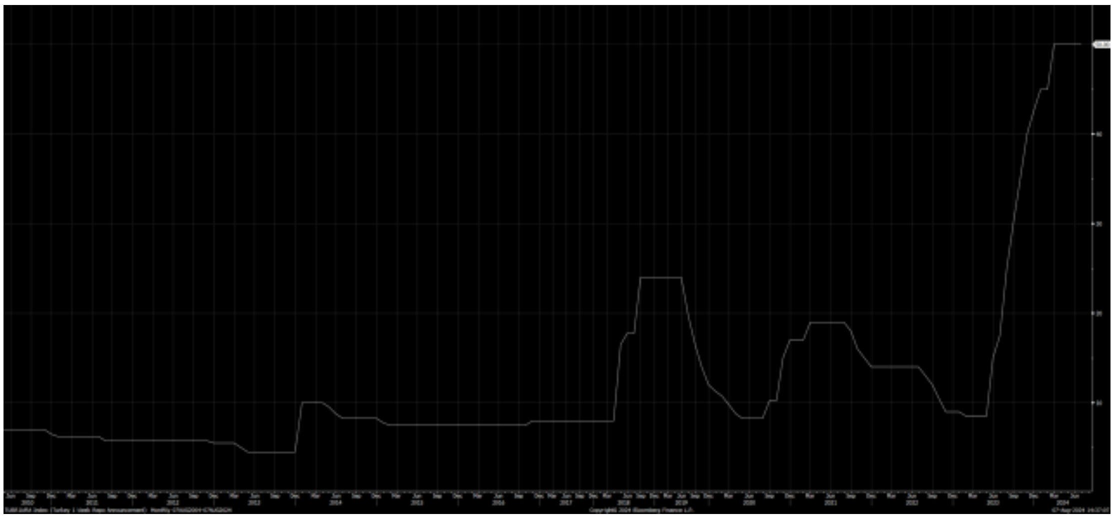
Exhibit 19. Increasing AI-Related Revenue from Leading BMC Producer



Source: HSBC Estimates

Elsewhere in EM, Turkey has emerged as a macro turnaround story, after a series of unorthodox policies starting in 2018 led to spiraling inflation and currency devaluation. The central bank sharply tightened monetary policy post the general election in May 2023 and largely stayed the course throughout 2024 with a 500bps rate hike in March, bringing the policy rate to 50% (Exhibit 20).

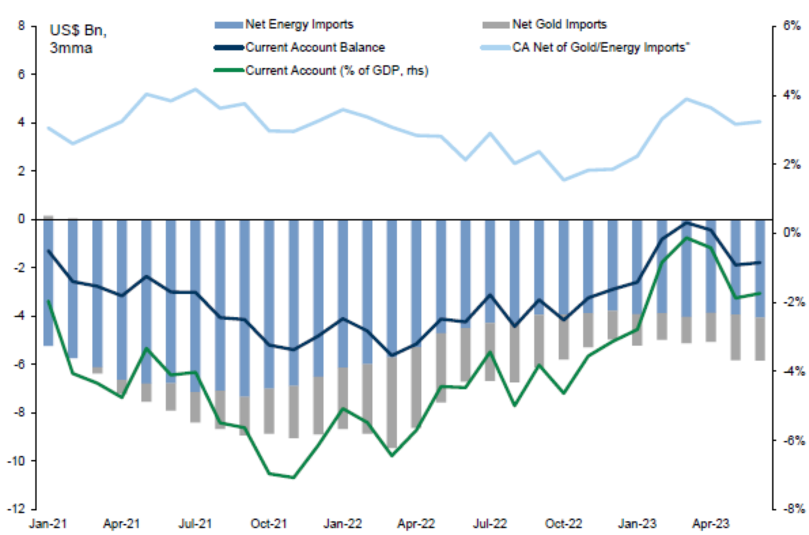
Exhibit 20. Turkey Policy Rate



Source: Bloomberg

Post the election last year, the new economic team tightened both fiscal and monetary policy and stopped intervening against currency depreciation. This ultimately led to a narrowing of the primary fiscal deficit as well as the current account deficit (Exhibit 21).

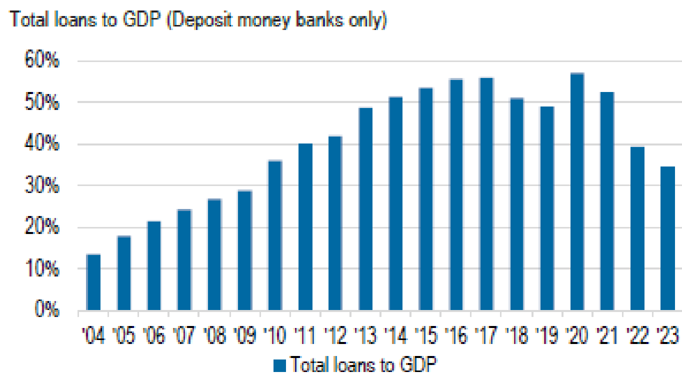
Exhibit 21. Turkey Current Account Deficit



Source: Goldman Sachs Global Investment Research, Haver Analytics

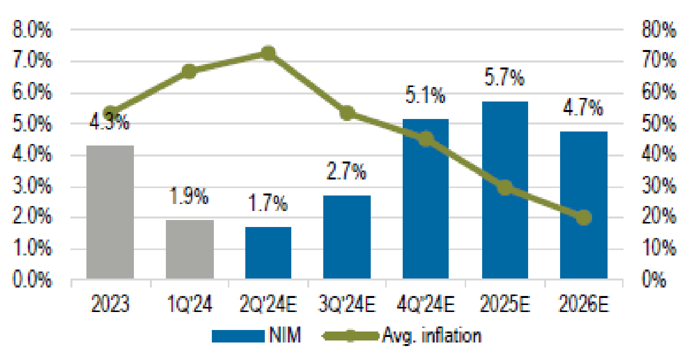
In tandem with this, inflation slowed as the Turkish economy rapidly deleveraged (Exhibits 22-23). Turkish household leverage is among the lowest in EM, and the strategy holds a position in a Turkish bank, which we expect to benefit from improving net interest margins and growth over time, as the recovery takes shape.

Exhibit 22. Turkey Loans to GDP



Source: CBRT, TURKSTAT, J.P. Morgan calculations. Comprises banking sector loans only.

Exhibit 23. Turkey Inflation and Bank Net Interest Margins



Source: Company data, J.P. Morgan estimates.

Lastly, we leave you with a series of charts and datapoints related to AI and power consumption that may be thought provoking.

According to Bloomberg New Energy Finance, the global shift toward net-zero emissions requires upwards of $21 trillion of investment in the electricity grid by 2050, of which $4 trillion is needed to sustain the existing grid, while $17 trillion would be needed to support new electricity production (Exhibit 24).

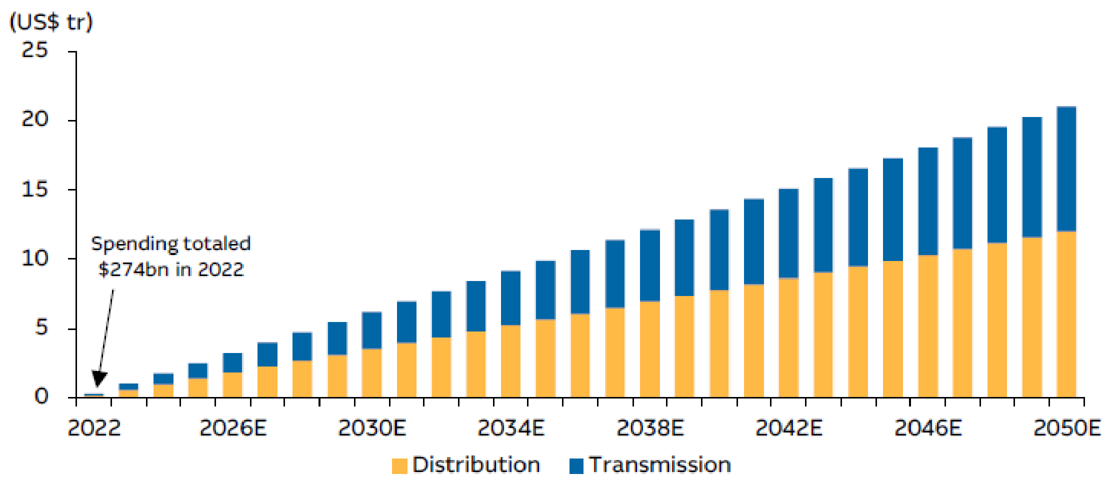
Grid spending amounted to $272 billion in 2022, and would need to accelerate meaningfully in order to meet longer-term targets around electrification. The International Energy Agency (IEA) expects the rate of annual grid spending to triple by 2030.

On top of this, accelerating investment in datacenters driven by the growth of AI is also necessitating greater investment in power generation, as well as transmission and distribution capacity. Per the IEA, datacenters account for roughly 1.5% of global electricity use, and this proportion could triple by 2027.

Power requirements of AI servers are significantly greater than conventional services, and the average size of datacenters under construction in Asia is a whopping 57% larger than those that are currently operational, according to Cushman & Wakefield. The trend of rising power consumption per server adds to the need for investment in new power capacity, and the inflection point in AI witnessed last year has only begun to translate into materially higher power demand (Exhibits 25-26).

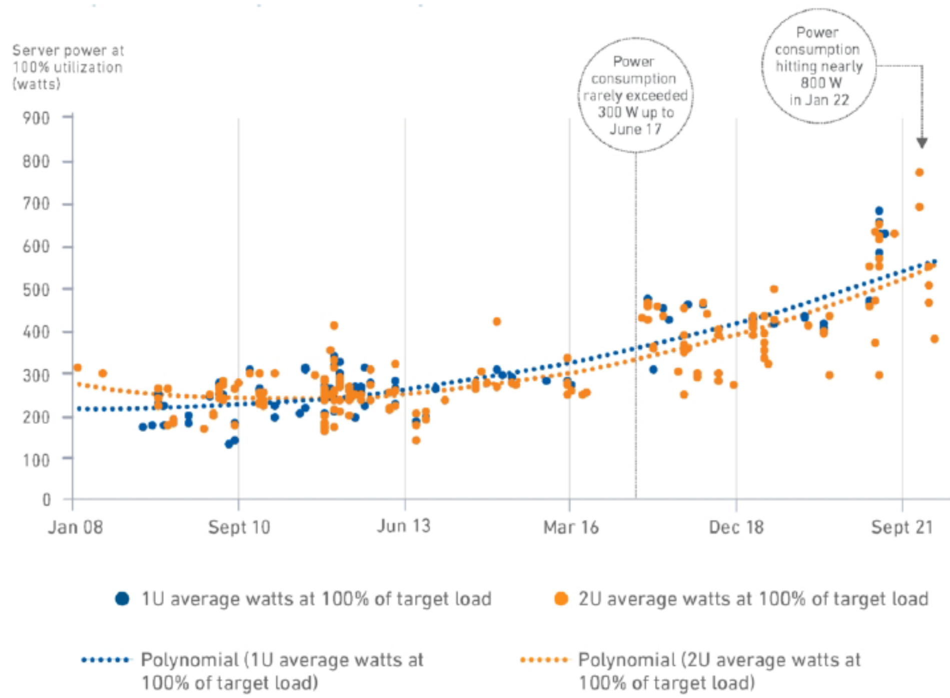
The theme of rising power infrastructure demand associated with AI has been prevalent throughout EM and heavily represented in the strategy's holdings. This includes a leading exporter of high voltage power transformers, as well as a Malaysian utility that provides clean energy sources to power datacenters in the region. Associated upstream areas, such as copper producers stand to benefit from this trend over time as well, despite current prospects being dampened by slowing demand in China.

Exhibit 24. Projected Global Transmission and Distribution Spending to Meet Net Zero Emissions



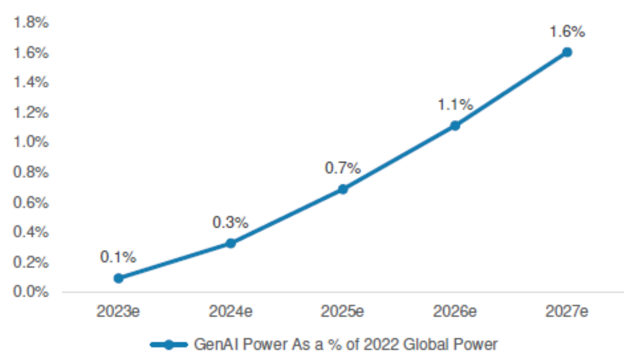
Source: BNEF, Macquarie Research, April 2024

Exhibit 25. Power Consumption Per Server



Source: SPEC org, compiled by Uptime Intelligence
Note: The data shows the sustained maximum power consumption of two-socket servers when running the SPECpower_ssj2008, which simulates a Java-based business logic. Results for 1U and 2U form factors. Data as at June 27, 2022.

Exhibit 26. Projected AI Power Usage as % of Total Global Power



Source: Company data, TrendForce, Morgan Stanley Recearch estimates

This year's summer chart pack reflects the dynamic opportunity set across small caps within emerging markets. We are encouraged by the ongoing relative performance trend of the asset class and continue to find many interesting growth stocks across a number of countries and sectors.

Until next month,

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