Investment **Research**

Profitability Trends in Emerging Markets
Setting the Stage for Active Management

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Emerging markets equity performance has lagged developed markets significantly over the past five years as overall profitability in emerging stocks has declined. We believe that this is an important time to understand the drivers of company profitability. To this end, we have examined the components of return on equity for emerging and developed markets. Importantly, profitability is inherently linked to a company's capital spending decisions—that is, management's effectiveness at investing in projects that add value. We also investigated trends in corporate capital spending, which revealed that emerging companies have invested more, in relative terms, than had their developed peers. We believe that a pickup in corporate investment in developed markets and a stabilization of investment in emerging markets could be supportive of emerging equities, but we acknowledge that quantifying or timing this inflection point remains difficult. Ultimately, as fundamental investors our view is that improving profitability will emerge from differentiation at the company level.

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Summary

- Profitability in emerging markets equities has been on a downward trend over the last five years. The opposite has occurred in developed markets, closing the gap observed historically when companies in emerging markets delivered higher returns on capital than their developed markets peers. In turn, the performance of emerging markets equities has meaningfully lagged the developed world.
- We examined the components of profitability (ROE) to gain a better understanding of the trend. Profit margins seem to be the culprit of lower emerging markets ROE—as a result, it is crucial to monitor signs of margin stabilization. Importantly, corporate investment decisions are inherently linked to profitability. As such, capex trends have been at the center of several research reports by prominent institutions such as the IMF and OECD.
- The key observations from capex trends point to a global slowdown—based mainly on a lackluster rebound in the developed markets after a severe drop during the 2008–2009 crisis. Moreover, the market has significantly rewarded companies engaged in financial engineering. Companies in the United States have been particularly aggressive in undertaking large buyback programs on the back of record-high profit margins and exceptionally low financing costs.
- The combination of buybacks as well as improving efficiency and cost rationalization through M&A also has played a meaningful role in the overall profitability in developed markets. This is important as organic revenue growth rates are slower than those of earnings.
- We believe that a pickup in corporate investment in developed markets can be a net positive for emerging stocks, but determining the catalyst and timing for this turning point is challenging, at best. We recognize fundamental investors rely on stock-specific analysis to find opportunities but it is instructive to also examine broad themes, as we've done for ROE and corporate investment trends.

Introduction

Emerging markets equities have significantly lagged developed markets equities over the last five years. As bottom-up investors we constantly examine fundamental metrics to get a deeper understanding of the drivers of market performance. The analysis throughout this paper is focused on profitability—as measured by return on equity (ROE)—for emerging and developed markets. Historically, emerging markets have displayed higher ROE and lower valuation, as measured by the price-to-earnings (P/E) ratio, than developed markets have. A combination of high ROE and low valuation typically indicated that emerging markets stocks were relatively attractive.

Today, however, the gap in ROE between developed and emerging markets stocks has virtually disappeared, making it a compelling topic for examination. At the same time, the P/E difference has widened between the two groups, as emerging markets are near historically low levels. This lower valuation is attractive, as we posit that the narrowing of the ROE gap can be explained in part by cost rationalization and efficiencies as well as financial engineering in developed markets that may be overstating long-term profitability. And we believe the ability of these companies to increase profitability further through these methods is now very limited. On the other hand, this does not negate that emerging markets stocks have suffered a drop in profitability—especially profit margins—and a recovery or stabilization would be a positive for emerging equities.

Over this period, GDP growth was also stronger in emerging markets and this suggests that economic growth does not necessarily correspond to stock market returns. Importantly, we believe economic growth needs to be reflected in *profitable* company growth to boost stock performance.

Company profitability is conceptually tied to the effectiveness of managements' capital allocation decisions. As a result, an analysis of ROE should take into account trends in corporate capital investment—which has been slow globally and particularly in developed markets. This topic has been the subject of growing attention recently, including publications from the IMF (chapter 4 in the April 2015 WEO, "Private Investment: What's the Holdup?") and the OECD (chapter 2 in the Business and Finance Outlook 2015, "Corporate investment and the stagnation puzzle"). To get a deeper understanding of the significance of this issue, we analyzed ROE in historical context and business investment trends.

A Historical Look at ROE

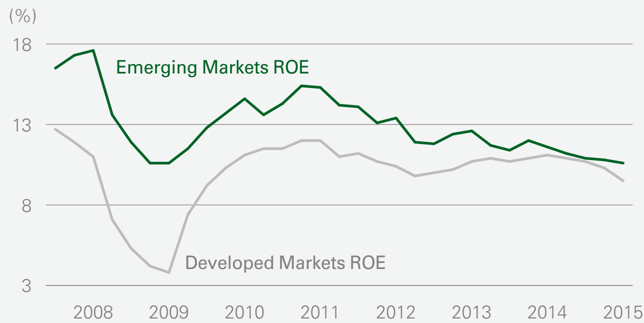
We examined the trajectory of ROE for emerging and developed markets focusing on the period after the global financial crisis.[1] ROE for the MSCI Emerging Markets Index has fallen more than 4 percentage points from its five-year high or almost 7 percentage points from its pre-crisis peak in 2008. By contrast, ROE in developed markets has been more stable after the crisis—even showing signs of an upward trend after a trough in 2012 (Exhibit 1). However, our latest reading in developed markets ROE in September 2015 dipped, for a more muted drop of about 3 percentage points versus the pre-crisis peak. When viewed in aggregate, important questions emerge: why have emerging markets and developed markets ROE converged? What has changed in the underlying components of profitability in emerging markets companies to drive this pattern? To help answer these questions, we relied on DuPont analysis for ROE. This well-known method equates ROE to its primary components: profit margin, asset turnover, and leverage (see callout box for definition).

DuPont Analysis

As a refresher, the DuPont model defines ROE in terms of the following components: corporate profitability (profit margin), efficiency of the use of assets for generating revenue (asset turnover), and the composition of the capital structure (leverage).

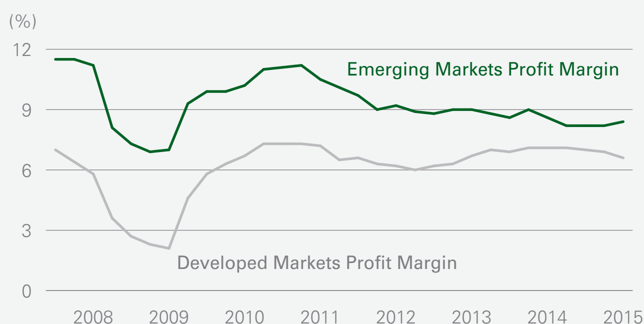
$$\text{ROE} = \underbrace{\frac{\text{Net Income}}{\text{Sales}}}_{\text{Profit Margin}} \times \underbrace{\frac{\text{Sales}}{\text{Assets}}}_{\text{Asset Turnover}} \times \underbrace{\frac{\text{Assets}}{\text{Equity}}}_{\text{Leverage}}$$

Exhibit 1
A Historic Shift: EM and DM ROE Converge

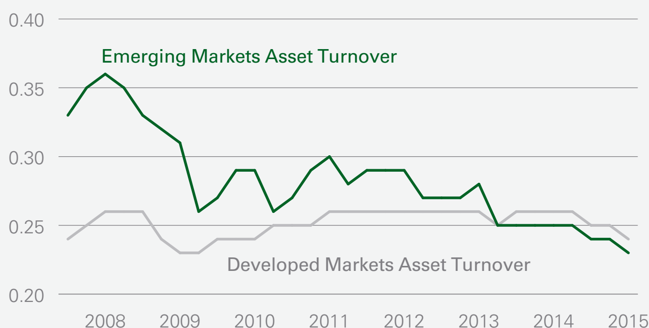


As of 30 September 2015
Source: FactSet Fundamentals, MSCI

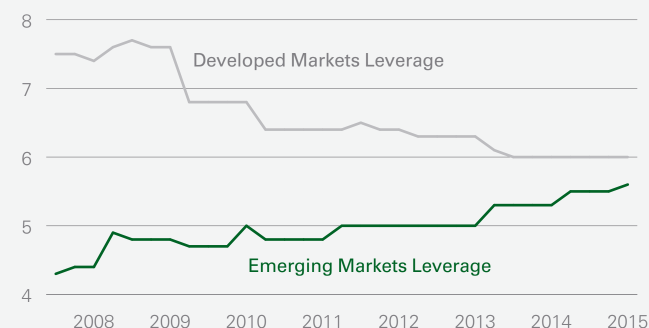
Exhibit 2
Emerging Markets Profit Margins Have Declined Compared to Developed Markets ...



... As Has Asset Turnover ...



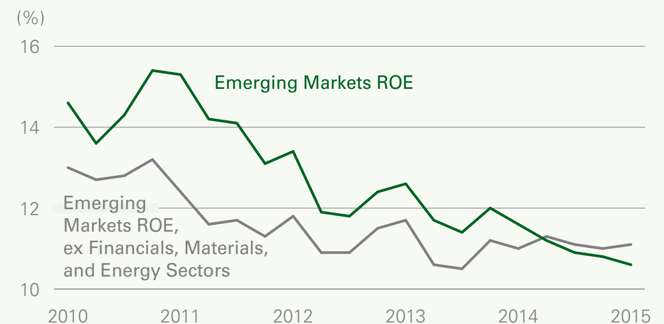
... Though Leverage Is Higher



As of 30 September 2015
Source: FactSet Fundamentals, MSCI

Historical ROE Excluding Materials, Energy, and Financials Sectors

We analyzed ROE and its components excluding materials, energy, and financials sectors, given the steep price drop in commodities and oil as well as company specifics in the financials sector. This adjustment can help identify these sectors' contribution to profitability in emerging markets. As shown in the graph, ROE appears more stable excluding these sectors. The change over the last five years for ROE and its components are: ROE -1.9 percentage points, profit margin -0.4 percentage points, asset turns -0.1, and leverage +0.2. These changes reflect more stability versus the entire market's ROE and its components.



As of 30 September 2015
Source: FactSet Fundamentals, MSCI

Emerging markets companies exhibited diminishing profit margins, while those of developed markets slightly increased or were more stable. Asset turnover declined in emerging markets and leverage increased, while almost the exact opposite took place in the developed world (Exhibit 2).

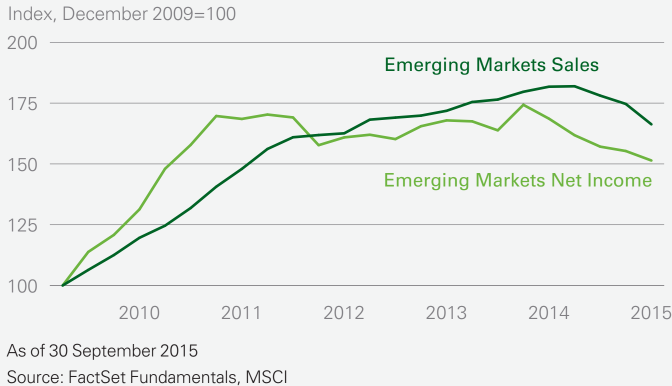
Centering the three DuPont metrics on the last five years of the post-crisis period (2010–2015), it appears that for emerging markets the increase in leverage was not enough to offset the decline in profit margin and asset turnover, leading to an overall decline in ROE (see Appendix for comments on specific countries and sectors). For example, using the September 2015 profit margin and asset turnover, leverage would have needed to be 6.8 times instead of 5.6 times, to reach the 2008–2015 ROE average of 13%. In developed markets, on the other hand, de-leveraging coupled with a slight decline in profit margins was offset by steady asset turnover, for a smaller decline in ROE versus that of emerging markets. We would like to emphasize that raising leverage to boost overall ROE can lead a company to the dangers of excessive debt, making its equity more volatile and could lead to contraction in valuation multiples.

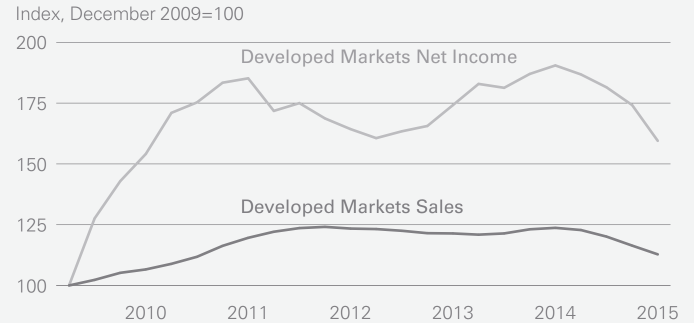
Potential Rationales for ROE Trends

Cost Efficiencies

For developed markets, we believe financial engineering—rather than revenue growth—has been a big contributor to profitability. In many cases these efficiencies are brought by M&A activity, which has benefited from extremely low financing costs. In other cases, expenses are simply reduced by abandoning capital expenditures (capex). As a blunt indicator of this phenomenon, we used our same data set to cal-

Exhibit 3
Sales and Net Income—Lower Sales Growth in Developed Markets





As of 30 September 2015
Source: FactSet Fundamentals, MSCI

culate the trend in sales and net income growth for both developed and emerging markets (Exhibit 3). In the post-crisis period, one can see sales and net income growing at a similar pace in emerging markets. This is not seen in developed markets, where sales growth is slower than net income growth. This can be indicative of cost rationalization having an effect in developed markets that was not present in emerging markets.

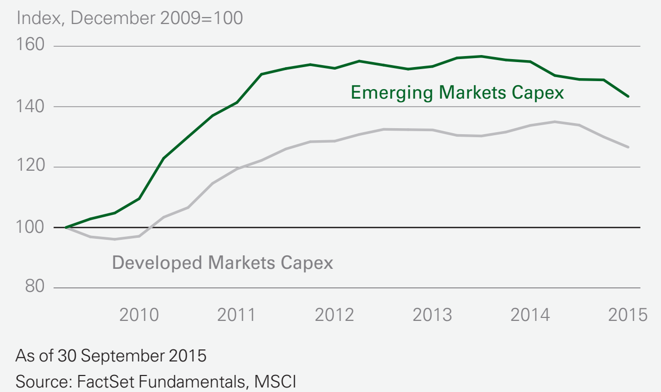
Business Investment

In our view, global business investment has had an impact on profitability drivers in emerging markets—mostly in two parts. First, as emerging markets businesses undertake investments, the components of ROE are affected. Second, as developed markets postpone investments it can indirectly impact emerging markets companies that are part of a network/supply chain that benefits from expansion. Evidently, global corporate investment is not the only driver of profitability trends, but it can help us understand the pattern. Other factors such as a strengthening US dollar, commodity prices, and productivity have also played important roles for emerging markets' profitability.

In general, emerging markets have seen faster growth in investment activity in the post-crisis period—which we have measured since December 2009—than have developed markets. Capex grew faster in emerging markets in the early years of the period under review and has plateaued more recently (Exhibit 4). Lower margins in emerging equities can be attributed, in part, to companies deducting higher depreciation expenses from fixed asset investment, lowering net income. This investment would also impact other ROE drivers. Asset turns would decline given a greater amount of assets relative to sales (sales increased in emerging markets, further emphasizing that the drop in asset turnover derives from capex). Leverage may also increase to finance these investments.

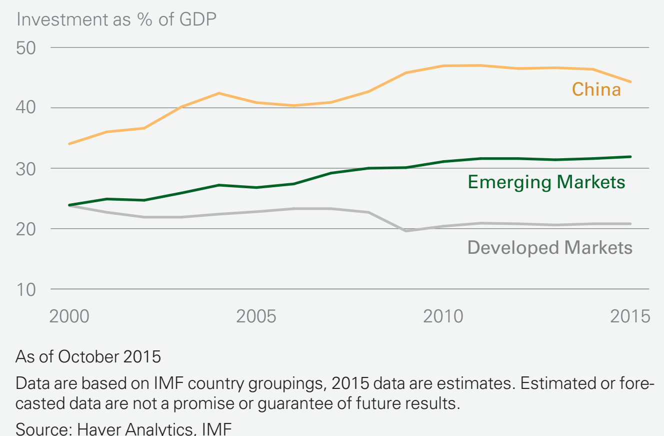
At the aggregate country level (and to obtain a longer data series), investment as a share of GDP[2] dropped significantly after the crisis in developed markets, while it kept rising in emerging. The data in this case has broader coverage, extending beyond the companies covered by the MSCI benchmarks (Exhibit 5). When viewed as a share of net sales, investment seems more stable in developed markets, but by this same measure, buybacks and dividends have taken a larger proportion—especially in the United States with European companies also following this trend in some form.[3] We discuss buyback activity in the box titled "The Market Has Favored Buybacks and Dividends Instead of Capital Spending."

Exhibit 4
EM Capex Growth Has Been Stronger than in DM



As of 30 September 2015
Source: FactSet Fundamentals, MSCI

Exhibit 5
Investment in Developed Economies Has Not Recovered



As of October 2015
Data are based on IMF country groupings, 2015 data are estimates. Estimated or forecasted data are not a promise or guarantee of future results.
Source: Haver Analytics, IMF

The Market Has Favored Buybacks and Dividends Instead of Capital Spending

Business investment is an essential driver of shareholder value. However, an investment must generate a return above the cost of capital, otherwise it is value destructive. In theory, a company should keep investing as long as management finds value-generating projects, and only return cash to shareholders in the absence of value-accretive projects. Buyback programs can be viewed as capital discipline from company management (i.e., the best use of cash), but these programs can also be viewed as companies curtailing too much investment, which drives future growth prospects.

In this market environment, investors have rewarded companies that have large buyback and dividend programs. The table below highlights the favorable performance results from buying companies with strong buybacks/dividends and selling those with strong capex programs. Although market returns have favored companies with high shareholder yield, this can be a function of investors' appetite for income in a low interest environment rather than a reward for capital discipline.

Infrastructure & General Industry

(Buying the bottom quartile of companies CAPEX / (CAPEX + DIV & BUYBACKS) index and selling the top quartile); (%)

	2009	2010	2011	2012	2013	2014	Cumulative
United States	0.56	1.70	16.18	11.98	3.84	15.55	49.82
Europe	-2.36	3.80	13.84	8.73	9.74	13.47	47.22
Japan	-7.27	0.45	9.63	9.29	2.17	-2.62	11.65
EMEs	-3.71	8.70	10.22	10.74	0.97	-5.52	21.40

As of 2014

Company data are based on the Bloomberg World Equity Index, as described in the Annex 2.A1 of OECD Business and Finance Outlook 2015.

Source: Bloomberg, OECD Calculations

China's Advancement

As is well known, China has been a big driver of overall investment in the emerging markets as pointed out in Exhibit 5. China's massive build out in fixed asset investment has had some significant implications for global markets since the early 2000s. In terms of commodities, China's demand supported rising prices in several basic materials, which was beneficial to other emerging markets. The rapid growth in China's economy was extrapolated by many investors to continue well into the 2020s. These two developments generally worked as a top-down tailwind for emerging markets equities. We believe that today, emerging markets equities will be entering a period where this tailwind is diminished, thereby raising the importance of bottom-up driven stock selection.

Implications for Emerging Markets Investing

Stabilization (or improvement) in ROE in emerging markets will depend largely on profit margin stabilization. This assessment is complicated by several macro factors. A stronger US dollar may help stabilize margins in some exporters, while hurting consumption of imports. Trends in industrial production and productivity can also point to broad-based effects on margins.[4] Reform agendas have been launched in several emerging countries and are now at varying stages of progress. However, forecasting these macro variables or the outcome of reforms is challenging, at best. Instead, we think visibility into improved profitability will start at the company level.

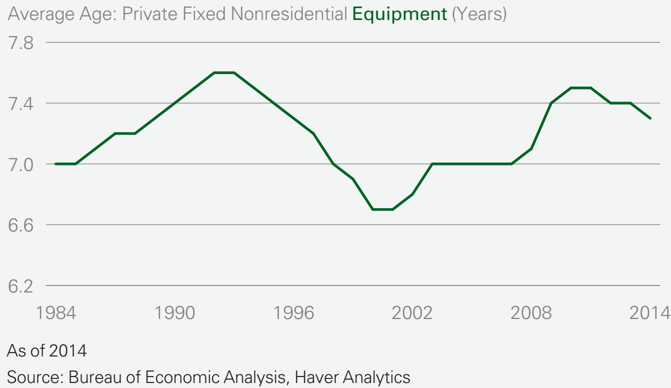
Importantly, the transition to better profitability is likely to differ in terms of timing and magnitude across companies. This means there will be significant differentiation across emerging markets stocks—an opportunity for fundamental stock pickers.

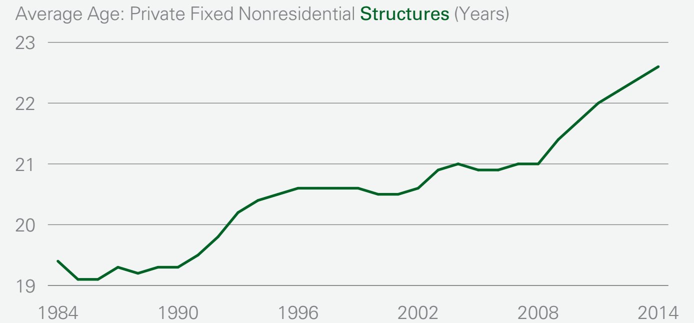
> "For developed markets, we believe financial engineering—rather than revenue growth—has been a big contributor to profitability."

We believe a revival in corporate spending in the developed world could be a tailwind for emerging markets. Obviously not all sectors are beneficiaries of this, but a significant number of emerging companies are connected to this dynamic. As companies in the developed world expand their investment programs, this can translate into a boost for industrial orders or infrastructure spending for more stable commodity prices. As investors, we can view the general implications of capex trends as directly showing where corporates find opportunities to create value. Also capex cycles set the base for productivity growth and output growth (through capital deepening).[5]

However, predicting exactly when this re-ignition of corporate investment may occur is difficult. Some commentators argue that business capital needs have undergone a structural shift. New technologies have made corporate spending in equipment and other fixed assets less necessary today. Recent US data, in fact, show that investment in intellectual property represents a larger, growing share of overall business investment (the largest share was historically equipment investing).[6] From 2009–2011, equipment dominated business investment; in the first half of 2015, intellectual property had the largest proportion of total investment. With this in mind, the change to more investments in intangible assets over fixed assets in the developed world can be suitable for emerging economies as they shift to consumption/services economies.

Exhibit 6
The US Asset Base Is Showing Its Age





As of 2014
Source: Bureau of Economic Analysis, Haver Analytics

That said, companies still need to expand plant and equipment. In the United States, for example, the equipment and structures are aging (Exhibit 6), demonstrating an apparent need to replace physical assets. This is also true in the public sector, as especially government structures' average age is at a multi-decade high. As a result, a revival in public investment is also a key development to watch. However, even if investment trends rebound in developed markets, it does not imply that the ROE trends we described earlier will immediately revert, as there is always a lagged effect on overall ROE.

Another important dynamic to consider is M&A activity—and the most significant deals are historically in the domain of developed markets. It will remain important to track this indicator as a signal of companies' preference for spending cash on these transactions in place of corporate investment. And more importantly, if deals continue to be effective generators of benefits through economies of scale, this can continue driving profitability (as previously mentioned).

> "...the transition to better profitability is likely to differ in terms of timing and magnitude across companies. This means there will be significant differentiation across emerging markets stocks—an opportunity for fundamental stock pickers."

Conclusion

As the historical gap of higher ROE in emerging versus developed markets narrowed, looking at the underlying ROE building blocks helps in understanding this trend. The drop in profit margins in emerging markets and the stability of these margins in developed stocks provide part of the explanation. As such, signs of margin stabilization are critical for emerging equities.

Several factors have been influencing ROE globally; along with macro factors like FX and a drop in commodities, we can point toward two others: 1) higher investment in the emerging world led to greater depreciation expense, lowering net income; in contrast, the universe of developed stocks has not undertaken as much capital spending; and 2) cost efficiencies in developed companies helped stabilize (and slightly improve) profitability.

In our view, a revival of business investment in the developed world can be a tailwind for emerging markets. However, the timing for and composition of renewed capex from developed markets is uncertain. And other factors complicate this analysis: the market seems to be rewarding stocks with generous buybacks/dividends, and lack of investing is not due to a shortfall of cash/sales. However, we believe indicators for a shift in this market behavior deserve close monitoring. Ultimately, in our view, a profitability revival in emerging markets will become apparent at the fundamental level leading to a higher degree of differentiation among stocks. Skilled investors who are able to identify profitable companies and balance this with valuation are positioned to benefit in this environment.

Appendix

Sector and Country Profitability in Emerging Markets

We examined the sectors in the MSCI Emerging Markets Index for the five years through September 2015. Nine out of ten sectors showed deterioration in ROE. The utilities sector was the only one improving in profitability. Not surprisingly, materials and energy suffered significant erosions in ROE—due to the general price drop of oil and commodities. As we looked at the DuPont components, profit margins evaporated in the materials sector with sharp drops as well in energy, consumer staples, and health care (although health care data were close to a peak at the start of our measurement in 2010). By contrast, information technology improved margins. We analyzed the financials sector separately given that asset turnover are hard to compare versus other sectors. We used return on assets (ROA) and leverage as the ROE components. Financials improved ROA slightly while at the same time reducing their leverage.

The broad-based ROE decline is confirmed at the country level. We looked at country-level detail for the largest ten constituent countries in the MSCI Emerging Markets Index, based on average weight (September 2010–September 2015). Nine out of ten countries saw a decline in profitability. The exception was South Africa and notably Taiwan fell only slightly. As we explored DuPont components a few observations were striking. Margins were reduced by about 60% in Brazil and close to one-half in Russia (given these countries' commodity and oil weights), with a significant decline for Mexican and Indian companies too. Taiwan, South Korea, and South Africa were the only notable improvers in margins, perhaps as a result of the bigger role of technology in the global economy as it relates to those first two. And in the case of leverage, the results were mixed as over this period Russia and Mexico levered up while South Korea and South Africa de-levered, importantly China has the highest leverage.

In terms of capex, we showed that China invested heavily when viewed through IMF country aggregates (investment as share of GDP). However, when viewed in terms of relative capex growth for the MSCI constituents we get different results. Of course, the absolute level of Chinese investment is the highest in emerging markets. But for the five-year period under review Mexico and South Korea exhibited the fastest growth—almost doubling their capex total. Only two countries of the ten largest weights were investing less in September 2015 than they were in September 2010: Brazil and Taiwan.

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Notes

1 Our data are for the period March 2008 to September 2015. We used the FactSet Fundamentals database for the components of ROE and other fundamental data (capex, sales). All data are in USD and on a last-twelve-months basis. The company universe is based on the constituents and composition of the MSCI Emerging Markets and World indices respectively. We also note that standard MSCI benchmarks would leave out small cap companies, but in our view the sample is representative of the investment universes.

2 Keep in mind that this definition of country-level investment is an approximation of business investment as typically these data also include residential investment. However, business investment is a larger share of total investment thus a good proxy, in our view.

3 OECD (2015)

4 These macro factors are also mentioned in the Credit Suisse Global EM Strategy 2016 outlook as the key drivers for profit margin stabilization.

5 Source: Morgan Stanley Research, as of 31 August 2015.

6 Furman (2015)

Important Information

Published on 14 September 2017.

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