Emerging Markets Investment Outlook

Value Investing in a Lower Growth Environment

China's economic challenges have been well documented. The hoped for economic rally following the opening up of the country post the almost three years of Covid disruption has failed to materialise. While consumption related to services and travel rebounded in Q1 this year; property developer and local government balance sheet stress has damaged confidence. This has rendered private sector businesses unwilling to invest and employ, as can be seen in the youth unemployment figures, causing consumers to save rather than consume. These short-term cyclical problems have intensified long term structural concerns. The list includes demographic pressures; slowing migration from rural to urban areas; high levels of debt, and President Xi's socially driven agenda. All the above are compounded by the ongoing economic decoupling from the West. The overwhelming negative sentiment that is already reflected in the Chinese stock market suggests a far worse economic backdrop than we believe is likely in reality. Nevertheless, it seems certain that economic growth in China over the next 10 years will trend below that of the last 10 years, albeit still at a premium to most countries in the developed world.

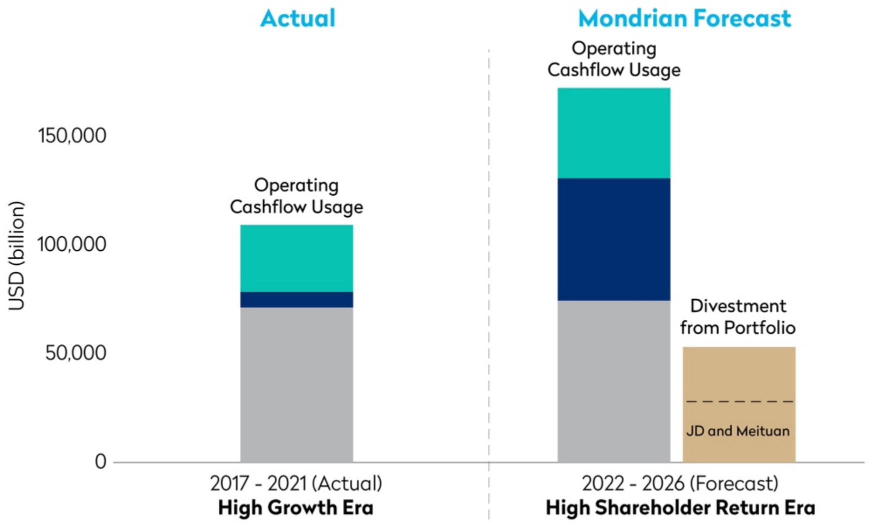
This of course has implications for investing in China's stock market. Clearly, many stocks that were once perceived as growth stocks are unlikely to deliver anything like the levels of profit expansion witnessed historically. However, China's stock market is deep and there will always be companies that are successful, and it is an active manager's job to try find them. We believe that many of these more successful companies will increasingly recognise the slower growth outlook and support their share prices from here by shifting focus towards shareholder return. We believe this combination should favour value managers such as Mondrian. This leads us to highlight Tencent as the prime example of a company we expect will now become much more in focus for value investors than growth managers.

Tencent was in many ways the poster child for China's robust economic growth during the last decade. In the 2010s, Tencent's revenue grew an astonishing 30x and its EBITDA 20x. This helped its share price's meteoric rise from 31HKD at the start of 2010 to 346HKD at the end of the decade. Tencent was thus the darling of growth investors and it's easy to understand why. As we write today, Tencent's shares sit at 300, below where it was in 2020. Revenue and EBITDA have continued to grow since 2020, although at a much lower rate, and hence Tencent stock's valuation metrics have sharply derated.

This is of course completely explicable. Tencent rode on the back of not just China's strong economic growth, but the rapid adoption of technology at a time when competition was nascent. By 2021, the Chinese government felt Tencent, and certain other technology platforms were showing anti-competitive characteristics and introduced regulation to limit their future expansion. While Tencent and others have adapted their business models to satisfy the regulators, this has occurred when the above economic slowdown is also weighing on them.

Tencent is still the second largest stock in the MSCI EM Growth Index, yet we believe it will be extremely demanding for the company to grow faster than double digits over the next five years. Nevertheless, Tencent has been, and will continue to be a significant generator of free cash flow. While much of that cash flow historically went into investments and acquisitions, we believe the next few years will see a large proportion returned to shareholders. In fact, this has already begun. In the last two years Tencent has been divesting stakes built up over previous years. It sold the majority of its stakes in JD.com and Meituan, and distributed this to shareholders as dividends totaling over $28billion. Additionally, they have begun buying back stock at a run rate of approximately $10billion per annum. This is in addition to an already established dividend policy which typically equates to a small pay-out of 10% of net income. The investment case has thus changed in our opinion from one of growth to value.

Tencent: A Value Investment Case Through Increasing Shareholder Returns



	2017 - 2021 (Actual) High Growth Era	2022 - 2026 (Forecast) High Shareholder Return Era
Revenue CAGR	30%	7%
EBITDA CAGR	24%	10%
Shareholder Return as % of NI	8%	53%
Shareholder Return with Divestments as % of NI	-	102%

Surplus Cash Generated · Dividends and Share Buy Backs · Capex and Acquisitions · Divestments

Source: Company Financial Statements, Mondrian
The opinions and forecasts expressed here are Mondrian's views based on proprietary research.
A position in the company is held as at June 30, 2023. Holdings are subject to change. Analysis is included for illustrative purposes only. There is no guarantee the investment will be successful or similar investments will be made.

As can be seen in the chart above, we forecast Tencent's revenue growth to fall in the period 2022-2026 to approximately 7% per annum compared to 30% over the previous 5 years. This isn't the level of growth we expect would be required by most growth managers. However, Tencent have broadly acknowledged this outlook and somewhat shifted the focus and messaging towards value creation through shareholder returns, as well as a greater focus on profitability rather than revenue or acquisitions led growth. They expect to realize additional value from divestments within an investment book worth roughly $100bn, as well as continuing to buy back stock and increasing regular dividends. In the five years between 2022-2026 we expect total shareholder return to equate to an approximate 5% yield per annum on current market cap. If Tencent executes as we hope and returns capital as stated, this makes the stock attractive to value managers such as Mondrian that use a shareholder return based value approach. To be clear, we still expect profit growth, albeit at a more sustainable level than historical periods. Whether Tencent moves from the growth to value index is not our concern, but we do expect perception of the company to continue to change. We have accordingly begun to add to our position amid the recent pull-back in the share price.

Our market weight to China is neutral at present, as while we acknowledge the top-down challenges, the last 2-3 years' underperformance of the market has left many companies considerably undervalued. For most of our Chinese stocks, we expect a substantial amount of value to be delivered from healthy and improving cash returns to shareholders, given high cash balances and robust free cash flow generation even as China's economy slows.

China isn't the only country where we expect slower growth. Many economic data points seem to indicate that it is a question of when, not if the US falls into some form of recession. In the last 12 months we have bought 11 new stocks for the portfolio of which 3 are telecoms, 2 utilities and 1 consumer staple which should indicate our conservative outlook for the global economy and hence stock markets. Outside of those, we have added to the Middle East as we expect the region to be relatively more disconnected in a global recessionary environment; as well as other areas where the portfolio had less exposure to enhance diversification. In Q3 we continued to reduce various cyclical stocks that had performed strongly for the portfolio, and identified value stocks to purchase in their place that we feel will be somewhat more recession proof, thereby adding a further level of resilience and downside protection to the portfolio. At the end of Q3 the portfolio is overweight Staples, Telecoms and Utilities, and approximately half of the portfolio is invested in companies with net cash on their balance sheets. This alongside the raw portfolio valuation metrics of a PE at c.10x and dividend yield of c.4.5% should all help provide defensive qualities if we were to move into more challenging economic times as a result of slowing growth in the world's largest two economies, China, and the US.

Disclosures

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