GRANT'S
FORTY YEARS
INTEREST RATE OBSERVER®

Vol. 41, No. 2c 233 Broadway, New York, New York 10279 • www.grantspub.com JANUARY 27, 2023

For the underdogs

Evan Lorenz writes:

The United States is home to 4.2% of the Earth's population, 24.7% of its annual economic output—and 59% of its stock market capitalization. As recently as 2009, American equities accounted for just 42% of the MSCI All Country World Index. Today, they grab 59%.

Now in progress is a bullish survey of investment opportunities in countries that you may or may not want to visit. The towering likes of Apple, Inc., Microsoft Corp. and Alphabet, Inc. go far to explain American exceptionalism in global equity-market cap. The very different kinds of businesses on offer in Turkey, the Philippines, Indonesia and Peru is the subject at hand.

Last year's selloff notwithstanding, the S&P 500 trades at 29.4 times its cyclically adjusted price-earnings ratio compared with a 50-year average of 21.2 times. To outperform the world on a similar scale for another decade-plus, the S&P would have to climb to nearly 80% of global equity values. Call it a high-grade problem for homebound American investors, and a high-grade opportunity for the adventurous kind.

Rich investors choose the nomenclature for poor and middle-income countries, and the phrases evolve. Today's emerging markets were formerly consigned to the "less developed" or "third" worlds; frontier markets were once deemed "waste places," a term that pious brokers borrowed from the Old Testament book of Isaiah. Functionally, "emerging" countries are held to be on the visible path to modernity. With frontier markets, you have to use a little imagination. Both groups have performed dismally. Since year-end 2009, the MSCI Emerging Markets Index has appreciated by just 5% in dollar terms and the MSCI Frontier Markets Index has fallen by 8%.

Simon Kitchen, head of strategy at EFG Hermes Holding S.A.E., an investment bank that focuses on frontier markets, has tracked assets under management for a sample of as many as 80 frontier funds since 2012. "AUM in October 2022 was $3.5 billion, 76% lower than September 2014 ($14.8 billion)," he reports. "Most of the drop in AUM was from outflows."

No surprise, then, that EM stocks trade at 11.5 times trailing earnings and frontier equities at 10.4 times, sizable discounts to the 12-month trailing multiple of 19.5 for the S&P 500. "If you rank multiples like price to book, dividend yield and price to earnings, in some of these markets you are in the lowest decile relative to their history," Kitchen advises.

The long exodus of foreign investors has put pressure on local stock prices and exchange rates alike. According to *The Economist*'s Big Mac Index, which measures the purchasing-power parity of currencies against exactly one juicy item of edible merchandise, undervaluations versus the U.S. dollar range from 30% for the Peruvian sol to 45% for the Philippine peso to 55% for the Indonesian rupiah.

Bulls observe that foreign ownership in most EM stock exchanges is low and that a return of foreign buyers could catalyze a new up cycle in emerging assets. Perhaps something like that has already started. According to the January BofA Global Fund Manager survey, a net 39% of investors are underweight U.S. stocks, the most since October 2005, while 26% are overweight emerging markets, the most since June 2021.

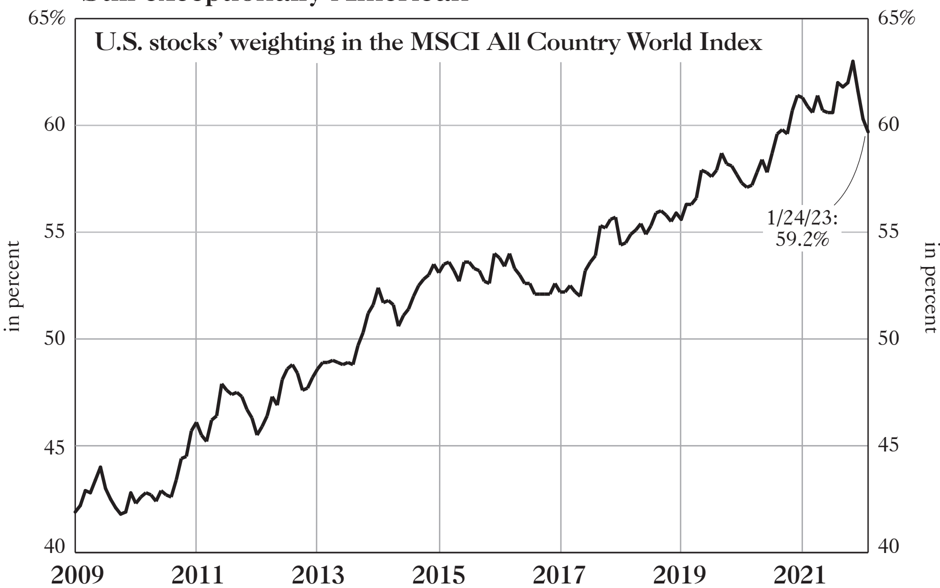
Turkey is a good example of what a change in liquidity can mean for stock prices. President Recep Tayyip Erdoğan, famously averse to interest rates, especially high ones, cycled through three central bank governors in three years before finding one who reliably toes the low-rate line. Implementing the president's novel monetary program, the Central Bank of Turkey slashed its target rate to 9% from a high of 14% last year despite an inflation rate that soared to 85.5% and a lira that lost nearly one-third of its value against the dollar.

This is not exactly the kind of backdrop that entices international investors, and foreign ownership of Turkish stocks has dropped to 32% of the total from 64% three years ago. However, high inflation and Erdoğan-compliant interest rates left few non-equity investment options to inflation-ravaged Turks. "What was left for local investors?" Haydar Acun, CEO and chairman of Marmara Capital Asset Management, rhetorically asks me.

"More than a million people opened stock market accounts in Turkey," Acun answers. "Every day we see thousands of people opening stock market accounts and newcomers buying our funds. When we started [our fund in 2014], we had only 20–25 investors and 100% of them were international. Now we have 45,000–46,000 investors, and everyday a couple of hundred join."

Thanks to the influx of local buyers last year, the Borsa Istanbul 100 Index

Still exceptionally American



source: The Bloomberg

logged a 117.4% total return and the Marmara Capital Equity Fund a 175.7% total return, both in dollar terms. Despite that meteoric performance, the Borsa Istanbul 100 trades at just seven times trailing earnings.

In monetary policy, Turkey is an emerging-markets outlier. It was the developed world, in its wealth and sophistication, that implemented QE and whisker-level policy rates. For the most part, emerging-market monetary authorities have been quicker and more forceful off the mark in meeting the post-Covid inflation surge than their counterparts in the United States and Europe.

Fiscal policy is another matter. Not a few EM governments borrowed heavily in the past decade, frequently via dollar- or euro-denominated bonds, with Ghana showing a 90.7% ratio of sovereign debt to GDP; Barbados, 117.9%; and Sri Lanka, 130.5%, leading the way. According to the International Monetary Fund, emerging-market sovereign debt as a percentage of emerging-market GDP rose to 64.5% in 2022 from 38.7% in 2009. As of October, the proportion of low-income economies in—or at risk of succumbing to—debt distress rose to 56% of the 70-nation total from 27% in 2015, again according to the IMF.

. . .

Where might the seeker after EM value look for opportunity? Many will hug the indices, though not Benjamin Isaac, chief investment officer of Brizo Capital, L.P. The trouble with the indices, he tells me, is the over-representation in those canned portfolios of mediocre businesses: "A state-run bank that's going to constantly earn a ROE below inflation deserves to trade at a material discount to book value."

Besides, you may not get much diversification from ETFs. The $26.8 billion iShares MSCI Emerging Markets fund, for example, invests 72% of its assets in only four countries. China, which just reported its first decline in population in 60 years (down by 850,000, to 1.41 billion, in 2022) and which, according to the United Nations, will suffer continued declines through 2050, commands a 32% weighting. A shrinking populace paired with a deflating real estate bubble may not be conducive to bounding asset prices.

Go beyond the EM indices, however, and "there's a tremendous range of opportunity everywhere," Isaac contends. "It's not difficult to find a range of fairly to very well-run banks trading at one-to-four times earnings in a lot of instances. Often there's a reason for that. These are well-run banks in difficult neighborhoods, just to be clear. If you're looking for higher-quality, relatively speaking, you can find a lot of stuff, we think, in the 6-to-10 times earnings range."

Isaac identifies food retailer Puregold Price Club, Inc. (PGOLD on the Philippine Stock Exchange) as one such quality name. Consider first, he says, that the Philippines is young (with nearly 30% of its 114 million population under the age of 15 versus 18% in the United States), fast-growing (the IMF estimates that its real GDP will expand by 5% in 2023) and not excessively encumbered (with a 59% ratio of sovereign debt to GDP at the end of 2022). Second, Puregold is priced to a 2.4% dividend yield and a 11.5 times trailing earnings multiple versus an average of 21.7 times in the three years ended 2019.

Puregold is the second-largest grocer in the Philippines, with 443 shops ("something like a 7-Eleven crossed with a dollar store," Isaac relays), 22 S&R Membership Shopping stores (modeled after Costco Wholesale Corp.) and 48 S&R-branded restaurants. "If you take a look at the Philippine retail market, basically Puregold and 7-Eleven are the only two companies that we can find that materially gained market share organically over the past decade," says Isaac. "It's a good retailer."

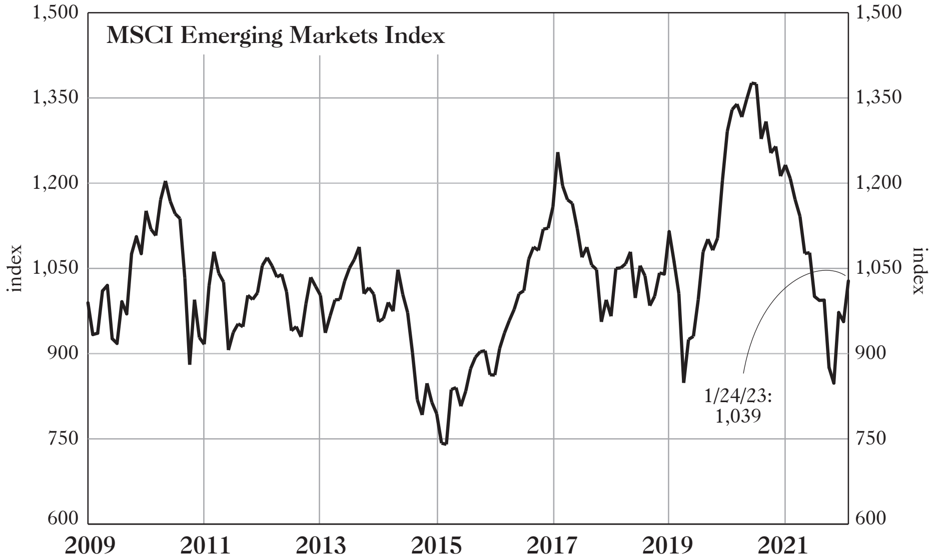
As of Sept. 30, 2022, Puregold's balance sheet showed net cash of PHP 18.8 billion ($344 million) and capitalized operating leases of PHP 37 billion versus trailing Ebitda of PHP 18.7 billion. In the third quarter, operating income covered net interest expense (which included an imputed charge for leases) by 6.4 times.

While crooks abound the world over, corporate governance usually does not improve as one descends the development ladder, and even the most knowledgeable local investors can get caught out. Thus, among the major investors in Americans S.A., a retailer headquartered in Rio de Janeiro that filed for bankruptcy protection last week after disclosing almost $4 billion in accounting inconsistencies, were none other than the founders of Brazilian hedge fund 3G Capital.

One way to avoid such situations, Nick Padgett, managing director of Frontaura Capital, LLC, tells me, is to invest in the publicly listed subsidiaries of big multinationals. These companies, says Padgett, "tend to bend over backwards to treat minority investors fairly, and one way to get cash flow back to the parent is to pay a generous dividend."

Ginebra San Miguel, Inc. (GSMI

No bubble here



source: The Bloomberg

on the Philippine Stock Exchange), for instance, maker of the eponymous gin, the world's best-seller by volume, is 75.8% owned by San Miguel Corp., a Philippine conglomerate with operations spanning alcohol, energy, finance and real estate. The stock is priced at 7.3 times trailing earnings and pays a 4.8% dividend yield.

Like many another business in many another market, Ginebra fell victim to overexpansion, overindebtedness and a loss of strategic focus—this was in the first half of the 2010s. A management change in 2017 righted the ship, and earnings per share grew by 691% through the 12 months ended Sept. 30, 2022. On that date the balance sheet showed a net cash balance of PHP 7.9 billion compared with a net debt of PHP 5.5 billion in 2017.

"To put it all together," Frontaura partner and head of research Timothy Raschuk tells me, "this is the largest gin company in the world [by volumes] and has the biggest liquor-market share in a large EM country." Ginebras's valuation is undemanding beside that of its Philippines-listed peer Emperador, Inc., which trades at 32.6 times trailing earnings and dominates the local brandy market. There are strengths and weaknesses in both companies: Ginebra is growing faster, but Emperador has higher margins. The biggest difference between the stocks, Raschuk relays, is liquidity. Some 43,809 shares of Ginebra (with a market cap of $638 million) change hands on an average trading day versus 4.3 million shares for Emperador (with a market cap of $5.9 billion). With that said, according to Raschuk, Ginebra has become easier to trade as the market cap has expanded from $171.4 million in 2017. Ginebra is Frontaura's largest stock holding.

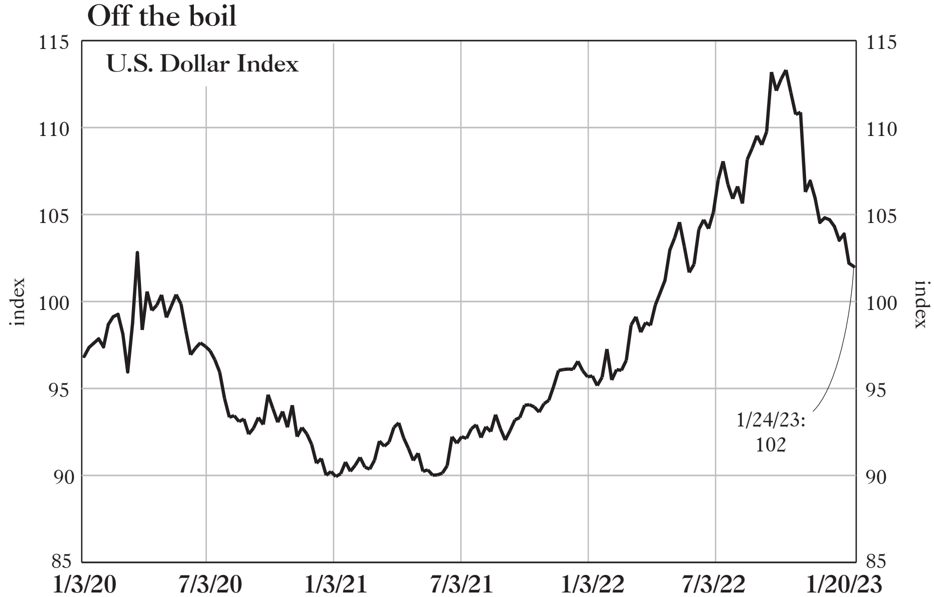
Further to the theme of investing in the listed subsidiaries of big companies, the Frontaura team is also long Banco BBVA Perú (BBVAC1 on the Lima Stock Exchange). Spanish banking giant Banco Bilbao Vizcaya Argentaria, S.A. holds 46.1% of shares in its namesake subsidiary. Like the Philippines, Peru has a youthful demographic profile (25% of its population is under the age of 15), but it has less government debt than the archipelagic nation (34.8% of GDP in 2022) and lower expected growth in 2023 (the IMF guesses 2.6%).

BBVA Perú is the second-largest Peruvian bank after Credicorp Ltd. (BAP on the New York Stock Exchange). Despite generating a 21.4% return on equity in the 12 months ended Sept. 30, 2022 versus a 17.5% ROE for its U.S.-listed peer, BBVA Perú trades at 6 times trailing earnings and 1.2 times book value versus Credicorp at 9.5 times earnings and 1.6 times book. Based on the current share price, BBVA Perú offers a 6.1% dividend yield.

The Peruvian subsidiary funds its loans via deposits, but just barely (the ratio of the two line items was 96.4% on Sept. 30, 2022). However, the company appears well-capitalized, with tangible equity equal to 11.5% of risk-weighted assets at the end of the third quarter. In that quarter, nonperforming loans accounted for 4.2% of the total book and reserves covered nonperforming credits by 151%. Padgett describes the bank as "conservatively managed."

Nonetheless, BBVA Perú does business in a rough neighborhood. President Dina Boluarte was sworn into office on Dec. 7, 2022, following the impeachment of her predecessor, Pe-

Off the boil



source: The Bloomberg

dro Castillo, to the accompaniment of riots by his followers. Starting in the Peruvian countryside, the disturbances last week moved to Lima.

"There are a lot of scary headlines out there about Peru," says Raschuk. "But the reality is that the economy and central bank are very well-managed. I think the currency's relative stability reflects that. The country has low debt, high reserves and an investment-grade credit rating. So the politics are volatile, but in reality—and this can always change, of course—politics haven't led to deterioration in the business environment such that a bank like this would be severely impacted."

John Haskell is a friend of this publication who has invested in emerging markets since he left the Boston Consulting Group as a project leader in 2015. His new venture, Atla Capital Management, LLC, of which he is founder, chief investment officer and chief cook and bottle-washer, is off to a strong start with a cumulative 19.1% return since its March 2021 inception versus a 29.8% drawdown in the MSCI EM Index. (A trio of ideas that Haskell shared in the April 30, 2021 issue of *Grant's* have delivered dollar returns of between 20% and 83%.) I called him while he was in Yogyakarta, Indonesia, recently conducting a due diligence mission on PT. Pakuwon Jati Tbk. (PWON on the Indonesia Stock Exchange).

Pakuwon, a real estate investor and developer that spans the gamut of commercial property types, owns a Marriott hotel in that central Java city. "Their occupancy rate right now is above 80% in what's usually a low month in January," Haskell told me. "Anecdotally, I was the only foreigner I could see in the whole hotel. They are oriented towards business conferences and also large families on vacation. The manager of the hotel was telling me that their performance in December this past month was the single highest sales record in their history of operating. So the city is booming. But it's driven by internal consumption, which I think is quite interesting."

Like the other less-developed countries featured above, Indonesia has a young population (25% are under the age of 15), a manageable level of government debt (40.9% of GDP in 2022) and high hopes for growth this year (the IMF pencils in 5%).

Pakuwon does not appear expensive at 11.7 times trailing earnings, a discount to Indonesian peers such as PT. Summarecon Agung Tbk., which trades at 20.9 times trailing earnings, and PT. Bumi Serpong Damai Tbk., which trades at 14.2 times. As of Sept. 30, 2022, the balance sheet showed a net cash balance of IDR 1.9 trillion ($122.5 million).

"I think there are a few ways to see Pakuwon's discounted valuation as an easy double from here," Haskell told me. "Replacement cost is the simplest. What if you burned it all down, literally, and rebuilt? Buried on page 56 of the consolidated financials you'll find that third-party insurers appraise Pakuwon's built assets at $2.6 billion as of third-quarter 2022, implying $3 billion if you add in the estimated market value of 465 hectares of uninsured land, or a double from today's enterprise value."

•