# Reemergence of Earnings Growth

## A Discussion with Artisan Sustainable Emerging Markets Strategy Analyst Meagan Nace and Portfolio Manager Maria Negrete-Gruson

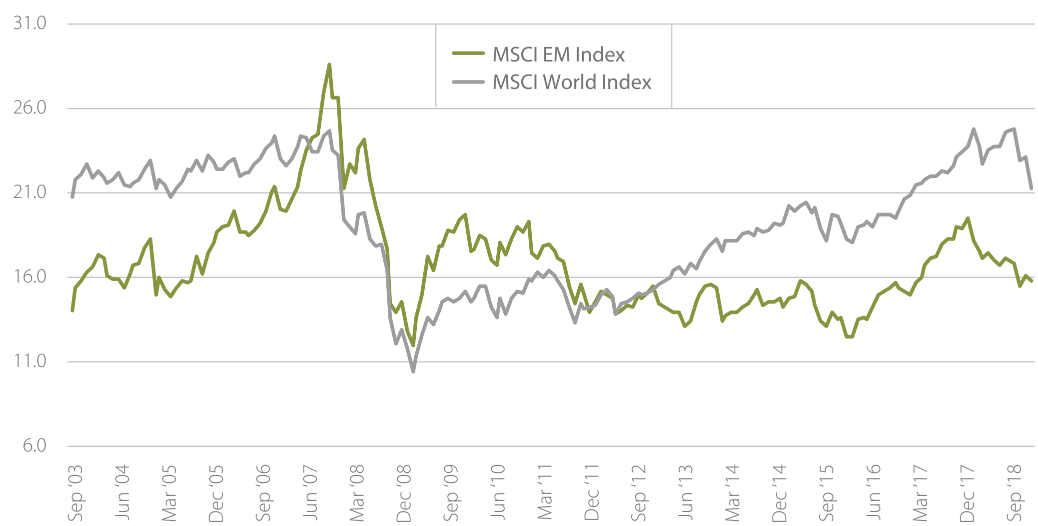
PORTFOLIO MANAGER
Viewpoints

December 2018

Since early 2016, emerging markets stocks have enjoyed a strong run vis-à-vis developed markets. In the trailing 36 months through December 2018, the MSCI Emerging Markets Index outpaced the MSCI World Index (a proxy for developed world stocks) by 10 percentage points cumulatively. The turnaround reflects a sharp departure from the prior 5 years through December 2015, when EM stocks trailed developed by an average of more than 12 percentage points per year.

Emerging markets stocks now trade at one of the largest valuation discounts to those in developed markets since 2003 (Exhibit 1)—making valuations optically attractive. To us, they're even more compelling given a key inflection point we have identified in the profitability of several emerging markets companies. Having navigated a number of difficult operating environments, several companies are now exercising more capital discipline, focusing on profitability and improving their balance sheets—a shift we see as favorable to our investment process of identifying companies that are attractively valued relative to their sustainable earnings-growth potential.

**Exhibit 1: Long-Term P/E**




Source: Bloomberg/MSCI. As of 31 Dec 2018.

### How We Got Here

In the glory days of the early 2000s, emerging markets enjoyed an economic boom amid a flood of foreign capital—both as foreign direct investment as well as into EM stocks.

Then, during the 2008 global financial crisis, money fled risk assets globally, including emerging markets stocks. However, in the subsequent recovery, monetary authorities flooded markets with easy money in a bid to spur economic growth. Emerging markets stocks were a major beneficiary of that wave of liquidity. From the global market bottom (9 Mar 2009) through year-end 2010, the MSCI EM Index was up nearly 150%, outstripping developed markets by 50%.

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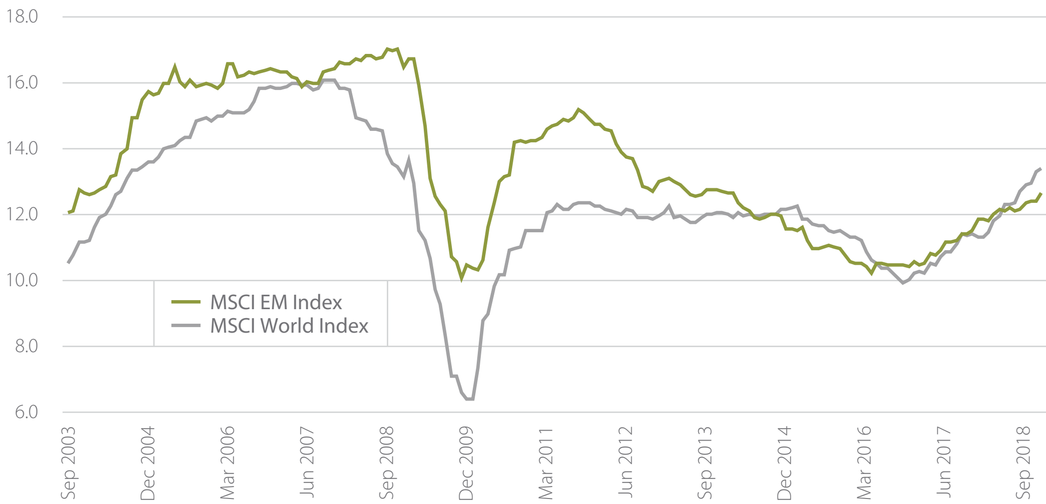
During the boom periods of easy money, a number of emerging markets companies fell prey to their own excesses, embarking on expansion projects, investing in R&D, making acquisitions and increasing capex. These efforts could be favorable for shareholders. However, there was a general lack of regard for profitability—a lot of spending led to top-line growth but did not lead to higher returns on equity (ROE). As a result, companies destroyed value as liquidity dried up. Apart from a brief rebound, emerging markets companies' ROEs steadily declined between 2011 and early 2016 (Exhibit 2).

**Exhibit 2: Return on Equity (%)**




*Several companies are now exercising more capital discipline, focusing on profitability and improving their balance sheets.*

Source: FactSet/MSCI. As of 31 Dec 2018.

## Shifting Tides

While there have been several promising developments in emerging markets in the post-2011 period—e.g., India's sweeping pro-business reforms and ongoing demographic tailwinds—there has also been no shortage of obstacles. A commodities bust, fears about China's slowing growth, major recessions in Brazil and Russia, a host of corruption scandals, the persistent threat of "Grexit" and the tenuous position of the "Fragile Five" have been among the asset class's many headwinds.

Yet, challenge often breeds opportunity. In several cases, this difficult operating environment has forced companies to improve profitability through a variety of self-help mechanisms, including deleveraging, cutting costs, divesting non-core businesses and diversifying geographically. It's no surprise to us that the companies we have observed to be most successful at executing these strategies have also been the ones with a sustainable competitive advantage, unique access to emerging markets' growth or both—qualities we demand in all of our investments.

For example, Telecom company Entel has successfully implemented a self-help strategy. In recent years, the company has faced a number of headwinds in its home country of Chile, including stagnating economic growth, increasing competition from new entrants and an increasingly mature wireless market. In an effort to diversify its business, in 2013 Entel entered the Peruvian telecom market—a relatively untapped market nearly twice the size of Chile's. We initiated our current position in 2014, capitalizing on what we saw as a highly attractive valuation that underestimated the firm's growth potential in Peru. Since then, Entel has leveraged its sustainable competitive advantages—strong execution and branding capabilities—to gain market share, build scale and gradually improve profitability in Peru's still underdeveloped wireless market. We are optimistic that Entel's Peruvian investment will continue to drive top-line growth and profitability gains on a consolidated basis.

## Conclusion

While emerging markets' valuations remain more attractive than those in the developed world, valuation discounts are insignificant when companies are destroying value. In this regard, we are encouraged by the renewed focus on value creation that we have observed across our coverage universe. As always, emerging markets will remain volatile. However, we believe companies capable of leveraging their unique access to growth and/or sustainable competitive advantages can best weather that volatility over the long term.

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