Growth from Real Assets in an Emerging World

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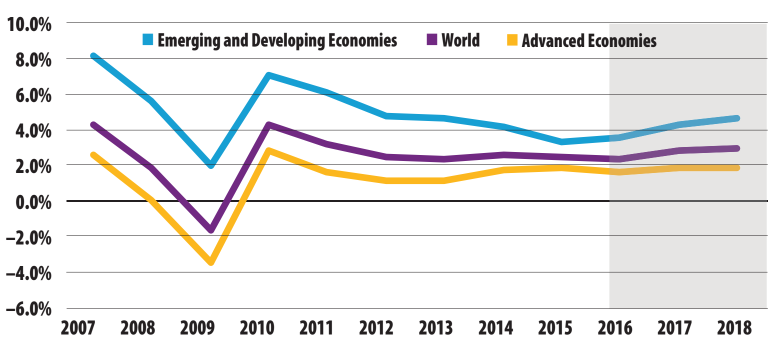
The case for institutional investment in emerging markets has been made often for many years. But to what extent is this relevant today in light of broad market uncertainty, and in this context, how do real assets offer anything different? In this article, we present a number of fundamental themes driving the opportunity in emerging markets via exposure to real assets, particularly outside of real estate. As part of this, we provide a current private equity case study to highlight how the identification of thematic ideas can translate into implementable investment options, as opposed to accessing emerging markets through a traditional, broad-based approach. Such a thematic approach to investing in emerging markets is not without risks, however, and neither is implementation through real assets, so we highlight these.

Growth Opportunities in Transforming Economies?

During past decades, emerging market economies have benefited from what has been termed a "commodity super cycle"—domestic economies have been growing at supernormal rates for a number of years as a result of a global commodities boom. This cycle is now coming to an end, with many emerging markets facing increased uncertainty and volatility in light of depressed commodity prices and economies that might be highly leveraged and overexposed to this sector. The medium-term outlook for growth in many emerging market economies may be challenging because of exposure to three key risks: potential US dollar liquidity tightening, commodity-price weakness, and slower growth in China. However, there are differing exposures to these risks, and divergences exist both between and within emerging market regions. Therefore, while the current macro environment may suggest a dampened case for a broad emerging market exposure at present, the disparity of expected outcomes may continue to present a ripe opportunity set for highly skilled active managers.

Furthermore, the present situation may also provide potential opportunities for long-term investors to capitalize upon asset mispricing largely predicated upon changing expectations, with more normalized economic growth expected in coming years. Indeed, with a long-term view, potential remains for continued growth as emerging economies develop and evolve to be more in line with developed markets or those that benefited favorably from lower commodity prices. Additionally, in a world where developed markets appear gripped by an economic environment for which the outlook of "lower for longer" offers little scope for material asset growth and returns, emerging markets may appear attractive on a relative basis, as shown in Exhibit 1.

Exhibit 1: World Bank Global Growth Forecast, June 2016



Source: World Bank, 2016

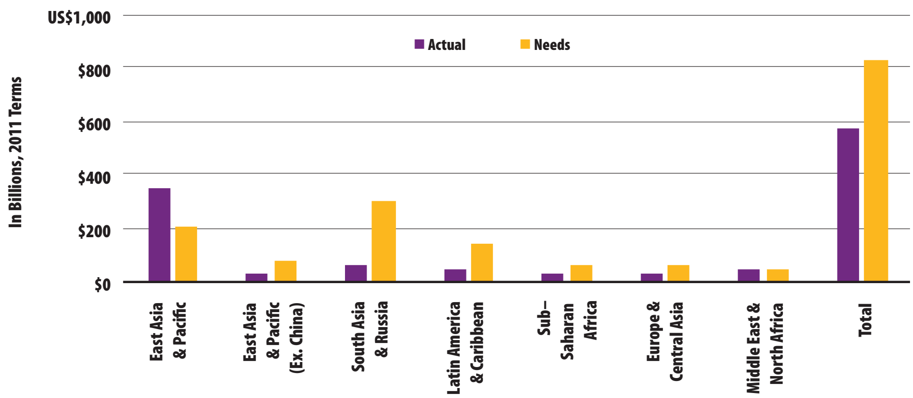
Investment Themes to Capture Growth

Thematic investment is not a new concept but is one that only a relatively small number of institutional investors have fully embraced. Typically, implementing thematic investment ideas necessitates the identification of particular themes or trends in markets that should unfold over a number of years and exposure to investments that are best placed to benefit from these trends through time. Critically, a forward-looking view and long-term time horizon are required to best position a portfolio in this way, along with a sensible valuation framework to determine what is and is not inherently discounted in the assets. Institutional investors with a long-term horizon have a major competitive advantage in accessing these themes; however, in our experience, the majority have not yet done so in a holistic manner.

A number of well-known fundamental trends remain pertinent and are likely to persist for a number of years but are not necessarily being fully captured by investors, if at all. We have identified four megatrends—evolving demographics, the degradation of natural resources, transforming economies, and disruptive technology—that we believe to be persistent and fundamental drivers of growth that will shape economies and markets over time. While these trends tend to be interlinked, discrete exposure can offer growth opportunities if effectively captured.

We have been scrutinizing thematic investing approaches as well as researching numerous real asset investment strate-

Exhibit 2: Emerging Market and Developing Economies Infrastructure Development Needs Versus Actual Investment, 2014–2020



Source: World Bank, 2015

gies for a number of years. Indeed, given the nature of the economies in emerging markets, the more compelling investment approaches integrate thematic concepts with the investment case. Opportunities have been identified across the spectrum of real assets, including real estate, infrastructure, and natural resources, although capital has been allocated to only a select number of opportunities. While there are numerous and broad opportunities for investment in emerging markets, central to the investment case must be an understanding and mitigation of the inherent risks involved with such investments and an expectation that an investor will be fairly compensated for the exposure to these risks. This makes it very difficult to ensure comfort and true conviction in many emerging market–focused opportunities and provides motivation for an alternative approach.

Why Real Assets in Emerging Markets?

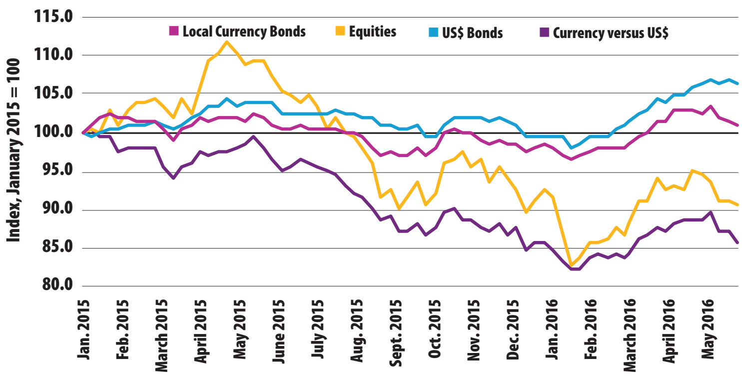
The well-known premise of investing in emerging markets is that such economies tend to offer opportunities for economic growth in environments with strong fundamental dynamics. These dynamics can be either secular or cyclical in nature and include a growing population, an expanding middle class, urbanization tendencies, improving regulatory environments and judicial regimes, ameliorating financial systems, or a combination of these, among others. These evolutions in emerging market economies can be identified as part of long-term themes driving economic development and change, for which real assets can be an effective solution.

However, progress can be hindered by the nascent nature of such markets; indeed, emerging market real assets significantly lack capital investment. An example of this is with natural resources—specifically, water and wastewater. In a number of countries, the theme of increasing urbanization has not been matched by improving water infrastructure, so investment in water treatment facilities is well received and much needed in regions where water availability and water quality is sometimes scarce. The divergence between the supply of state-funded investment and the demand for new or modernized assets is clearly creating a space for real asset investors to provide private capital for more compelling returns than for equivalent assets in developed markets, perhaps through a Public-Private Investment Partnership framework. This need for capital is illustrated in Exhibit 2.

In an environment in which governments have almost exhausted their arsenals of policy initiatives, economies are likely to become increasingly reliant on growth investing to deliver economic growth, which is likely to lean heavily on the requirement for real assets. However, ownership of real assets has strong political implications, especially in emerging markets where government ownership of assets, especially infrastructure, is widespread. Therefore, governments open to the concept of private investment in real assets are often those where the environment for such investment is favorable and well received. Where national governments are heavily leveraged, private capital is likely to fill the increasing void between capital supply and real asset demand for the delivery of growth. Accordingly, governments may become obligated or evolve to become welcoming of such capital and take steps to improve their domestic environment in order to accommodate, attract, and retain such capital, if they have not already begun to do so.

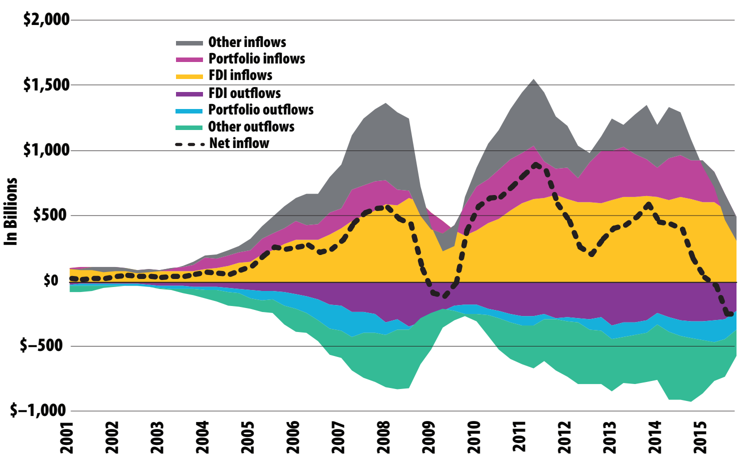
Investors may also begin to look more closely at emerging markets on a valuation basis, as there are suggestions that asset valuations have evolved or are evolving to now favor some emerging market economies, in addition to the presence of fundamental growth drivers. This can be illustrated by proxy through listed instruments and by the flow of foreign direct investment (FDI), which can help indicate investor appetite for assets and infer a valuation view, as shown in Exhibits 3 and 4. However, there is significant divergence in markets, and each should be evaluated on a fundamental basis for potential investment.

Exhibit 3: Emerging Market Financial Asset Valuations



Source: World Bank, 2016

Exhibit 4: Net Capital Flows to Emerging Markets and Developing Economies



Source: World Bank, 2016

Understanding Risk Is Understanding the Investment

When researching investment opportunities and evaluating manager propositions, risk identification and mitigation is key to our approach. This is especially true in emerging markets, where risks are frequently different from those found in developed markets, and often the need for a long-term investment horizon increases the obscurity of the eventual investment outcome. As a result, a rigorous evaluation of an investment manager's approach to such risks is paramount to gaining conviction in a strategy.

Emerging market investment can present and sometimes elevate risks across the spectrum, from asset-specific to sector-specific or macro-level risk considerations. The origination of quality assets remains essential in securing the initial investment thesis. This can be achieved by identifying assets for which there is inherent demand, that have a propensity to pay, and that have the ability to deliver the intended returns for a given strategy with effective asset management and a well-executed business plan. Assets that demonstrate real-return drivers inherently linked to the dynamics of an identified theme are likely to be the most compelling.

At an asset level, thematic association aside, it remains important to identify asset-specific risks peculiar to emerging market economies that may differ from more established markets. For example, the ability to exit an investment may be limited by the existing political or regulatory regime, or the ability to execute asset management initiatives may be impacted by local considerations that may not be immediately evident.

Furthermore, it is important to see in emerging markets a clear identification of environments where private, usually foreign, capital investment would be supported, endorsed, facilitated, or otherwise accepted by the incumbent political regime. In addition, identification of risks in the regulatory regime, such as the clarity of shareholder rights, as well as the judicial regime (for example the enforcement or maintenance of a concession framework) would be required to ensure comfort in the security of investment into a particular sector. The Multilateral Investment Guarantee Agency is a World Bank entity established to mitigate sovereign risk. It offers political risk insurance and coverage of financial obligations that are not honored by sovereign, sub-sovereign, or state-owned entities. While this coverage may add to the costs of a transaction, it can provide greater security and risk mitigation for investors. Although these areas overlap, the level of governance and transparency present in a market can direct the conviction in a proposition, and an asset manager's ability to mitigate these factors is essential.

The impact of currency in emerging markets should not be ignored. Many emerging market currencies tend to be more volatile and sensitive to global market conditions than reserve currencies or those more deeply traded. Indeed, many emerging market currencies are not hedged by managers because of the high cost of doing so. We continue to view emerging market growth as a broad, long-term theme, if well accessed. However, we note that a diversified approach to emerging market currency exposure or a strong view on currency may be required, especially if the ability to hedge such exposure is not possible.

A Private Equity Approach

When considering investment routes, investing in emerging markets through a private equity approach has advantages. Principally, the opportunity set is far larger with regard to the number of unlisted or privately held entities or assets that exist in any one country. Furthermore, a private market approach allows expression of an investment view more purely, without incorporating sizable unintended exposures into the portfolio. Additionally, a private equity approach facilitates a more incisive and thorough due diligence process than what might be achieved for a listed entity, thereby offering greater transparency of risk considerations that tend to be more opaque in emerging markets. Finally, a private ownership capacity permits greater control over an asset and can simplify the ability to improve management and structures, as well as allow greater independence to drive best practices for the market more broadly, among other advantages of such an approach.

How do institutional investors translate thematic ideas into implementable investment options? In one of a number of specific examples, we executed this approach through renewable energy exposure in Asia. Following the identification of megatrends such as the degradation of natural resources and the transformation of economies expected to shape Asian markets in years to come, we distinguished the theme of resource sustainability as a promising opportunity for fundamental growth. Noting recent government initiatives aimed at driving sustainable and clean methods of generating energy, we completed due diligence on an investment manager targeting renewable energy installations in order to get real asset exposure. To date, investors in this strategy have received returns far exceeding expectations. This outperformance is attributable not only to the highly skilled manager but also to early identification of the thematic opportunity reinforcing the strategy.

Summarizing Thoughts

Investment in emerging markets, while a well-researched and well-reported proposition, remains fraught with uncertainty and risk. We believe that the most effective means of gaining exposure to such markets is through a thematic approach that captures the fundamental growth drivers or supply-demand imbalances that are likely to deliver returns over the long term. Accessing these markets can be effectively achieved through quality real assets that can service local domestic needs over this time horizon and for which the risks are mitigated or at least well understood. A thorough awareness of risks in emerging markets is crucial, especially in the real assets space. Real assets tend to be more politically sensitive and more affected by regulatory and judicial regimes where local considerations may be critical. As a result, investment in this area through a private equity approach is attractive because of the more detailed level of due diligence that can be applied, the increased control that can be achieved, and the larger opportunity set that exists in unlisted and privately held entities in order to capture attractively valued growth from identified emerging market themes. ■

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