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Emerging Markets That Live Up to the Name

After repeatedly disappointing U.S. investors, a few countries in Latin America and Asia are finally reaping the benefits of a rising middle class. This time it really is different.

by Carolyn Whelan

YOU COULD FORGIVE U.S. INvestors for feeling a little xenophobic lately, especially when it comes to less developed markets. Take Latin America. Decades of crushing inflation and political turmoil kept economies there stuck in first gear. During the early 1990s some pro-reform leaders took a few positive steps, selling off state-run companies and coordinating aid packages from international banks. Then, after the early signs looked promising, foreigners rushed to invest, just in time to see Mexico devalue the peso in 1994 and send the entire region reeling.

Southeast Asia is a similar story. By the mid-1990s, countries like Singapore and South Korea had catapulted their economies from agrarian fiefdoms to high-tech havens. The Asian Tigers were roaring, foreigners poured money in, and then Thailand devalued its currency in 1997. The resulting turmoil sent the Korean exchange down 67% that year. Those markets weren't emerging; they were submerging.

"We repeatedly have crisis and euphoria," says Margaret Forster, co-portfolio manager of the Liberty Acorn International fund.

So we can understand your skepticism when experts point to the resurgent economies in Latin America and say that *this* time it's different. Much of that region does look to be stabilizing right now, with pro-reform governments, lower inflation, plentiful jobs, and more spending on infrastructure. Brazil's economy, for example, grew 4% last year and, even more surprising, managed to do so without triggering inflation (it's now at 6% and dropping, down from 78% just five years ago). Meanwhile, in Mexico, the political climate looks more promising than it has in decades.

What's different about now? In both countries, plus a few others we'll get to, strong economies have led to a rising middle class—perhaps the truest sign that a market really is "emerging." Workers are enjoying higher wages, which means extra cash for homes, bank accounts, and consumer goods. That discretionary spending boosts the overall economy and creates a kind of virtuous circle—wealth begetting wealth.

To find out where this effect is strongest now, FORTUNE canvassed money managers, economists, and key strategists at international banks. They gave us four countries to focus on: Mexico, Brazil, India, and China. We then went a step further and found a single company in each country with the best prospects of catering to this growing army of consumers. All four of our picks are listed in the U.S. as American depositary receipts (meaning they're easier to trade and

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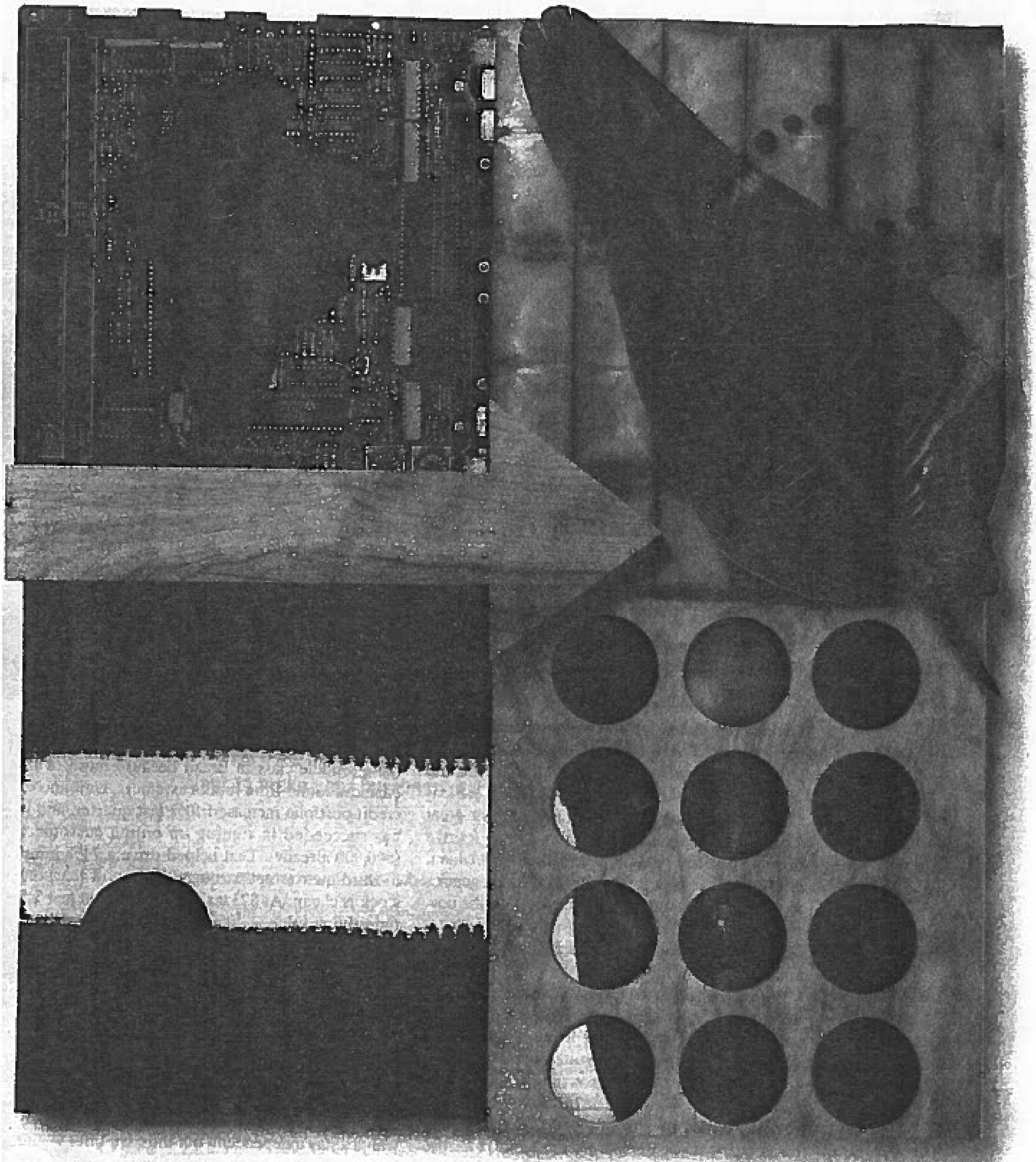

follow stricter, U.S.-style accounting standards).

Now, we're not suggesting you sink your life savings into some exotic overseas locale. But if you can tolerate some risk and believe—as we do—that these four countries are rising for all the right reasons, you might consider putting a modest slice of your portfolio in them (the pros suggest anywhere from 1% to 5%). That said, on to the Cook's tour.

Shopping Spree

A class of affluent consumers has benefited from technology—and also spent more money on it.

	Mobile phones 1999 Increase from 1995	Computers 1999 Increase from 1995
Brazil	7.3 million +750%	1.4 million +720%
China	21.3 million +965%	4.9 million +390%
India	777,000 +1,425%	686,000 +85%
Mexico	3.2 million +1,675%	1.4 million +300%

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Mexico

The 1992 North American Free Trade Agreement was a watershed for Mexico, as U.S. manufacturers set up plants there and hired Mexican employees en masse. About half of all new jobs created in the country since then stem directly from NAFTA. Those new jobs have helped foster a burgeoning middle class of consumers.

Even better news right now is Mexico's political situation. The recent election of President Vincente Fox marked the end of a notoriously corrupt one-party system. Fox, a former Coca-Cola executive, has set 2001 budget goals of 4.5% GDP growth and 7% inflation, and analysts say both numbers are feasible. Already, the Mexican economy has made great strides: Inflation has fallen by about three-fourths over the past five years, to 9%, and unemployment is less than 5%. That progress has led bond agencies to upgrade the country's debt in March to the coveted "investment" rating—alongside that of such decidedly post-emerging nations as Japan, Germany, and the United Kingdom.

"Mexico is very strong," says Kevin Moore, manager of the USAA Emerging Markets fund. "As you improve the standard of living, discretionary spending goes up." The result? Retailers in the country posted 10% sales growth this year. In particular, we think Wal-Mart de México (WMMVY), partially owned by U.S. Wal-Mart, is a winner. It turns out that the company's secret salsa—close inventory control, volume discounts, and better technology and logistics—works as well in Mexico as it does in the states. Walmex is already the country's biggest chain (1999 sales of $6 billion nearly equaled those of its three closest competitors combined), and it's putting up numbers that would make Sam Walton proud. Third-quarter operating earnings were up 22% this year, and revenues rose 11%. "It's the highest-quality retail play in the country," says Daniel Barker, manager of the J&W Seligman Emerging Markets fund.

Brazil

After decades of staggering inflation and backbreaking poverty, Brazil's economy has finally stabilized under the stewardship of President Fernando Henrique Cardoso. As part of Cardoso's "*Plano Real*" initiative, launched back in 1994, Brazil restructured its banks, rewrote the constitution (radically reducing the President's power), and kicked off privatization by selling state-owned businesses.

Those moves were initially slow to take effect, but lately they're showing results. Inflation has fallen, interest rates are just 17%—which may not sound low until you consider that they were 200% back in the early 1990s—and corporate earnings are on the rise. What's more, Brazil's credit ratings have perked up significantly. And as the government privatizes its biggest businesses, foreign companies are setting up shop. Both WorldCom and BellSouth, for example, have invested heavily in telecom networks there.

That macroeconomic success has, not surprisingly, improved the lives of Brazilians, helping swell the middle-class population steadily over the past decade, according to a Brookings Institution study. Paychecks for this group grew a real 18.5% from 1989 through 1996, and banks in the country have benefited, as Brazilians are now saving, borrowing, and investing at increasing levels.

Which brings us to our stock choice: Unibanco (UBB), the nation's third-largest private bank. While it may be smaller than rivals Banco Itau and Bradesco, it's better positioned to benefit from the rising middle class in Brazil because more of its business comes from retail customers. Unibanco's credit portfolio increased 10% last quarter, and it has succeeded in signing up online customers (600,000 already). That helped drive a 74% jump in third-quarter net earnings. On top of that, the stock is cheap: At $23 a share, it trades at just 1.5 times book value, a 40% discount to Banco Itau. And even though earnings are projected to grow 10% a year for the next five years, it carries a P/E ratio of just seven.

One final note: Unibanco could also be an attractive takeover target. Citibank has been eying the company for some time, and the Brazilian government is spurring consolidation in the banking industry by selling off state-owned institutions. As a fast-growing but smaller player, Unibanco may want to stay independent, but the right offer would be hard to turn down. "Privatization could force Unibanco's hand," says Paul Warme, an ING Barings analyst. "That could attract a nice little premium of 30% to 50%."