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Emerging Markets: Beyond GDP growth

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Looking towards the next decade, the prospects for countries in Emerging Markets (EM) are not uniformly bright.

New challenges have arisen, such as the rise of protectionism, and how poor countries will recover from COVID-19. Nevertheless, there are a multitude of opportunities for active investors in EM.

The crucial difference from a long-term investment perspective will however be to identify the leaders and winners and avoid the rest. The leaders will be those companies which, by virtue of their intrinsic competitive advantages, will be able to deliver above-industry average growth, and consequently stock-price performance. The importance of good ESG practices is growing in EM, however disclosure levels lag behind Developed Markets (DM). Fundamental research and engagement help to form an informed opinion and bring about positive change.

This is a white paper/thought leadership document written by the Emerging Markets Equities team of UBS Asset Management, and is not meant to discuss our investment process, stocks or products. Company examples have been kept to a minimum to illustrate some points and none of the names mentioned are meant to be investment recommendations.

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Introduction

Investing in Emerging Markets over the next decade
Looking towards the next decade, the prospects for countries in Emerging Markets (EM) are not uniformly bright. New challenges, such as the rise of protectionism and the recovery from COVID-19 have arisen. Nevertheless, there are a multitude of opportunities for active investors in EM.

Megatrends result in great disparity between winners and losers, and investment in these winners can continue to be highly profitable even in a challenging world.

We believe that to take advantage of these opportunities, it is necessary to look behind headline GDP figures, and indeed newspaper headlines, and examine how major trends are affecting industries and companies and, which countries are best positioned to provide a supporting environment for the same. This is the focus of this paper. Identifying specific companies is not in scope.

Winners and losers
The past decade or two created strong winners and losers within sectors and sub-sectors, and even more so amongst companies.

Just looking at a broad sector level, the difference in performance between the information technology sector which has returned 215% over the past decade and materials which has lost 23%[1], illustrates this point.

The victors and the vanquished have been much stronger and clearer amongst companies. As examples, over the past decade one of China's leading internet names, Tencent, has returned over 1700% and leading foundry Taiwan Semiconductor Manufacturing (TSMC) returned over 850%. Meanwhile, many stocks have lost over half their value[1], such as Taiwan's tech companies HTC and Acer that lost over 90% and 65% of their value respectively.

If anything, this differentiation between winners and losers has increased over time and looks set to continue into the future.

1 Factset, as of July 2020

“These structural trends serve as long-term transformative forces that have the capacity to change the global social, economic and political landscape over the longer term, including the way we live, work and operate.“

Identifying future drivers
While company specific factors, like quality of management and business model definitely play a strong role, equally important are the trends and themes that provide strong tailwinds for some industries, and headwinds for others.

The digital transformation of the global economy we have seen being the most obvious example of such a strong structural trend.

These structural trends serve as long-term transformative forces that have the capacity to change the global social, economic and political landscape over the longer term, including the way we live, work and operate,.

After extensive discussion we arrived at the following five broad trend categories:

- Digital transformation & disruption continuing to radically transform business models and consumption patterns across industries

- The evolution of the EM consumer, changing consumption patterns, like increasing wallet share of discretionary consumption and premiumization

- New horizons in health care: driven by an aging population, urbanization and changing lifestyles. EM countries almost universally underspend on health care and spending has to increase

- Climate change and Environmental, Social, Governance (ESG) issues are likely to have an increasing and varied impact on the returns to industries and companies

- De-globalization driven by geopolitics, leading to reconfiguration of manufacturing supply-chains, import substitution and reshoring

What about country and macro factors one might well ask?
Certainly, these too play a crucial role in providing varying degrees of support for these trends and themes to flourish, and for companies to take advantage of them.

One gauge of their importance from an investment perspective can perhaps be the performance of specific stock markets. E.g. over the past decade, Taiwan has returned 168% and China 96%, while Brazil is down 32%[1].

We identified several key measurable variables as being correlated to the development of a market and impacting the prospects of themes and companies within it. We elaborate on these in the next section.

Thereafter, we share our thoughts from our team of experienced analysts who are sector/industry specialists. We asked them to think about the implications of the above factors on their areas of expertise and coverage and then also come up with investable ideas in terms of sub-sectors that could win or lose over the medium to long term, say over the next three-to-10 years.

1 Factset, as of July 2020

Country overview

The key global trends may lead to accelerating differentiation in the economic development of the respective countries, resulting in many winners, but also losers. The well prepared ones will be better able to manage the challenges and capture the opportunities, whereas the weaker countries might struggle.

The methodology
We have ranked each of the 18 examined markets within each of the respective parameters considered. The final ranking reflects the average rank across the examined parameters. We have added Germany, Japan and the USA to this analysis as comparison benchmarks. The parameters include:

- *A well-educated population*, able to implement new technologies in the economy and perform higher value added activities, as lower value added ones get replaced by automation – *PISA study ranking (latest level and trend)*

- *High degree of innovation*, which could enable the country to focus more on higher value added economic activities and climb the value-added ladder, as the lower value-added activities get replaced by robots and the production migrates back to developed markets amid ongoing deglobalization – *R&D spend as % GDP*

- *A well balanced wealth distribution* across society helps to avoid social unrest and rise of populist policies, and enables a wider spectrum of the population to contribute to and benefit from economic development - *GINI coefficient, a measure of income inequality (latest level and change over the last 10 years)*

- *Healthy public finances*, enables spending on soft and hard public services and infrastructure such education, health, social security, transport, power, etc., thereby increasing the ability of a country to develop economically as well as withstand difficult times (e.g. GFC, COVID-19,) – *Public debt % GDP (latest level and momentum)*

- *A business-friendly setup*, and the ability to attract global flows of capital, both financial and human - *Ease of doing business (by World Bank – latest level and trend)*

- *Vulnerability to climate change*, both in terms of geographic conditions as well as economic structure *(Notre Dame-Gain Country Index)*

We have overlaid the results with the size of the investment opportunity, defined as the size of the domestic consumption market. The results are as below: note the lower the number/rank, the better.

Country rankings

	EODB	GINI	PD/GDP	PISA	R&D % GDP	Climate vulnerability	Final rank	Size
Korea	2	4	2	3	1	2	1	9
Taiwan	1	6	1	11	2	1	2	13
Poland	11	1	5	2	10	7	3	12
Russia	2	2	2	13	12	14	4	7
China	3	7	13	1	6	13	4	2
Germany	11	7	14	8	4	3	6	4
Japan	14	10	17	4	3	3	7	3
Malaysia	4	4	10	15	8	11	8	15
Hungary	13	11	6	9	7	8	9	18
Thailand	8	2	9	14	11	10	9	14
Turkey	7	17	6	4	13	9	11	11
USA	5	17	18	6	5	6	12	1
India	8	13	10	4	15	16	13	5
Chile	17	12	12	7	16	5	14	17
Mexico	16	7	4	11	17	14	14	8
Brazil	15	14	15	10	9	11	16	6
Indonesia	10	16	6	16	18	18	17	10
South Africa	18	14	16	-	14	17	18	15

Sources

Ease of doing business:	World Bank, 2020
GINI coefficient:	World Development Indicators, 2020
PD/GDP:	Morgan Stanley, 2020
PISA, R&D of GDP:	World Bank, 2020
Climate vulnerability:	ND-Gain Country index (Notre Dame Global Adaptation Initiative), 2019

Notes

EODB	= Ease of doing business
GINI coefficient	= a measure of the distribution of income across a population
PD/GDP	= public debt / GDP
PISA	= PISA score, an assessment of 15-year-old's reading, maths, and science knowledge and skills across countries, named after the OECD's Programme for International Student Assessment
R&D as % of GDP	= Research & Development
Size	= size of investment opportunity, defined as the size of the domestic consumption market

> "On a top-down basis, we conclude that China, Russia and Korea offer the best opportunities going forward."

We believe that the markets in the bottom left of the scatterplot below are the best prepared and also offer a good investment opportunity in terms of size of the market. Markets in the top right corner are smaller and have lower ability to benefit from the key trends.

On a top-down basis, we conclude that **China, Russia and Korea** offer the best opportunities going forward. Their economies have relatively good preconditions, while also offering sizable domestic markets. The comparison with the key DM markets USA, Japan and Germany also bodes well for these EM leaders.

Korea stands out in all the considered metrics, being among the top four in any of the examined variables.

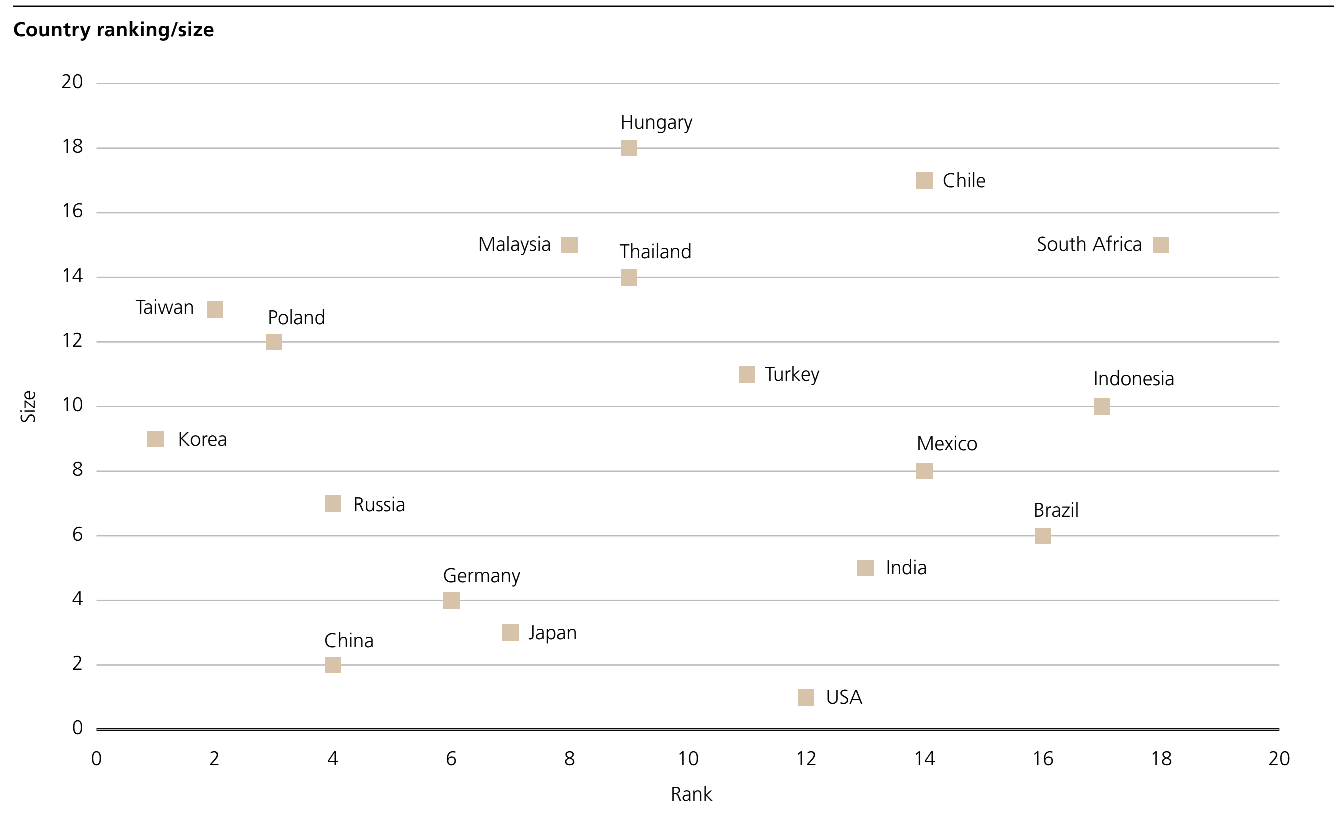
China benefits especially from its excellent education and high and quickly rising R&D expenditures in combination with a business-friendly environment. Not to mention the investment opportunities in the huge domestic market. However high public debt and climate vulnerability are the key negatives.

Somewhat surprisingly **Russia** came out high in the ranking. Its clean public balance sheet, a relatively equal society with broad access to education and improving business conditions compensate for somewhat low expenditures on innovation and high climate vulnerability amid large dependence on fossil fuel production.

On the other end is **South Africa**, with both poor pre-conditions across the board as well as a small market.

Markets such as **India**, **Brazil** or **Mexico** score relatively poorly in terms of their outlook, but are of large size. For **India**, good education and improving conditions for business fail to compensate for the traditional problems of high inequality, low spend on R&D or high vulnerability to climate change. For **Brazil**, ease of doing business is traditionally a big negative, as well as extreme inequality and quickly declining fiscal flexibility. However, the large market sizes provide opportunities for winning companies and investors.

Country ranking/size



Source: UBS Asset Management, October 2020

Information technology

Key takeaways

- Asia is the manufacturing base for the global IT sector and Asian companies have become global leaders
- The 5G era will increase demand for advanced semiconductor chips & components
- Automation and regional diversification will heavily impact EM supply chains
- National champions may emerge amid geopolitical tensions

Asia – an important hub of the global IT sector
Asia's status as a manufacturing base for products such as PCs and mobile phones has underpinned the IT sector in EM in the past.

And over time Asian companies have moved up the value chain and industry clusters have emerged across various geographies. Now, Asian companies have become global leaders in their respective industries.

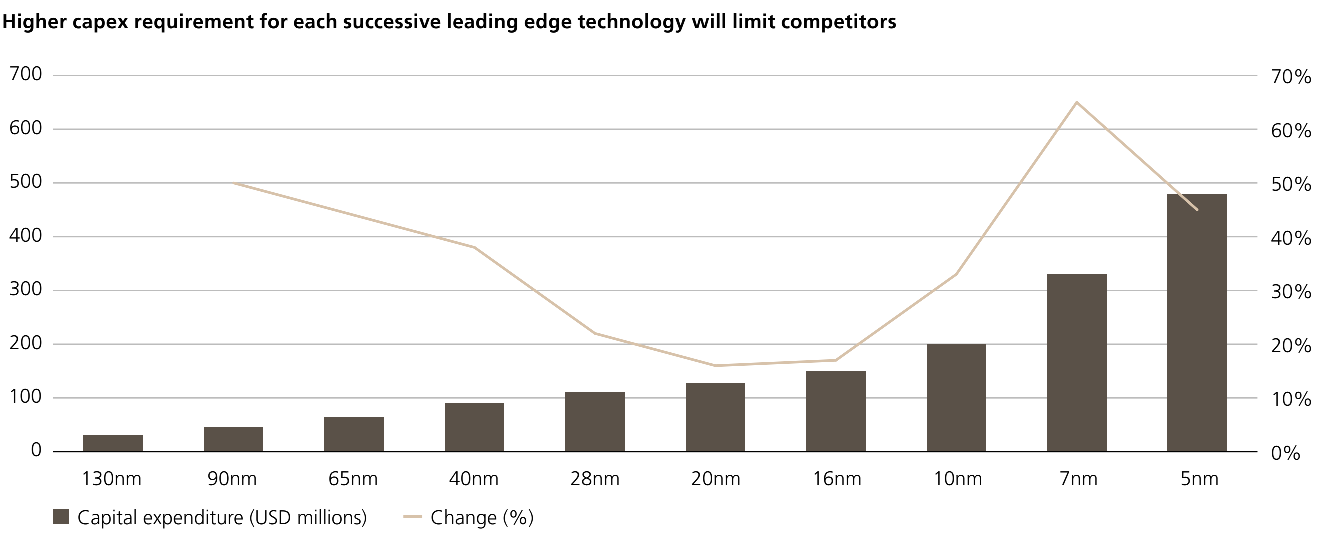
Opportunities in the 5G era
As digital transformation and disruption both continue and accelerate, we believe the 5G era will bring new applications and disruption, and drive an exponential increase in data creation, processing, transmission and storage.

Chips and components: focus on market leaders
We expect this will drive demand for advanced semiconductor chips. More powerful chips will be required to provide computing power to Artificial Intelligence (AI)-type applications and also to consume less power as mobility remains a critical requirement.

There are a small number of companies in Asia that possess the technological leadership to manufacture such advanced chips and we expect that these companies would do well as the critical enablers in the era of digital transformation.

Commodity-type components would also see greater demand and there are also many Asian companies that are market leaders in such components.

Higher capex requirement for each successive leading edge technology will limit competitors



Note: TSMC is currently producing 5nm
Source: Company data, CLSA, as of July 2020

For certain components, consolidation has taken place and if supply-side capital expenditure (capex) discipline remains intact, the companies in these industries should continue to generate good returns through the cycle going forward.

Automation in the new manufacturing era
Wages and overall operational costs have increased over the years while the labor supply for traditional manufacturing has tightened.

As such, we are seeing greater use of automation and a general upgrade of equipment. Increasingly, terms like new manufacturing, industry 4.0 and industrial internet of things –are being used to describe greater use of technology and data analytics to upgrade manufacturing lines and consumer products.

We believe companies that embrace and enable such changes will be positioned to benefit from this secular trend.

Longer, more diversified supply chains
We expect ongoing relocation of manufacturing capacity out of China, prompted by rising costs and geo-political tensions.

Furthermore, the COVID-19 outbreak has underscored the importance of supply chain diversification, which we expect will drive downstream manufacturing supply chains outside of China.

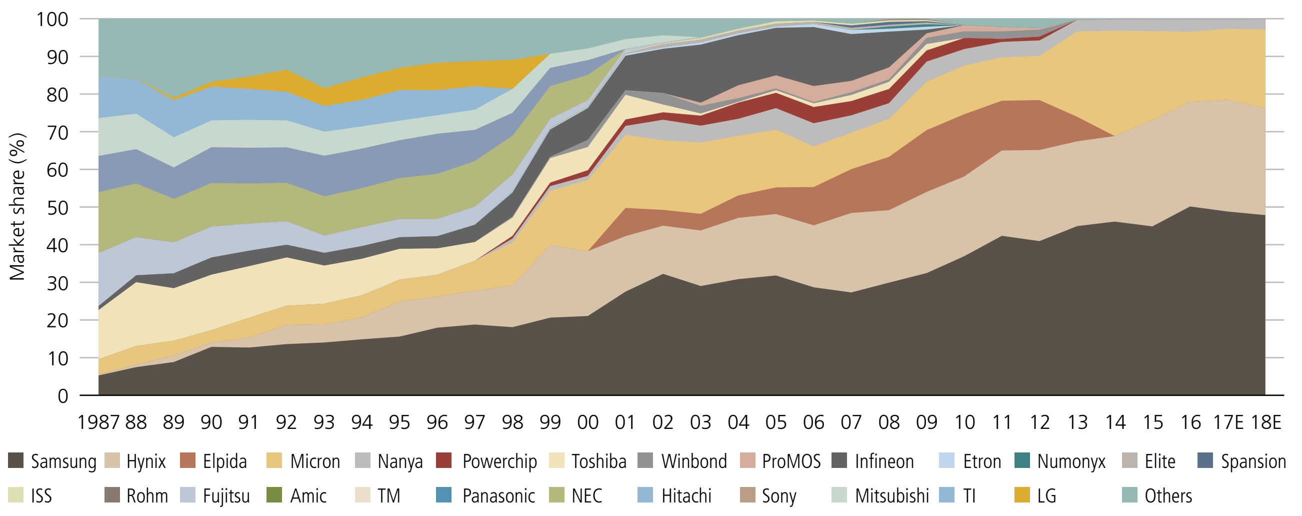
Vietnam is one location that we expect will continue to be a major beneficiary from this trend.

Geopolitical tensions may also lead to the emergence of so-called national or regional champions. Some companies and regions will therefore see new opportunities whereas others may suffer the consequences.

In summary, we believe long-term winners in the EM IT sector will include semiconductor global leaders, particularly those with exposure to advanced process technology. Overall consumption of selected components will increase, hence favoring companies in related industries where consolidation has taken place.

Concurrently, de-globalization and changing geopolitical dynamics will likely see the growth of downstream manufacturing supply chains outside of China, while China would look to accelerate its localization efforts, particularly in the semiconductor space, thereby potentially creating new national champions.

Consolidation in the DRAM industry



Source: Bernstein Analysis, Gartner, DRAMeXchange, updated Feb 20
Note: Only top names in legend

Financials

Key takeaways

- Structurally lower Return on Equity (ROE) for incumbents driven by lower interest rate and growth
- Disruption from fintech is reshaping parts of the industry
- Evidence from China indicates that collaboration between banks and tech companies is the way forward rather than outright competition
- Russia, China, Brazil, India offer attractive opportunities in the financial sector space
- Demographic changes will also benefit the insurance and asset management sectors

Fintech and sector disruption
Fintech, referring to innovations in the financial and technology crossover space, widens the reach of financial companies by lowering the cost of reaching and servicing customers, and expanding the addressable market by providing access to parts of population which were unbanked before.

Furthermore, fintech lowers the traditional barriers to entry for new financial market players. In the past, incumbent firms' extensive distribution infrastructure and access to client data has kept competitors out; now, fintech companies are eroding this advantage through access to more complete and frequent data on users.

As such, we are seeing an influx of fintech and large tech companies into the payments, asset management and brokerage industries. This trend is putting pressure on the profitability and market share of incumbents.

Typically, markets most at risk from fintech disruption are those with a progressive regulator, excessive profitability, and large-enough market size to make it interesting for investors to provide funding. Among the countries most at risk are Brazil, South Africa and China.

The evidence from the most well penetrated fintech markets, like China, shows that the way forward for lending is collaboration between tech companies and banks rather than outright competition. For example, Ant Group, a Chinese fintech, also serves as a platform connecting borrowers (banks) and lenders, using its big data algorithms to assess credit worthiness of borrowers. In several areas, they earn platform fees without taking credit risk on their balance sheet.

The low interest rate environment
The other key trend we see is a flattening growth amid low interest rates. Compounding with a record high public debt globally, the current situation may last for longer. We believe that this will put structural pressure on banks' margins and ROEs across EM, especially in the more mature countries.

The upside risk from this base case is a change in global monetary policy – i.e. rising inflation and interest rates, which we believe would lead to a major rerating, i.e. improvement in sentiment, towards the entire sector. At the moment, we believe the likelihood is low.

Nevertheless, there are opportunities within the sector for investors to position in the leaders, early tech adaptors, and disruptors who we believe will quickly gain market share and more than compensate for the unfavorable outlook for sector profits as a whole.

We see such opportunities in the larger markets with strong domestic tech players and a tech savvy population, such as Russia, Brazil, China, and India. Additionally, markets with a large and unbanked population, such as The Philippines and Indonesia, may provide fertile space for growth.

In addition, there are also opportunities in the insurance segment, as well as wealth management services, as we transition from youthful and low income to middle aged and affluent populations – which is a sizeable sweet spot before aging kicks in.

Consumer, retail & e-commerce

Key takeaways

- Wallet share is shifting toward discretionary consumption throughout EM
- Demand from premium goods is expected to remain robust in the coming years
- E-commerce remains a fast-growing part of the consumer sector and the COVID-19 pandemic has given it a major boost
- We see good prospects for established e-commerce players and traditional retailers with omni-channel capabilities

Wallet share is shifting toward discretionary consumption
As countries move from lower income (~USD 1,000 per capita) to middle income (~USD 5,000 per capita), consumers tend to upgrade their purchases from basic goods to higher quality and discretionary goods and services, as has been the experience in developed markets.

Markets such as India, Indonesia, and Philippines are all poised to transition to mid-income levels in the coming years. We expect that growth rates for categories such as home improvement, education, leisure & entertainment and health care services should accelerate, while growth rates for basic staples should start to plateau.

Premiumization
Apart from change in wallet share, we also expect changes within the same category as EM sees a rapid increase in the number of high- and middle-income households. Our research across industries and sectors shows that EM consumers in higher income brackets are willing to pay a premium for better quality products and services.

In markets like China, these consumer trends are visible across segments such as beer, dairy, spirits, cosmetics, condiments, branded foods and four-wheelers.

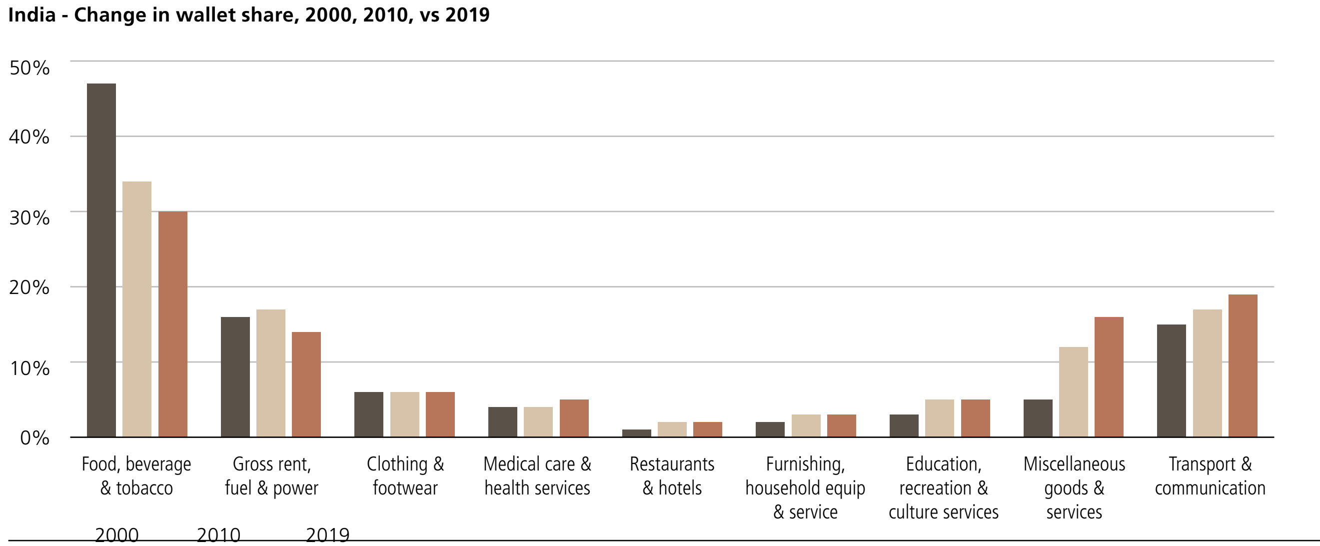
In India, the premium home and personal care segment is growing at 2x the overall category growth rate[2], while the share of premium 2 wheelers is also rising.

In Latin America, the sharp macroeconomic slowdown hitting major economies such as Brazil in recent years has negatively affected consumer income and inhibited the emergence of premiumization. However, recent surveys[3] indicate that private education and private healthcare are among Brazilian consumers' top three consumption priorities. We believe this indicates a willingness to premiumize and shift from free-access public education and healthcare services to paid access for higher quality private services.

In general, we believe that players providing premium products and services should continue to gain market share and benefit from this trend.

2 CEIC, JP Morgan, as of August 2020
3 E-bit, Cielo and UBS AM estimates, as of August 2020

India - Change in wallet share, 2000, 2010, vs 2019



Source: CEIC, JP Morgan, August 2020

E-commerce is disrupting traditional distribution models
While China already leads global e-commerce penetration spearheaded by companies like Alibaba, Latin America, ASEAN and India are catching up fast.

Aided by regulations favoring local companies, fragmented markets and local customization, these markets are growing their local champions.

In Latin America, both e-commerce and financial services (banking, credit and electronic payments) are underpenetrated relative to other parts of the EM universe, but these sectors are growing rapidly.

COVID-19 has accelerated e-commerce adoption
The COVID-19 pandemic has increased the use of e-commerce, including for large, high-frequency categories such as groceries that had previously been difficult to penetrate.

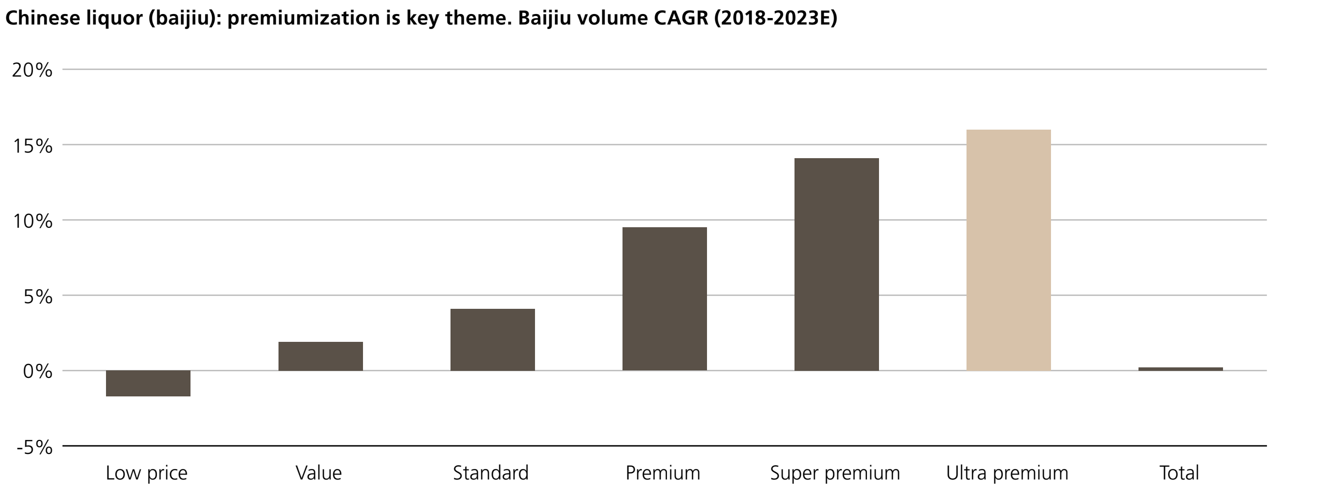
In Brazil, e-commerce penetration as share of total retail sales doubled to 10%[4] as COVID-19-related restrictions were imposed, adding millions of first time users and incentivizing existing users to increase purchase frequency.

In Southeast Asia, e-commerce penetration has doubled from 5% in 2017 to 10% in 2019 and has been estimated to grow at 25% Compound Annual Growth Rate (CAGR) over next 5 years[5].

We expect that leading e-commerce players with scale and strong logistics backbone and traditional retailers with omni-channel capabilities will be key beneficiaries of the shift in consumer behavior. In addition to the empirical evidence is that local and regional EM players in e-commerce can often do better than their global rivals in their home countries e.g. Alibaba and Tencent in China and MercadoLibre in Latin America.

4 E-bit, Cielo and UBS AM estimates, as of August 2020
5 CEIC, JP Morgan, as of August 2020

Chinese liquor (baijiu): premiumization is key theme. Baijiu volume CAGR (2018-2023E)



Source: IWSR, NBS, Canback, Bernstein analysis & estimates, updated September 2019

Internet, media and telecom

Key takeaways

- Many parts of EM are seeing mega apps emerge that combine search, entertainment, food delivery, ride hailing and payments among others into a single platform
- Cloud service providers and IT service providers with exposure to digital services are also key names to watch amid an ongoing digital transformation in EM
- The rise of online entertainment will benefit online gaming publishers and distributors, social media and other digital service platforms

The emergence of mega apps
Local online platforms are increasingly paying more attention to user lifetime value management.

These platforms use their better understanding of local user bases to develop mega-apps that emphasize increasing user retention rates and tap into a higher share of the consumer wallet.

Many parts of EM are seeing mega apps emerge that combine search, entertainment, food delivery, ride hailing and payments among others into a single platform. For instance, the leading search engine in Korea has expanded into e-commerce and payments.

Internet companies in Russia, such as the leading search engine and social network service providers, have expanded into e-hailing, food delivery, digital media & entertainment, e-commerce and payments.

Against this backdrop, we believe that leading internet platforms with high user retention capabilities and high share of user time spent share will be key beneficiaries from the emergence of mega apps.

Losers may include internet companies that lack good user acquisition and retention strategies.

ASEAN Mega Apps that are expanding to capture a wider share of consumer wallet

	Ride sharing	Food	e-Commerce	Fintech	Banking
Grab	✓	✓		✓	✓
gojek	✓	✓		✓	
sea		✓	✓	✓	✓
Lazada			✓	✓	
carousell			✓	✓	

Source: Company data, Morgan Stanley Research, August 2020

Acceleration of digital adoption by enterprises
While enterprises across EM have been increasingly adopting digitization, COVID-19 has accelerated this trend. An increasing number of merchants and enterprises are utilizing online platforms. This is evident across China, ASEAN and Latin America.

Besides e-commerce players, we believe other key beneficiaries will be cloud and IT service providers with exposure to digital services. Cloud service providers are growing rapidly in markets like China, where cloud spending is expected to grow at a CAGR of 28% over next five years[6].

Cord cutting and the rise of online entertainment
Consumers are increasingly spending more time on Over The Top (OTT) platforms, i.e. streaming services, and online gaming. Digital media and entertainment activities are taking share of screen time spend away from traditional media channels.

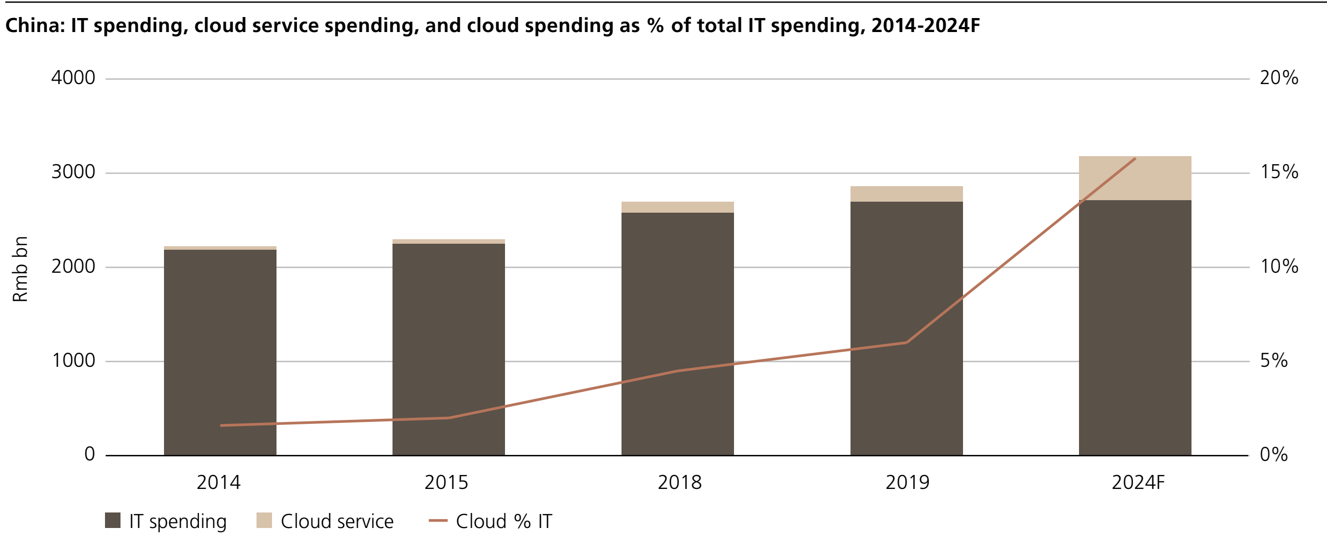
As a result, advertising spend continues to shift from traditional channels such as TV and print to online channels, reflecting the time spend pattern of consumers.

We believe the key beneficiaries from this trend will be online gaming publishers and distributors, social media and other digital service platforms, while losers are traditional media companies, including print and TV broadcasters.

Telecom service providers are also on the losing side because although they have been investing in infrastructure, they have not been able to monetize these investments adequately, with data pricing continuing to compress.

6 Frost & Sullivan and UBS, as of August 2020

China: IT spending, cloud service spending, and cloud spending as % of total IT spending, 2014-2024F



Source: Frost & Sullivan, UBS, 2019

Health care

Key takeaways

- We expect increased demand for health care services from both private and public channels
- Asian health care companies are moving up the value chain and leading pharmaceutical and biotech companies offer attractive growth prospects
- COVID-19 will drive investment in infrastructure and online health care services

Asia demographics support increased health care demand
Demographic trends such as urbanization and aging are leading to increased prevalence of chronic and lifestyle conditions, such as cancer, diabetes, and cardiovascular diseases.

As EM's population grows more affluent, citizens can afford more health care services, further driving up health care demand. Governments too are investing more in health care infrastructure.

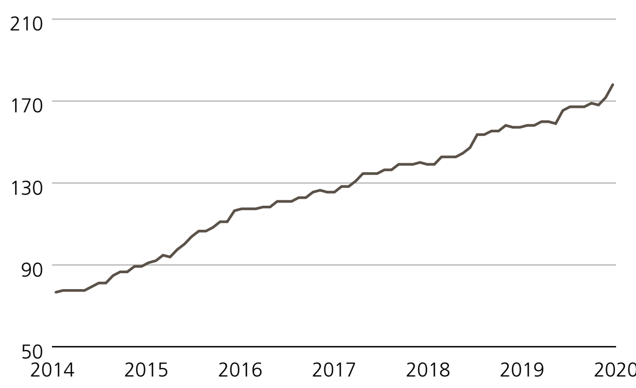
Health care companies are moving up the value chain
There are significant investment opportunities as the drug manufacturing industry in Asia moves up the value chain to create higher value, innovative products.

Besides just investing in companies that can successfully transition to innovative leaders, there are also companies that can provide services that support higher innovation in the industry like Contract Research Organizations (CRO) and Contract Manufacturing Organizations (CMO).

Leading pharma companies and large biotechs are well positioned to move up the value chain. Small- and mid-cap innovative biotechs also offer differentiated R&D capabilities and pipelines.

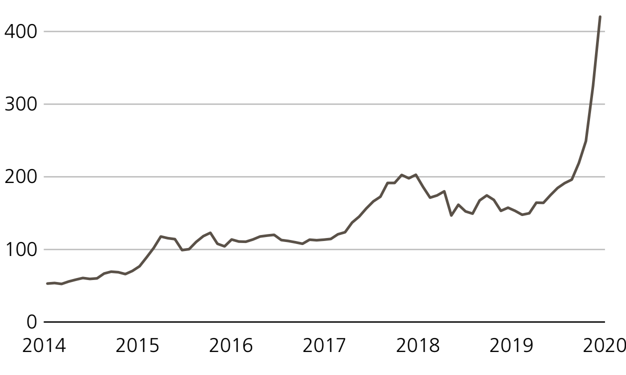
In Asia, the number of listed biotech companies has increased and the growing market capitalization of biotech companies is a sign that investors already acknowledge value in the long-term potential of their R&D pipeline.

Number of biotech companies in Asia ex-Japan, Jan 2014-Jul 2020



Source: Bloomberg, as of August 2020

Total market cap of biotech companies in Asia ex-Japan (USD bn), Jan 2014-Jul 2020



Source: Bloomberg, as of August 2020

Chinese and Korean companies are now looking to launch their own products globally as they gain confidence around their own R&D capabilities and the competitiveness of their pipeline candidates. As a result, we see more Chinese and Korean companies running global clinical trials.

Post COVID-19 increases in health care infrastructure spending and the growth of online health care
The COVID-19 outbreak clearly highlighted infrastructure deficits in many countries.

As a result, public health and regulatory policies have started to prioritize investments to upgrade and support nationwide health care infrastructure, particularly in lower-tier regions.

Online health care could also continue to grow with favorable policies. We have already seen increasing acceptance of online health care post-COVID-19 due to convenience and easy accessibility.

Incremental policy reforms are driving the establishment of internet hospitals and internet primary health care platforms by both private and public companies.

Medtech
The medical technology "medtech" (medical devices) industry has been affected most during COVID-19 as elective procedures in hospitals have been delayed and/or cancelled. However, we remain positive on leaders in China's medical devices industry, particularly in areas such as in-vitro diagnostics (IVD), orthopedics, and cardiovascular stent manufacturing, as this is still at an early stage of import substitution of foreign medical devices. In addition, end-demand for medical devices will likely continue to grow given low penetration in the end market.

Basic industries: energy, materials & industrials

Key takeaways

- Renewables, energy storage and electric vehicles will benefit as countries move to adopt the goals of the Paris Agreement
- This will also bring opportunities for mining companies focused on lithium, nickel, copper, and platinum group metals
- The trend toward cleaner, more efficient manufacturing processes will boost demand for robots, laser processing and advanced machine processing industries

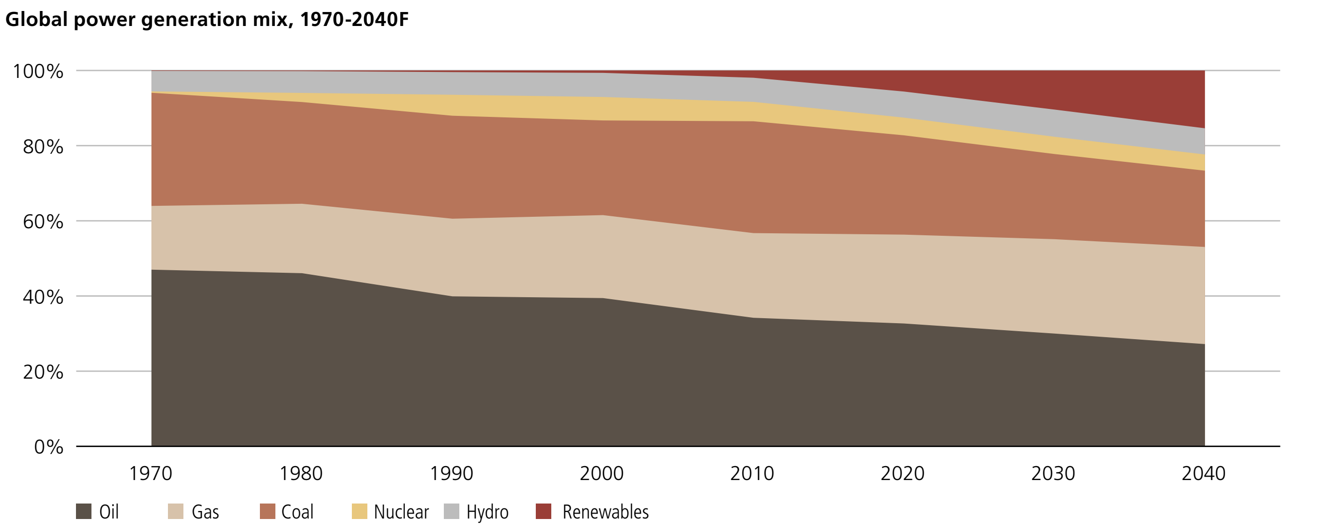
Beneficiaries of an increasing focus on climate change
No other sector is as directly impacted by climate change as basic industries.

The Paris Agreement has reached a consensus to keep the long-term increase in global average temperatures lower than 2 degrees above pre-industrial levels in this century, with significant ramifications for companies in this sector.

This will bring many challenges for "old" industries, with several at risk of becoming stranded assets, including thermal coal mines, and many oil and gas resources, with greener solutions coming out as clear long term winners.

This backdrop brings long-term opportunities for companies exposed to renewables, energy storage systems, and hydrogen value chains, as these technologies not only enjoy policy support, but are also scaling up and becoming more competitive, with cost parity expected to be reached within the next few years.

Global power generation mix, 1970-2040F



Source: Bloomberg NEF, 2019

With respect to Industrials, Capital Goods and Materials sectors, over the past decade Chinese companies have displaced their global peers in the domestic market in sectors such as construction machinery and railway equipment because they have been able to make technological breakthroughs and rapidly iterate products.

Amid increased pressure on supply chains from geopolitical tensions and more stringent ESG rules on manufacturing processes, we foresee even stronger demand for industrial automation like robots, laser processing and advanced machine processing. China is also producing high quality low-cost ceramic materials with potential promising downstream applications including electronic, bio-medicals, and environment protection.

Climate change shift will create winners & losers in mining and battery sectors

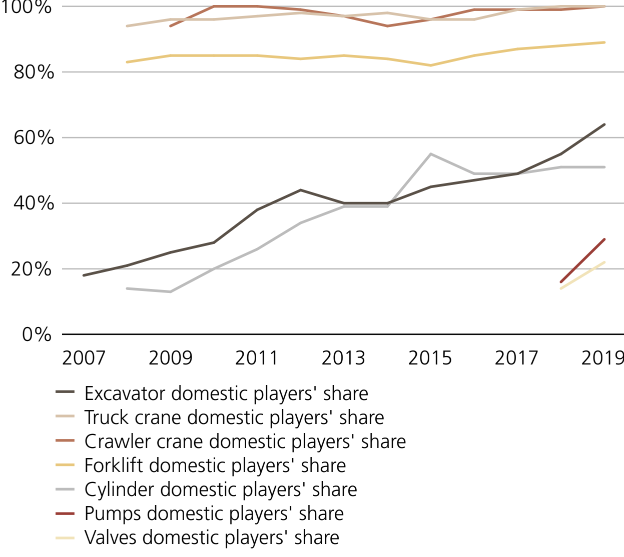
Lastly, with respect to mining and batteries, we also observe a divergence in terms of winners and losers, driven by the debates around climate change and ESG. Higher social and environmental operating costs are raising the risk of stranded assets for some commodities and select regions.

On the other hand, these trends will require big investments in electrification and new markets (e.g. electric vehicles, renewables, batteries, power grid), which will bring opportunities for the mining complex on rising demand for many of its products, including lithium & nickel (batteries), copper (electrification), and PGMs (auto catalysts, hydrogen), especially for companies operating in countries with low costs and ample resources (e.g. lithium miners in Chile, copper in Mexico, PGMs in Russia and South Africa, etc.).

Just as an example, assuming 100% penetration of electric vehicle production, lithium demand would increase by 2,511%, nickel by 118%, and copper by 21%, according to UBS estimates.

Moving down the value chain towards batteries within the electric vehicle space, we think Chinese and Korean players along the EV component value chain are likely to benefit based on their first mover advantages, technological investments, cost leadership, operational expertise as well as government support.

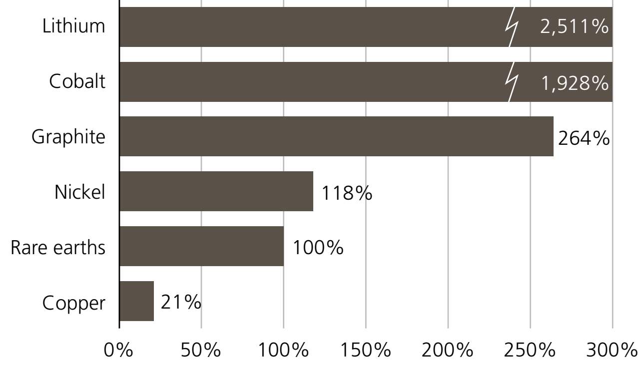
Domestic Leaders: Import substitution trends in capital goods in China, 2007-2019



Source: Goldman Sachs, Company data, CCMA, 2019

Mining has a key role to play in decarbonization and electrification

In a 100% EV world, demand for commodities would change by...
(in % of global market today)



Source UBS. As of May 2017. Updated Jul 2020.
Only related to EV part, this is not taking into account the demand coming from the infrastructure required to power this industry.

Real estate

Key takeaways

- Mall operators will have to adapt to changing customer demands to remain relevant and successful
- Integrating shopping with entertainment and experiences, as well as new technology, will be necessary for mall operators to be long-term winners
- Developers will likely diversify into hospital or day care centers and those with strong property management would be best set for success over the longer term

Digital transformation will increase focus on consumer experience
E-commerce is a threat but leading developers are adjusting their malls to new structural changes.

Developers who are able to make good use of their stores as promotional and experience spaces, e.g. Apple stores, could in fact see demand for floor space increase.

Retail mall owners that recognize that the general trend is towards integration of shopping and entertainment will remain relevant. In addition, with lower birthrates in EM, we believe parents will increase spending on products and services for children, thus creating an opportunity for mall owners.

To be a long-term winner, mall operators will also need to change and embrace or withstand new technology threats. For example, location Wi-Fi and increasing cashless payments will enable operators to have timely instant access to tenant sales and consumer behavior which could enable marketing efforts to be changed instantaneously.

Real estate to cater to an aging population and address concerns on climate change
An aging population will become an issue in many parts of the world. Developers are likely to diversify into hospital or day care centers which will see increasing demand in society. Developers with strong property management would be best set for success over the longer term.

Value added services such as shared day care services, e.g. food delivery and clinical services, can also be provided within these facilities.

In addition, some developers that are adept at design could become known for reducing their impact on climate change, such as through better control of their indoor building temperature to reduce air-conditioning needs or by collecting rain water for recycling.

Sustainability

Key takeaways

- EM companies get low scores for ESG from traditional metrics
- In part, that's because of lower levels of public, English language disclosure of traditional sustainability metrics in EM
- On-the-ground primary research, including regular interaction with management allow for an informed view on the fundamentals and sustainability practices long-term of a company
- Empirical evidence shows that improvements in sustainability metrics can drive market performance for EM companies

Underlying all of these sector trends is the growing importance of sustainability issues for both companies and investors in EM. Sustainability performance is derived from a company's performance on environmental, social and governance metrics.

A core aspect of sustainability also involves assessing the quality of a company's management and its ability to orient the business away from material risks, toward opportunities.

EM companies = ESG laggards or lower disclosures?
EM companies are sometimes considered laggards in sustainability, given their relatively lower average sustainability scores compared to developed markets peers.

From our experience, however, these lower scores are often less due to actual performance differences and more a reflection of lower levels of public, English language disclosure of traditional sustainability metrics. For example, in carbon dioxide emissions disclosures - the most frequently reported ESG metric among MSCI ACWI constituents - 68% of developed markets companies report Scope 1 and Scope 2 emissions figures, compared to below 45% of EM companies.

Distribution of industry-adjusted ESG scores for three sub-regions

Source: MSCI 2019

Sustainable leaders outperform, and particularly in EM
The most basic measure of ESG performance, the MSCI ESG EM Leader Index, has demonstrated that companies with top ESG scores significantly out-performed over the past decade, generating 3.09% of annualized out-performance against MSCI EM index since 2010. The MSCI ESG EM Leader Index selects companies with the top 50% of ESG scores within each sector of the MSCI EM Index.

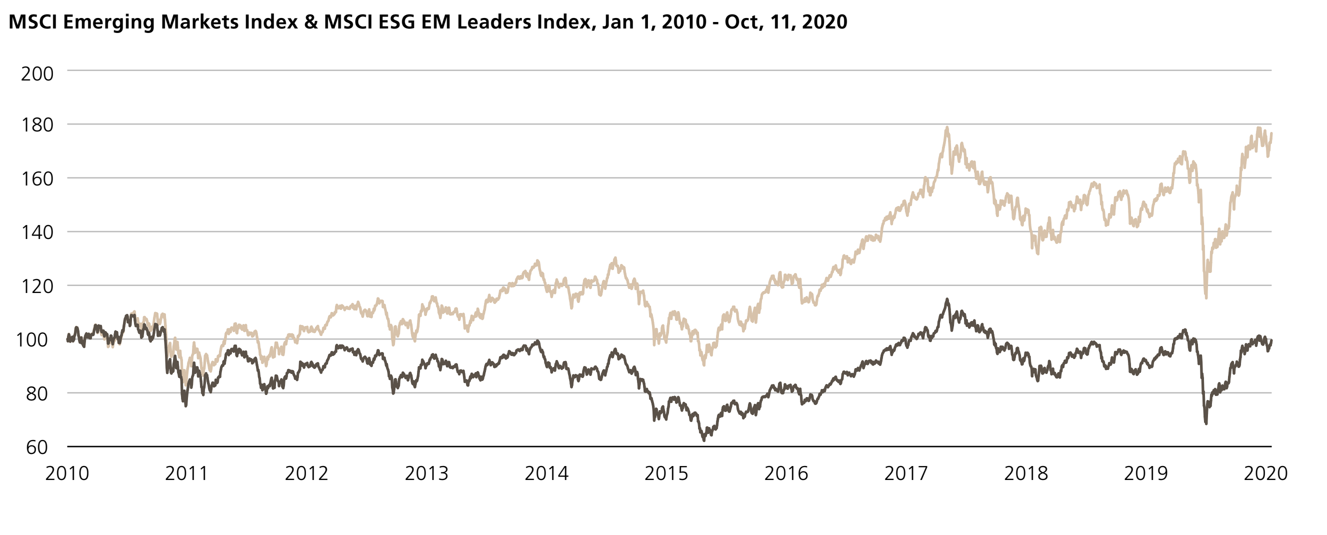
A study by MSCI "How Markets Price ESG: Have Changes in ESG Scores Affected Stock Prices?" demonstrated that from 2013-2017, companies with improving ratings have outperformed the benchmark globally by 0.97% returns annually, this outperformance in EM was higher, at 2.88% annually.

This is also borne out by our experience wherein good quality companies - ESG being one component of quality - tend to outperform poor quality ones over the medium to long term.

Identifying improvers
Given the lower levels of public English language disclosure of traditional sustainability metrics in EM, there is greater need for primary research on EM companies including regular interactions with management and other stakeholders. This helps to supplement data and ESG scores/ratings from third-party providers, and allows for an informed judgement on the fundamentals and sustainability practices of a company.

In addition this can lead to opportunities to engage with the companies and encourage them to improve in their practices. This can not only lead to better ESG scores and ratings for the company but also have a positive impact on their long-term financial performance.

MSCI Emerging Markets Index & MSCI ESG EM Leaders Index, Jan 1, 2010 - Oct, 11, 2020



Source: Bloomberg, October 2020

Conclusion

A few trends will drive EM in the next decade
We have identified a few key trends and themes that we believe will not only drive growth in Emerging Markets over the next three-to-10 years, but also create differentiation amongst countries, industries and companies.

Some EM countries are best placed to benefit, others less so
Based on our analysis, we have concluded that China, Russia and Korea offer the best opportunities, followed by India, Brazil or Mexico. In contrast, South Africa is poorly placed.

5G will bring new applications and open up growth opportunities
We believe the advent of 5G should bring about more new applications, leading to greater demand for advanced semiconductor chips which will benefit global leaders in the semiconductor sector. New manufacturing, industry 4.0, and industrial internet of things are also associated areas of growth.

Geo-political issues should spur the growth of downstream manufacturing supply chains outside of China and the emergence of national or regional champions across geographies.

Leaders, early adaptors, and disruptors will gain market share amid an influx of fintech into financial services
The influx of fintech into payments, asset management, insurance, and wealth management should lead to more collaboration between technology and financial companies. Leaders, early adaptors, and disruptors will gain market share, while structural pressure on banks' margins and ROEs will hinder the outlook for others.

Evolving consumer trends in EM will have a wide impact across sectors
A shift in wallet share towards discretionary consumption should increase growth rates for home improvement, education, leisure & entertainment, and health care services sectors with the premium providers doing better, while growth rates for basic staples should start to plateau. Leading e-commerce players with scale and a strong logistics backbone, as well as traditional retailers with omni-channel capabilities will be key beneficiaries.

Digital transformation will benefit mega-apps, cloud & IT service providers, online gaming and social media platforms
Apart from the clear and present (and future) growth of e-commerce, we see the continued emergence of mega-apps that emphasize increasing user retention rates and tapping into a higher share of the consumer wallet. The acceleration of enterprise digital adoption should benefit cloud service providers and IT service providers. Other key beneficiaries are online gaming, social media and other digital service platforms, while losers are traditional media companies, including print and TV broadcasters. Telecom service providers are also likely to lose, as we believe they will be unlikely to adequately monetize their large capex.

Health care companies are moving up the value chain; internet health platforms and medical devices could be growth areas
Health care companies - both leading pharma and biotech - are moving up the value chain by creating innovative products by dint of increasing R&D. Contract Research/Manufacturing Organizations (CRO/CMO) providing support services to greater innovation in the industry are another area of growth. COVID-19 and digital transformation are accelerating the growth of internet health care with the setting up of internet hospitals and internet primary health care platforms. The leaders in China's medical devices industry are also well poised.

Climate change and decarbonization to benefit renewables, energy storage systems and solar equipment
Within basic industries, climate change and decarbonization bring challenges for thermal coal mines, and many oil and gas resources, while benefiting providers of renewables, energy storage systems and solar equipment. We see rising demand for lithium/nickel (batteries), copper (electrification) and platinum-group metals (PGMs) (auto catalysts and hydrogen) within the mining complex.

Real estate: focus on consumer experience, demographic trends
In real estate, digital transformation will lead to a greater focus on consumer experience and the integration of shopping and entertainment. Real estate will also increasingly cater to both children at one end and to an aging population at the other by diversifying more into hospitals and day-care centers.

The crucial difference from a long-term investment perspective will be to identify the leaders and winners and avoid the rest.

We believe that the leaders will be those companies which, by virtue of their intrinsic competitive advantages (business model, management quality, reputation/brand, R&D, distribution, etc.), will be able to deliver above-industry average growth, and consequently stock-price performance. And hence, investing actively by trying to identify the leaders and winners will be key to achieving superior returns.

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