The Search for Value in Emerging Markets

By Paul Espinosa, CFA®

Despite empirical research demonstrating the merit and effectiveness of a value investment approach, and a fervent following among developed-market investors, emerging-market investors rarely have pursued a value discipline. Using Morningstar data, we note that only six U.S. mutual funds in the diversified emerging-markets category self-identify as value strategies—just 3 percent of the total.

What is striking about the paucity of emerging-market (EM) value strategies is that one might think the approach would yield superior returns in this universe given the more inefficient nature of developing economies and financial markets.

In light of such apparent advantages for a value investment discipline, why do so few strategies exist? Is there an impediment to profitable value strategies in EM that is absent from developed markets? Is the opportunity set too small or insufficiently attractive despite the higher discount rates employed in these markets, or are value traps simply too complex to unravel?

Table 1 shows that EM overall, and an identifiable value universe within it, do not appear to be niche markets. Table 1 shows the size of the value universe in EM—including Chinese A-shares—as defined by the development of criteria specifically designed to identify seven sets of fundamental criteria that give rise to potential value opportunities.

Table 2 outlines the salient characteristics of value and each of its categories in EM.

The parameters presented paint a picture in broad strokes and do not constitute a comprehensive list of the variables used to identify companies in each value category. It is important to note the large variance of results around the median figures shown, illustrating the idea that value extends beyond the traditional definition of low multiples. Indeed, one of the interesting conclusions from this study is that defining value in fundamental terms often leads to companies trading at high multiples.

Consider the seven main sources of value in EM and the idiosyncrasies of each related to industry, geography, or valuation, and the different manner in which value manifests itself.

More than a survey of the value landscape in EM, the investment discussion that follows represents a viable alternative for developed-market investors facing diminished expectations of future investment returns. Substantial equity market returns in the United States, combined with the unprecedented rise of debt since the early 1990s, force one to question the sustainability of returns on capital, because future returns may have been brought forward.

Exacerbating the uncertainty of adequate future returns is the popularity of passive funds that purchase benchmark securities indiscriminately and procyclically—buying more of a security as its price rises—thus undermining the foundation of future returns in formulaic fashion. The investment approach that follows seeks to create a strong foundation for future returns by discriminating among securities and using price as the primary tool to derive adequate investment returns.
Balance Sheet Liquidity

**Source of value:** Balance sheet liquidity relates to a firm’s net cash or liquid short-term net assets. Companies can often trade near their cash or liquid net asset values if the underlying operations generate losses that will consume said liquidity or the nature of the business is working-capital intensive. There is, however, a third type of balance sheet liquidity that should generate most value opportunities in this category: accumulated operating cash flow not previously shared with minority shareholders (i.e., large amounts of undeployed and unencumbered cash on the balance sheet). There is a subset of companies in EM that routinely decline to return excess cash to shareholders, neglecting to pay dividends or engage in share buybacks. Some use it for empire building—usually destroying capital in the process.3 Others simply sit on the excess cash. This is a prevalent source of value within EM, but unfortunately such value has languished on these companies’ balance sheets because minority investors often lack sufficient leverage to force companies to disgorgue such cash. However, this situation is beginning to change, given the push for improved governance in many of the major emerging markets.4 For example, in late 2014 the Korean National Assembly passed legislation that aims to increase the return of capital to shareholders and reduce the barriers to competition imposed by large conglomerates. These changes are motivated by the recognition that the conglomerates that once propelled the country’s development are now a source of economic stagnation.

**Criteria:** The practical pursuit of value here goes beyond simply searching for a high cash balance relative to market capitalization. It also measures cash relative to assets and enterprise value (EV) as it guards against cash coming from debt as opposed to operating cash flow. To identify a set of potential value opportunities—as opposed to simply stocks that quantitatively appear cheap—the search focused on companies that show signs of incrementally returning more of their cash balance to investors by reducing retained earnings or cancelling shares.

**Manifestations of value:** No single country dominates this category, but certain sectors do: real estate, commodity trading houses, engineering and construction (E&C) companies, as well as brand-based enterprises such as sports apparel companies. The common denominator in these industries is a high working-capital (WC) intensity, originating from down payments related to infrastructure new-order growth. Brand-based businesses tend to generate positive free cash flow and undercapitalize brand equity, resulting in cash-rich balance sheets. Beyond identifying broad sector categories to potentially hunt for liquidity-related value, these screens prove useful in shedding light on EM company operations. For example, in checking for the cash component of book value (BV), two groups of companies surface as having a very low residual BV: E&C and consumer products. The search criteria employed lays bare the fact that the former category has a low residual BV because it generates little retained earnings over the course of a full cycle (the high negative WC previously referred to turns positive), whereas consumer companies have a low residual BV because they tend to pay out most of the substantial retained earnings they generate. This latter case corrects the misconception that EM companies do not constitute a significant source of dividends.5

**Value traps:** Not all liquidity that glitters is gold. Chinese real estate companies are a case in point. A subset of these enterprises trades at a seemingly cheap 0.8 × Price/BV with a 7-percent dividend yield. As attractive as that combination looks, expectations are tempered by the fact that they have paid out in dividends more than 60 percent of the cash flow from operations that they have generated during the past five years (before capital expenditures)—thus, effectively borrowing against new projects to pay dividends. That’s why a slowdown in Chinese credit growth is of such importance to market returns.

**Breakup Value**

**Source of value:** Breakup value relates to the long-term segment of the balance sheet rather than to short-term liquidity. It is common for the price of assets in the public market to fall below their depreciated

---

**Table 2: Characteristics of Value Stocks in Emerging Markets**

<table>
<thead>
<tr>
<th>Constituents</th>
<th>Market Capitalization (billion)</th>
<th>Enterprise Value (billion)</th>
<th>Price/Book Value</th>
<th>Dividend Yield</th>
<th>Cash/Assets</th>
<th>Price/Operating Cash Flow</th>
<th>Market Capitalization/Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seafarer Value Universe</td>
<td>446</td>
<td>$1,439</td>
<td>$1,579</td>
<td>1.2x</td>
<td>6.2%</td>
<td>12.7%</td>
<td>7.5x</td>
</tr>
<tr>
<td>Balance Sheet Liquidity</td>
<td>117</td>
<td>523</td>
<td>188</td>
<td>0.8</td>
<td>5.7</td>
<td>24.8</td>
<td>7.6</td>
</tr>
<tr>
<td>Breakup Value</td>
<td>12</td>
<td>9</td>
<td>33</td>
<td>0.2</td>
<td>3.2</td>
<td>4.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Management Change</td>
<td>57</td>
<td>157</td>
<td>380</td>
<td>0.7</td>
<td>1.7</td>
<td>8.3</td>
<td>6.7</td>
</tr>
<tr>
<td>Deleveraging</td>
<td>45</td>
<td>181</td>
<td>504</td>
<td>0.6</td>
<td>3.4</td>
<td>5.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Asset Productivity</td>
<td>85</td>
<td>234</td>
<td>281</td>
<td>1.0</td>
<td>6.9</td>
<td>12.2</td>
<td>6.2</td>
</tr>
<tr>
<td>Structural Shift</td>
<td>120</td>
<td>471</td>
<td>536</td>
<td>1.3</td>
<td>6.5</td>
<td>10.0</td>
<td>7.9</td>
</tr>
<tr>
<td>Segregated Market</td>
<td>130</td>
<td>230</td>
<td>206</td>
<td>1.8</td>
<td>7.0</td>
<td>18.4</td>
<td>9.0</td>
</tr>
<tr>
<td>Aggregate</td>
<td>566</td>
<td>$1,805</td>
<td>$2,128</td>
<td>1.1x</td>
<td>6.3%</td>
<td>13.2%</td>
<td>7.3x</td>
</tr>
</tbody>
</table>

N.B. Seafarer Value Universe figures calculated on 446 unique securities out of 566 aggregate number of stocks in all categories. Companies with market capitalization of $250 million or greater.
book value. In the case of fungible operating assets (e.g., vessels or aircraft), a company may trade below replacement cost if it operates at an efficiency level below the global norm. In the case of nontradable assets, based on a concession for example, a company may trade below its liquidation value if its operations underperform for non-concession-related reasons.

**Criteria:** A low price-to-book value multiple would seem ideal to pursue this asset-based category of value, but using it on its own fails to guard against value traps. Instead, the search in this category focused on the cash-flow yield of operating assets combined with a low EV in relation to the book value of said assets. Searching for value in this manner, instead of simply looking for a low price-to-book ratio, ensures that the assets are productive, highlights the potential for cheapness, and guards against debt-holder claims on said assets.

**Manifestations of value:** The results in this category are remarkable for the dominance of Russian companies in general and Russian utilities in particular. Under normal conditions, the fair value of a productive asset is higher than its price-to-book value (P/BV >1x) in proportion to its productivity. The cash return of Russian utility assets is in the teens, but they trade at an abnormally low median P/BV of 0.22x. And even though they are burdened with significant debt, their ability to service such debt is very high due to generous interest cover ratios (>10x). Should one wish to pursue this avenue, this is where research work would begin in pursuit of the currency denomination and maturity of the debt, as well as reinvestment requirements, to determine how much of said cash flow actually accrue to shareholders. Nevertheless, in light of the decline in the U.S. dollar price of Russian equities since the collapse of oil prices and the Ukraine conflict, it makes intuitive sense that Russia should dominate the breakup value sleeve of EM.

**Value traps:** A good method for identifying value traps in this category is to search for high dividend yield stocks. The reason a high dividend yield correlates with a value trap in examining breakup value is that the market is already discounting the unsustainability of the dividend. This tends to occur with asset-intensive businesses. When their margins cannot support the costs of expansion, they tend to leverage the balance sheet, threatening the dividend.

**Management Change**

**Source of value:** Some EM assets display signs of being undervalued by the market for macro-related reasons, but other companies show signs of potentially being cheap due to poor management decisions. Value in this category arises when cumulative value destruction leads to either a change in management by the control party or industry consolidation. A third solution to an asset’s unsustainable underperformance is, of course, bankruptcy. This is the outcome that fundamental research must guard against and that the value trap screens evaluating on simple multiples have difficulty detecting.

**Criteria:** It is important to note that underperforming enterprises tend to trade at very high multiples if earnings are low or book value is depleted. The search in this category centered on the combination of low margin, low turnover, and high leverage. Pursuing value here ultimately would require fundamental research to validate the presumption of inevitable management change in the foreseeable future.

**Manifestations of value:** What stands out in this category is the preponderance of Chinese A-shares (mainland stocks listed in Shanghai or Shenzhen). These companies have grown revenue and assets meaningfully over the years. Yet, they display dismal asset turnover and margins. Increasing debt has financed the growth that their operations could not support. Given how credit is generally directed and priced in the country (via government rather than free-market direction), it makes intuitive sense that Chinese companies dominate this sleeve. Indeed, although China is still undergoing a long process of interest-rate liberalization, Chinese banks effectively lend at the benchmark rate (set by the People’s Bank of China) plus or minus a few basis points.6 This practice likely means that they fail to price risk adequately. In addition, the country’s five-year economic plans tend to direct bank lending, crowding out the private sector. Before confirming preconceptions and writing off Chinese companies as investment candidates, it is important to note that the data revealed here is precisely why China has engaged in a corporate productivity drive for a number of years now? Some companies are further along that process than others and that is precisely where the opportunity lies.

**Value traps:** Avoiding traps in this category hinges on understanding the control party and its intentions. Government-owned entities tend to have unlimited capacities to sustain losses, because the government acts as the explicit or implicit guarantor of the debt (an example of moral hazard). Thus, the limit to debt extension is not the asset value that nominally acts as collateral to the debt, but rather the government’s capacity to tax its citizens. A corollary of this line of reasoning is to avoid global industries where state-owned competitors command substantial market share, because these will destroy the economics of the entire industry, including private-sector participants. This can extend to public-private partnerships, where private capital partially funds public infrastructure projects.

**Deleveraging**

**Source of value:** By sustainably reducing their debt burden, companies engaged in deleveraging increase the future cash flows that accrue to shareholders, thus creating value. This is a particularly interesting area to look to for value in EM for two reasons. First, it is easier for companies to overextend their balance sheets in high growth environments, such as EM. Second, enterprises engaged in paying down debt tend to suffer from a downward shift in growth, leading to an exit of growth investors and lower valuations.8 The point that is usually overlooked in these circumstances is that growth tends to normalize when the deleveraging cycle nears its completion.

**Criteria:** The criteria used to search for opportunities in this driver focus on the composition of enterprise value versus the
capital structure appropriate for an industry while guarding against an apparent inability to service debt. More generally, each industry has a characteristic turnover and margin combination that supports a natural level of leverage for that industry. Companies with balance sheets that deviate from their natural composition for prolonged periods of time tend to suffer from lower equity valuations. The key to realizing value in this category is to identify a realistic path to balance sheet normalization, which usually is accompanied by a rerating of equity valuations.

Manifestations of value: Unsurprisingly, given sharp price declines in commodities and currencies during 2014 and 2015, materials and energy companies dominate this category. A salient example is a global cement company whose leverage increased beyond the limits of conventional debt covenants as its profitability deteriorated following the 2008 crisis. Trading below book, the case for potential value in this stock resides on the replacement value of its global assets relative to the debt burden (i.e., the company can normalize its balance sheet through asset sales), together with margin normalization.

Value traps: Potential traps in this sleeve relate to companies with high leverage that don’t have the balance sheet to survive a prolonged downturn, or companies that have unclear asset value. An example is a subscale Latin American iron-ore producer. Like many other companies in this industry, it consumed its cash and increased leverage to invest in additional capacity, concurrently paying dividends that often exceeded free cash flow. The difference with other iron-ore producers is that this company is likely on the upper end of the global production cost curve, thus reducing its ability to survive as the lowest-cost producers displace other competitors. Thus, the very low price-to-book value ratio likely represents a trap.

Asset Productivity
Source of value: The asset productivity category of value relates to demand and supply cycles. Specifically, it refers to assets operating at low capacity utilization due to a demand downturn or following a period of capacity expansion. Investors have a tendency to extrapolate short-term dynamics, often overlooking that cycles are self-correcting if the price mechanism is allowed to work.

Criteria: The search for value here focuses on comparing a company’s current valuation against the long-term cash flow it has generated historically. This is one of the best methods to use to look through earnings cycles and gauge the potential to discover value in a security. Only fundamental research can determine the actual presence of value by assessing normalized cash flow as a distinct concept from historical cash-flow generation.

Value traps: Following the above discussion, traps in this category would consist of companies with high leverage that deployed new capital procyclically (i.e., purchased assets expensively at the peak of the cycle). Other potential value traps would be businesses whose normalized cash flows do not correspond to their historical track records. Examples among these companies include a highway operator trading below book that faces traffic diversion to new roads; its cash flows are unlikely to ever recover to the previous peak. Other examples: a media company challenged by a new regulatory environment, and a wireless operator whose future cash flow suffers from deteriorating business economics due to competition.

Structural Shift
Source of value: Investors pursuing growth traditionally have focused on emerging markets as their hunting grounds. Thus, it is not uncommon to find cash-flow generative businesses trading at attractive valuations when their growth plateaus. The source of value in this category is the price paid for the underlying cash flow plus the fact that investors tend to underestimate the contribution of dividends to total return.

Criteria: The search for value in this category focuses on finding incrementally higher dividends or buybacks, and potentially an outright reduction in invested capital, combined with business sustainability.

Value traps: An apt contrasting case to the one above is a Brazilian consumer discretionary company that finds itself in a similar position of suffering a sharp deceleration in revenue growth over the past three years. This stock enjoys a healthy dividend yield of 7 percent, but the difference with the Eastern European company is that the management of this stock chose to consume cash and almost triple its debt to finance a dividend well in excess of free cash flow. The Brazilian stock has yet to find a natural level for its revenue base and growth rate and needs to cut its dividend; the Eastern
European company’s cash flow and dividend seem eminently more stable and secure. Not all 7–8-percent dividend yields are created equal.

**Segregated Market**

**Source of value:** The final potential source of value opportunities in EM relates to stocks that are in segregated markets. These markets are naturally small, obscure, and typically disconnected from the global flow of liquidity. We believe that securities that trade in such markets might naturally trade at discounts to their intrinsic values due to their relative illiquidity. We believe a patient value investor can harvest an illiquidity premium by investing carefully in such segregated markets. Most frontier countries constitute classic examples of segregated markets, because their capital markets are small and thinly traded, potentially causing liquidity-driven discounts. As table 2 shows, the number of listed stocks in emerging markets exceeds that of the United States and Western Europe. Their combined market capitalization is of comparable size. As such, myriad well-managed companies typically are apparent only to domestic investors. As capital markets in EM gain depth, the value inherent in these companies should surface in the form of higher security prices.

**Criteria:** The search for value here focuses on finding businesses with a sensible mix of reinvestment and capital return that is designed to sustain them as going concerns. The value opportunity emerges when such firms are trading at discounted valuations as a result of dynamics outside of the fundamentals of the company.

**Manifestations of value:** Small-capitalization and medium-capitalization companies tend to dominate this space. What is remarkable regarding this group of companies is the combination of attributes seen in table 2: The median stock trades at an attractive price to cash flow from operating activities (CFO) of 9x, with a dividend yield of 7 percent and significant cash on the balance sheet. Other categories of value offer more-attractive terms on any single variable but not in this combination. One of the companies in this group trades at the median levels cited and has been listed in Hong Kong since 1992. Despite the company’s long track record spanning several business cycles with reasonably consistent cash-flow generation, the 8-percent dividend yield indicates that the market still discounts its cash flows as if there were low future visibility.

**Value traps:** For an example of another company in the same group trading at similar levels that likely does not offer value, consider the case of a Hong Kong media company. The reason for the different assessment of similar dividend yields is that this second company is a media enterprise facing new competition in its traditionally protected home market, and its efforts to explore new avenues of growth are failing short of expectations. This is a case that warrants an assessment of normalized cash flow as distinctly different from the company’s historical record.

**Conclusion**

Convinced by the weight of theoretical and empirical evidence in support of a value investment discipline, we were perplexed by the paucity of value-oriented strategies in the emerging-market universe. We were particularly puzzled because we assume that a disciplined, fundamental approach could capitalize on markets that are presumably less efficient than their developed-world counterparts.

We then set out to answer the questions posed by such a seemingly obvious gap. The exploration discovered a large value opportunity set with an aggregate market capitalization of $1.4 trillion, characterized by financial metrics that strongly suggest the pervasive presence of discounts to intrinsic worth. After examining most possible deterrents, this study found no compelling reason that investors would forgo value investing in the emerging markets.

Paul Espinosa, CFA®, is the lead portfolio manager of the Seafarer Overseas Value Fund and an associate portfolio manager of the Seafarer Overseas Growth and Income Fund. He earned an AB in economics with honors from Brown University. Contact him at paul.espinosa@seafarerfunds.com.

**Endnotes**

4. Currents of change are gathering pace within major emerging markets in support of the interests of minority shareholders. Consider the following:
5. Korea’s legislative change increasing the return of capital to shareholders and reducing the barriers to competition imposed by the chequebook—family-controlled industrial conglomerates in South Korea—is probably an enabling factor of the undercurrents gaining critical mass. At the end of 2014, Korea’s Ministry of Strategy and Finance issued new legislation to tax retained earnings that are not distributed to shareholders, invested, or paid to employees. The aim is to address the infamous capital-hoarding of Korean corporates. For more information, see “South Korea: Notable 2015 Tax Law Amendments Affecting Foreign Invested Companies and Foreign Individuals,” International Tax Review (January 27, 2015), http://www.internationaltaxreview.com/Article/3421924/South-Korea-Notable-2015-tax-lawamendments-affecting-foreign-invested-companies-and-foreign.html.
6. China’s drive to raise the productivity of state-owned enterprises is a form of potential incremental shareholder return. The higher dividend payout demanded by China’s State-Owned Assets Supervision and Administration Commission (SASAC) is another example. Furthermore, one of the unintended (or perhaps intended) consequences of Beijing’s anti-corruption drive is to reduce capital misallocation, which directly enhances returns to minority shareholders. For more information, see “China Announces Plan for Reform of State-Owned Enterprises,” Financial Times (July 15, 2014), http://www.ft.com/intl/cms/s/0/9728638-0c24-11e4-a096-014f4ed6bcb0.html#axzz3LuEKF4Wp and “Chinese SOEs and the Way Forward” http://www.seafarerfunds.com/commentary/chinese-soes-and-the-way-forward/.
7. The dividend contribution to total return for EM stocks is meaningful in absolute terms and exceeds that of U.S. equities. From 1996 to 2014, dividends attributed 40 percent of emerging-market equity total returns but 24 percent of the MSCI US Index total return.

Disclaimer: The views and information discussed in this commentary are as of the date of publication, are subject to change, and may not reflect the writer’s current views.