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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro
Capital Management Group

Q1 2018 outlook: avoiding expensive growth; backing India, South Korea and Taiwan

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As active investors, we believe at heart that markets are inefficient and that, through a well-thought out and well-tested investment process, it is possible to outperform over the longer term.

As top-down investors, we believe that a lot of that inefficiency will be found at the country level, through excessive optimism or pessimism about the growth prospects, sustainability of growth, currency outlook or political and governance environment in that country. As growth-at-reasonable-price investors, we pragmatically believe that markets will at times misprice part of the growth-value spectrum in the asset class.

Current concerns: the aggressive and excessive re-rating of growth

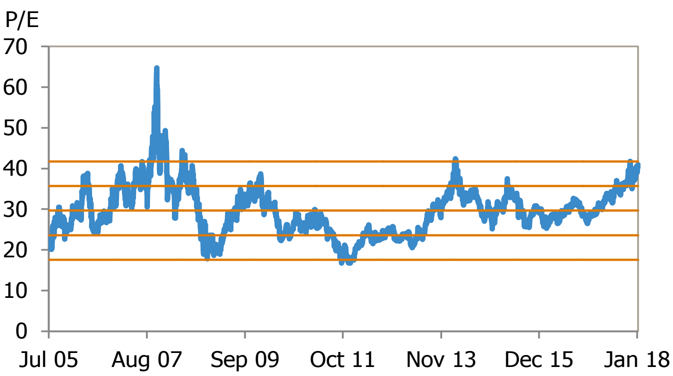
Currently we believe that errors exist within the emerging markets equity asset class in the pricing of growth and fundamentals in both top-down and sector/stock-specific dimensions. The following are a sample of those that we have looked at, rather than a definitive list, and do not constitute investment advice.

Chinese internet stocks

Chinese internet stocks soared in 2017. One of the biggest winners was Tencent, a colossus of the Chinese technology landscape, in large part because of its ubiquitous WeChat messaging app, which has one billion users.

At the time of writing, Tencent is valued on a dizzying 37x 12-month forward price/earnings ratio, over one standard deviation over the historic mean 12-month forward P/E ratio for the stock. Previous occasions when the stock has been valued at this elevated level have been followed by de-ratings back to the mean. Should Tencent finish 2018 at its long-term average (29.7x 12-month forward P/E), the stock would finish the year below its current level, assuming it achieves consensus 2019 earnings. And this assumes that Tencent continues to grow its revenues at 50+% for the foreseeable future in an economy growing at an estimated 11% in nominal terms.

Tencent's toppy valuation



Source: Bloomberg.Data as at 23 January 2018.

Other Chinese internet names have lower but still demanding valuations, arguably weaker business models and more challenging governance aspects. Of particular note is the re-rating of Alibaba, which has just enjoyed three very strong quarters in terms of both Chinese revenue/active user and international revenue, but which seems to have been priced in (the share price has risen 112% since the start of 2017).

An additional component of our growing caution on Alibaba is the firm's use of cash flow. Since the end of 2015, the company has generated RMB 196bn in cash flow from operations. This might not seem much over eight quarters for a company with a market cap of RMB 3 trillion (US$482bn), but of that RMB 196bn, RMB 117bn was used in acquisitions in everything from e-commerce in other emerging markets to luxury malls, newspapers and supermarkets. It remains to be seen whether all those assets will, over the longer term, attract the 29x 12-month forward P/E multiple that Alibaba currently trades on.

Beyond Tencent and Alibaba other Chinese internet names have performed similarly, reacting to strong operational growth with very large share price rises in the last year. The space has enjoyed growth, price momentum and significant investor interest, but it remains our view that share prices cannot outstrip earnings indefinitely.

But it is not just in the Chinese internet sector where valuations have exploded far beyond levels supported by underlying earnings fundamentals.

MercadoLibre

MercadoLibre is a high-profile, off-index emerging market stock. The company (listed on NASDAQ) operates an online trading site in Latin America and has grown successfully in recent years. The majority of the company's revenues come from Brazil, while Mexico, Argentina and Venezuela are also material markets.

We have owned MercadoLibre in the past and hold the management in high regard. Again, though, it comes down to valuations. In 2011, MercadoLibre earned US$107.0m in EBITDA and US$77m in net profit. Its market cap at the end of that year was US$3.5bn, compared to 12-month forward net earnings of US$104m, which put the stock on a 33.8x 12-month forward price/earnings ratio. In 2017, MercadoLibre earned US$185.8m in EBITDA and US$70.5m in net profit, with net profit for 2018 estimated at US$109.3m. At its current market cap of US$16.6bn, the stock is on a 12-month forward price/earnings ratio of 152.5x.

Celltrion

Celltrion is the largest of a group of related Korean biotechnology companies. Celltrion, Celltrion Pharmaceutical and Celltrion Healthcare, all listed on the local KOSDAQ market, have the same majority shareholder. Celltrion effectively has two customers, the smaller Celltrion Pharmaceutical (which it owns) and the larger Celltrion Healthcare (which it does not).

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The group has a very strong product in the biosimilar drug Remsima. This drug has driven rapid growth in revenues at Celltrion, from KRW 603bn in 2015 to an estimated KRW 953bn in 2017, with an estimated 2017 net margin of 41.6%, for KRW 396bn of estimated 2017 net earnings and KRW 574bn of forecast 12-month forward earnings. Recently, the market cap of Celltrion reached KRW 44.2 trillion, or 89x 12-month forward P/E, which clearly makes highly positive assumptions about both the forward pipeline and corporate governance.

Remsima competes with Johnson & Johnson's Infliximab, the world's fourth-largest-selling drug with US$8.4bn (KRW 8.5 trillion) per year in global sales. Even at a 40% net margin and a 20x terminal P/E ratio, Remsima could take half of Inflixmab's global market share and the valuation of Celltrion would still require the research pipeline to deliver results.

At about US$41bn in market capitalisation, Celltrion is larger in enterprise value terms than Russian mining company Norilsk Nickel (US$41bn vs. US$31bn). Norilsk is one of the world's largest and cheapest producers of five different metals, has over 20 years of reserves/production and is expected to generate US$5.2bn of earnings in 2018, compared to one-tenth of that at Celltrion.

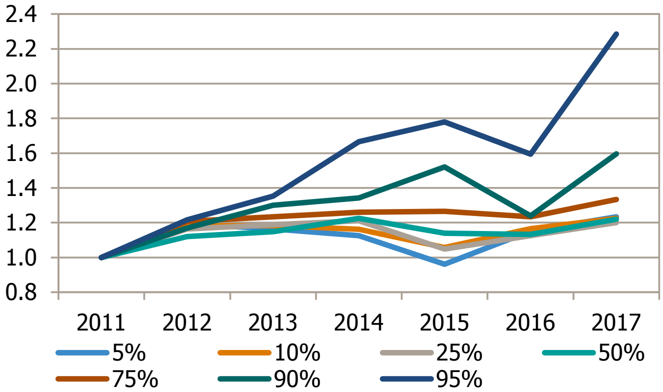
HDFC Standard Life Insurance

HDFC Life is the life insurance subsidiary of leading Indian financial services firm HDFC. A minority stake was listed in November 2017. At the time of writing, the stock is priced at INR 461 per share, which represents a price/book value of around 25x; that's not a misplaced decimal point.

In contrast, industry-leading regional insurer AIA trades at a price/book value of 2.4x and China Life Insurance trades at 1.7x. If HDFC Life de-rates to either of those multiples, even over a 10- or 15-year timeframe, it is essentially mathematically impossible for investors to make a positive return, even ignoring the time value of money.

It is clear that these companies very much represent the growth end of the growth spectrum, and this aggressive re-rating of growth stocks is borne out in the index-wide data. By constructing a composite valuation measure (using price/book ratio, price/earnings ratio and the inverse of dividend yield), we can look at the re-rating of the most expensive stocks. The chart below clearly shows that the top-quartile of stocks has re-rated away from the rest of the asset class.

The most expensive EM stocks have become far more expensive



Source: JOHCM. Composite value measure of MSCI EM index constituents, based on price/book, price/earnings and inverse dividend yield, 2011 = 1.0. Data as at 23 January 2018.

Looking into the top and bottom quartiles (by composite valuation), we finds some interesting trends. The top quartile is dominated by China (by benchmark weight), with India and Indonesia over-represented. At a sector level, information technology, consumer staples and consumer discretionary make up over 70% of the top quartile. The bottom quartile sees South Korea, China and Russia over-represented at a country level while financials is the dominant sector.

There is no natural limit to the premium to which growth stocks can trade at over other stocks. Nonetheless, we certainly feel that parts of the asset class (Chinese internet, consumer growth stocks in parts of Asia) will experience valuation headwinds from these levels.

A distorted index: no time for a passive approach

One further impact from the aggressive re-rating of growth over the last two years has been its effect on the valuation of the overall asset class, as calculated by market cap-weighted or free-float-weighted indices. As these larger growth stocks have performed and re-rated, they have driven the overall valuation of the MSCI Emerging Markets index higher. Some of these growth stocks now dominate the benchmark. At the time of writing, Tencent represents 5.6% of the index, Alibaba 3.8% and Chinese internet in total 12.6%. Naspers (held in the portfolio and discussed below) has significant exposure to Chinese internet stocks and is a further 2.2%. Collectively, this 15% weighting is slightly larger than the index weight represented by the whole of Latin America plus Turkey plus Poland.

This really matters when one considers passive investing in emerging markets equity. An investor putting US$100 to work in a passive, MSCI Emerging Markets index-based fund is putting the first US$15 into Chinese internet exposure and only about US$11 in total into the long-term growth stories of India, Pakistan, Indonesia and Egypt. Seen from another perspective, this hypothetical investor is putting over US$27 into information technology exposure and just over half of that into energy and materials.

Active opportunities

None of this is to call for a crisis in emerging markets. Global economic conditions remain robust. For about the last two years, exports and manufacturing purchasing manager surveys (PMIs) across the world have been robust, while an absence of inflation has allowed central banks to tighten slowly while longer-dated bond yields remain benign. This environment of stronger global growth but supportive global monetary policy is an ideal one for emerging economies. It will create exciting investment opportunities in the emerging markets equity asset class.

Naspers – market-leading internet exposure at a discount

The portfolio retains a large position in South African-listed consumer stock Naspers. Naspers is a media holding company, with the single largest asset being 33% of Tencent. It also owns 28.7% of Russian internet company Mail.ru (also listed). Naspers also has substantial investments in pay TV, e-commerce, online classifieds and online marketplaces.

By subtracting the current market value of the Tencent and Mail stakes from Naspers' market cap, it is possible to calculate the net value of Naspers' other assets (including net debt and central costs). This stub has historically had a small positive value, but in 2016 it began to fall as Tencent outperformed Naspers, finishing the year at US$-13.4bn (i.e. Naspers was worth US$13.4bn less than its stakes in Tencent and Mail.ru). In 2017, the value of the stub fell substantially (touching US$-50bn and finishing at US$-42.3bn) despite some very positive operational and financial developments in the stub. We see this as a major mispricing and as a further indication that passive flows, factor investing and active momentum investing are causing an increasing deviation between valuation and fundamentals in parts of the EM equity space.

India – a coiled spring

Serial economic underperformer India should be one of the world's fastest-growing economies. It has struggled recently with below-trend growth, but the conditions are in place for growth to explode over the next two years. In the short term, a general election to be held by 2019 at the latest means we can expect plenty of fiscal stimulus by the Modi government to ensure that the Indian economy is firing on all cylinders going into the polls.

On a more long-term structural note, last year saw two major developments in India that only add to our optimism over the Indian economy and, by extension, Indian equities. The first was the announcement of a recapitalisation of the state-owned banks of approximately US$32 billion over the next two years. This was by far the most significant move of any recent Indian government to tackle the under-capitalisation of the state-owned banks.

The second was the announcement of a US$105 billion five-year road-building plan to improve transport infrastructure to allow the economy to benefit fully from the liberalising effects of the national goods and services tax (GST). These steps are indicative of a government keen to ensure that the positive effects of its reforms are felt before the election.

We believe the Indian economy resembles a coiled spring waiting to be released. Moreover, it is a growth story that should materialise irrespective of developments in the Chinese and US economies. Whilst Indian equities are not cheap in an absolute sense, the premium they attract over the average for emerging markets is slightly below its normal level, and we feel that the very strong growth opportunity and the prospects for further reforms justify current valuations.

South Korea – Samsung Electronics and other positive corporate governance stories

We believe South Korean stocks are cheap for corporate governance, not geopolitical, reasons. Korean companies are rich in cash yet Korea has the lowest payout ratio of any major market in the world, because a lack of effective oversight allows company managers to simply hold cash back from shareholders. This is changing. The behaviour of corporate Korea and the related lack of dividends has become an increasing issue in Korean politics, as an ageing population needs income from its investments. We feel that both the Korean public's response to a recent corruption scandal, and the resulting election of a left-wing administration, will put huge pressure on Korean companies to reform, and that this will be the catalyst to unlock much of the hidden value in the Korean equity market.

Taiwan – a play on global growth and rising yields

Taiwan is currently our third large overweight country position in the portfolio. As a heavily export-oriented economy with a large tech sector, it is an obvious beneficiary of the synchronised recovery in global economic growth. But it's not just the export growth story that attracts us here. Taiwanese financials such as Cathay Financial Holding stand to profit from rising interest rates and bond yields, especially insurance names with large back books.

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