Invesco

Investment Insights

A rising tide of opportunities across many frontiers

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Investment philosophy

Focus on companies not countries

Many investors operate under the assumption that emerging markets (EM) equities can generate superior returns simply because EM countries generate higher rates of economic growth than the developed world does. In our view, not only is it incorrect to assume that all EM are growing at a faster rate, but it is also wrong to use macro growth as the basis for investing in EM equities and pursuing sustainable returns.

To generate long-term alpha in EM equities, we believe that investors need to apply the same approach that should be applied to investing anywhere – invest for the long term in attractive companies with durable growth, sustainable advantages, and real options that will manifest over years. These opportunities exist not only in economies posting strong gross domestic product growth, but also in low-growth economies where companies are able to tap into structural demand and deliver innovative products and services that are likely to enhance earnings.

We look to avoid short-term tactical positions and macroeconomic calls. Investing in EM is about identifying extraordinary businesses that have the capacity to generate above average earnings even in pedestrian macro environments. In slower growth economies – in both developed and EM – we believe there are two broad categories of companies that meet these criteria:

- Globally competitive companies that are not entirely dependent on their domestic markets
- Domestic disrupters that gather market share in their own markets over time because of their significant efficiency advantages.

In the **Invesco Developing Markets Equity Fund**, some of our largest investments are in globally advantaged companies such as Novatek, the Russian gas "behemoth" behind the unfolding liquefied natural gas (LNG) revolution in the Yamal Peninsula; Taiwan Semiconductor, the dominant global semiconductor foundry; and Tata Consulting, one of the world's leading technology services giant.

Much of the balance of the **Invesco Developing Markets Equity Fund** is concentrated in domestic disrupters, companies that are growing by increasing efficiencies in relatively pedestrian growth economies. These include our large holdings in Latin American retailers – Femsa (Mexico), Falabella (Chile) and Lojas Americanas (Brazil) – and our selective investments in EM banks – Credicorp (Peru), Kotak (India), FirstRand (South Africa) and Akbank (Turkey).

Embracing LNG

Global interest in cleaner fuels is helping to increase the demand for LNG. We expect this trend to continue into the foreseeable future.

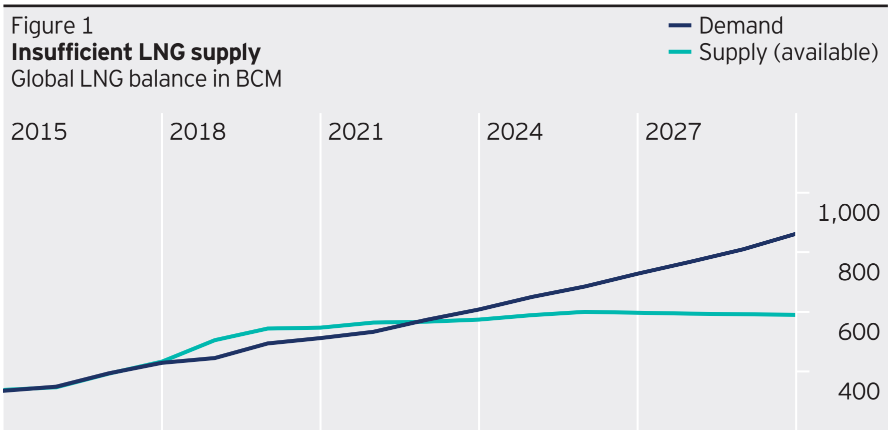
Two major structural shifts are happening now: the globalisation of LNG – traditionally a local or, at best, regional commodity – and the political will in China and elsewhere in Asia to secure affordable, reliable, and clean energy. LNG has long been viewed as the "fuel of choice," a privilege confined either to producing countries like the US and Russia, or to the domain of the economically developed, like Europe or Japan. We believe that this old-world view is now collapsing.

Earlier last year, China became the largest importer of natural gas, overtaking Japan. LNG specifically is becoming the "fuel of necessity," with growth likely to be driven by China and other Asian countries. Our meetings with policymakers in China reconfirmed this outlook – fostering a healthy environment is being viewed as critical to maintaining social stability, and nurturing gas consumption are integral to both.

The supply side is shifting as well. Qatar, which accounted for nearly a third of the market in 2016, will likely be temporarily overtaken by Australia next year. The US, irrelevant on the LNG map until three years ago, could account for one-sixth of global LNG production as soon as 2020. Finally, Russia should challenge all three contenders for the LNG throne, securing at least one-tenth of the market by the middle of the next decade, and a credible chance to become the "next Qatar" in the long run.

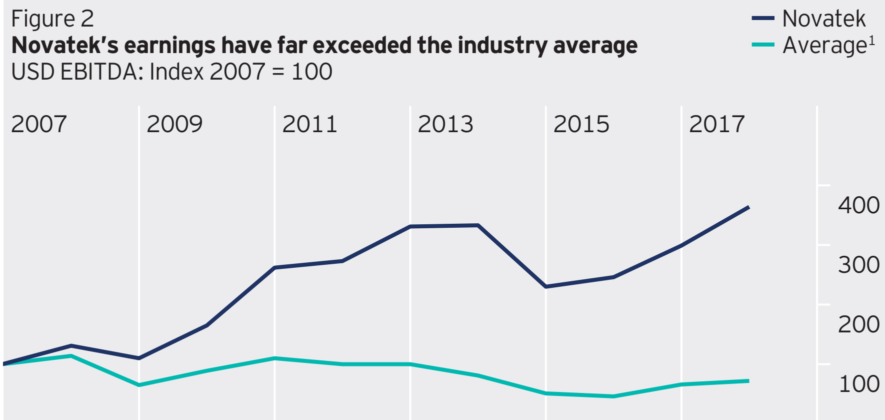
The narrative becomes much more powerful considering that the LNG market may begin tightening in 2020 and could move into deficit early in the next decade. We believe the world will need more LNG than is currently being sanctioned by the energy companies, which under-invested in LNG during the oil price debacle of 2014-2016. The energy companies lack an insufficient quantity of viable projects and are using their cash flow to channel dividends to their still wounded shareholders rather than invest.

Figure 1
Insufficient LNG supply
Global LNG balance in BCM



Source: HSBC, Invesco as at 4 November 2019. BCM is a billion cubic metres.

Figure 2
Novatek's earnings have far exceeded the industry average
USD EBITDA: Index 2007 = 100



Source: Novatek, Bloomberg L.P., Invesco, as at 4 November 2019. EBITDA is earnings before interest, taxes, depreciation, and amortization.
[1] ExxonMobi, Chevron, British Petroleum and Royal Dutch Shell.

The question is how to invest in such a powerful and structurally durable theme in an EM context?

This is where the challenges begin. First, it is hard to find pure exposure outside of the US. Second, the credibility of the major energy companies is extremely low. Wood Mackenzie, one of the leading research and consulting firms for the energy industry, recently estimated that during the last decade, "The 15 largest offshore projects were late and collectively US$80 billion over budget." Finally, we remain highly sceptical of the risk-reward profile in the next generation LNG provinces such as Mozambique.

Hence our approach to investing in commodity companies is no different from our approach with any other sector. We look for companies with a unique and scalable asset base, management/owners who are culturally inclined to consistently create value, and stock valuations that, for some temporary reasons, reflect neither of these strengths.

Our search has been global, but we believe one of the most promising opportunities is Novatek, a Russian-listed private gas company. While the entire industry was suffering from a lack of capital discipline, Novatek launched its first and the world's largest (non-government owned) LNG project – Yamal LNG – at the end of 2017. It did so on time, on budget, and in the harshest environmental conditions imaginable (the Russian Arctic). It is estimated that it will be bigger in size than the infamous Australian Gorgon project (Chevron) and built with less than half of the price tag.

Many of the firm's future projects, in our view, will enhance its strengths. Novatek's long-term strategy is to increase its LNG production capacity target to 70 million tonnes per year by 2030, up from a previous target of 57 million. Hence, we were not surprised last year when the French oil and gas company Total SA acquired a stake in its second future project (Arctic LNG-2) at a valuation of more than half of Novatek's market capitalisation.

In May this year, Novatek announced that its third major LNG plant in the Yamal-Nenets Autonomous District will be launched in 2022 (Obsky LNG). Given the Russian government's focus on developing LNG, and what we perceive as Novatek's flawless execution over its 24-year history, and its strong partners like Total and China's CNPC, we see a bright future for this company.

Fintech

Our travels in EM have made us acutely aware of the vast opportunity this sector presents but have also made us cognizant of the unique contextual factors that bode more sober and situational evaluation of all the investment opportunities. The success of fintech in China has provided enthusiasm to investors and companies around the world but applying a "China template" to all fintech circumstances in EM is overly simplistic.

Variations in three broad factors make us question the conventional false analogues between China and EM fintech today:

Catalysts
The driving force of fintech adoption comes from transactional use cases, which differ in intensity and characteristics across EM. For example, ecommerce penetration in many EM countries, for example India and Brazil, is much lower than it is in China. Elsewhere, ride hailing and food delivery, rather than ecommerce, are the more common catalysts in areas such as South East Asia.

Competitive intensity
Fintech is no longer the surprise no one saw coming. The China story is well known to challengers and incumbents alike. This implies a longer competitive tussle in many parts of EM, and a more agile response from incumbent banks, as rival platforms vie for supremacy.

China's fintech explosion
Mobile payment adoption in China has led to spectacular expansion in related services. For example, nearly a billion people use Tencent's WeChat Pay – a keystone payment method for businesses wanting to reach Chinese shoppers, both home and aboard – and over 700 million people use Alibaba's Alipay – a third-party mobile and online payment platform. Both companies own a bank licence and offer insurance distribution, credit scoring and technology services.

Tencent and Alibaba are held in the **Invesco Developing Markets Equity Fund**.

Latin America – rising transactions
Simply put, Latin America is a largely cash-centric region where many citizens still do not have bank accounts but instead rely on cash to conduct daily business. However, Brazil is unique in that over 60% of purchases are made on credit, and of that, over half are routed through multiple monthly interest-free instalments. This indicates selling merchants must wait for cash, and a thriving pre-payment business (i.e. factoring of receivables), where fintech companies have created profitable beachheads. Annualised yields on this business can range from 20% at the lower end to nearly 40% at the upper end, depending on the bargaining power of the merchants.

Powered by pre-payment revenues, fintech companies are now flexing their muscle to expand into adjacent markets. As we mentioned earlier, vast swaths of people remain unbanked and with no access to any financial product but cash. These factors create a two-sided opportunity for fintech companies.

1. For small businesses, faster access and adoption of credit over cash is a key area fintech companies can tap into.
2. For consumers, fintech companies aspire to roll out mobile wallet use cases, through which asset management products, insurance distribution, remittances, as well as consumer loans could flourish.

While ecommerce penetration in Latin America remains low by international standards it is rising. This should be supportive for companies that own both an ecommerce and fintech platform, for example Mercado Libre (held in the **Invesco Developing Markets Equity Fund**). In its Q3 2019 report, the company reported that off-platform payments exceeded those from on-platform ecommerce payments. For a cash-heavy region, we believe this is a positive sign for MercadoLibre as it shows that they are building a disruptive foundation that could solidify its future place as a leader in payment processing.

South East Asia (SEA) – land grab
Collectively, SEA represents a US$4 trillion economy, almost two times larger than that of India. The topology of SEA is highly nuanced in terms of economic development, competitive dynamics, and regulatory directions.

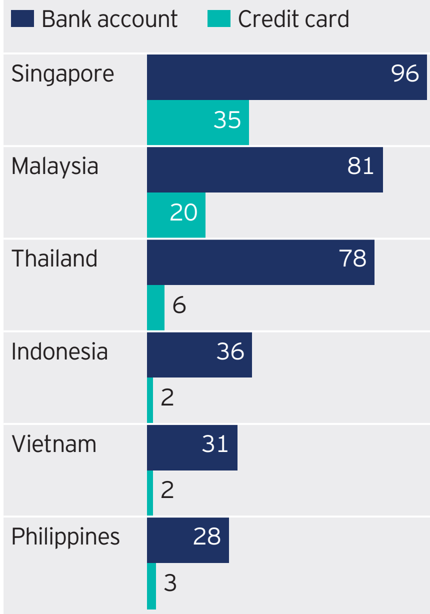
We believe that the biggest opportunity in SEA is Indonesia, a US$1 trillion economy, where the drive to acquire customers pushes from the two front-running fintech platforms, Ovo, backed by Grab (held in the **Invesco Developing Markets Equity Fund**), and Go-Jek, have expanded the fintech market significantly. As of July 2019, Grab/Ovo had covered 110 million users. (Source: www.entrepreneur.com/article/330561).

Grab/Ovo has been the payment of choice for Tokopedia, the largest ecommerce platform with 30% market share in Indonesia, and the Lippo group, the largest offline retailer in the country. As a result, Grab/Ovo has on-boarded 400,000 retailer outlets (versus 300,000 for Go-Jek) and is now available in 90% of shopping malls, department stores, coffee shops, cinemas, and food and beverage outlets.

The race to payment ubiquity is relentless. Grab/Ovo's willingness to partner – rather than doing it alone – helped put it ahead of their closest rival. That said, card penetration – including both debit and credit – in Indonesia is still less than 10%, and about 60% of local people don't have access to banks.

The multilateral relations among SEA countries allow for development of regional apps, like Grab's ride hailing. Leveraging their customer traffic, these apps have been able to nurture their own fintech platforms, first as payment solution providers and subsequently as a channel to cross-sell additional financial products.

Figure 3
SEA bank account and credit card penetration (%)



Source: ecommerceiq.asia (February 2018).

Outlook
While we believe in the potentials of fintech to bring about significant changes in the EM financial sector, we think there are a very wide variance of outcomes. Even within each emerging country, outcomes can differ significantly between companies which have the right ingredients to succeed and those which don't. The fintech battles are far from being over, and the winners are most often not decided yet. Moreover, it's important to see how traditional banks evolve in response to the rising competition in fintech.

As fundamental, bottom-up investors, we will continue focusing on understanding the business models of fintech and banks alike and we place our trust in companies which have superior economics protected by a wide moat in the long run. Ultimately, we believe the best predictor of long-term performance is earnings, which are dictated by microeconomics and not short-term trends.

We believe that navigating the long-term complexity and short-term volatility of the Indian equity market requires a nuanced, active investment approach. A propensity to look for compelling analogues without understanding the underlying economic drivers and risks, for example, likening India to China, can lead to dangerous conclusions and inappropriate portfolio exposures.

Our approach in India, and elsewhere in our universe, looks beyond seductive narratives to appreciate structural drivers and real options, both of which are often unique to individual companies.

India's economic realities have given birth to some extraordinary companies that have been able to turn the country's longstanding challenges into long-term opportunities. A good illustration of that is how Kotak Mahindra Bank and HDFC (both held in the **Invesco Developing Markets Equity Fund**) have been capitalising on India's extensive and ineffective state involvement in the banking sector to support their long-term growth trajectory.

The Indian banking sector today is saddled with more than 11% non-performing loans (Source: CEIC as at 29 March 2019) thanks to the reckless behaviours of the public sector banks during India's credit boom following the great financial crisis. These banks represent two-thirds of the system's total assets and almost 100% of the system's non-performing loans.

Setting the public sector banks on the right path would require overcoming four "R" hurdles:
- Recognition
- Resolution
- Recapitalisation
- Reform

Today these public sector banks have barely cleared the first. As a result, the Indian economic machine is currently running with two-thirds of its financial engines turned off, and only one-third - where Kotak and HDFC play - powering its credit growth. With their clean balance sheets and excess capital, we believe Kotak and HDFC will continue gaining market share as the public sector banks continue retreating in the upcoming years.

Kotak and HDFC are just two of many extraordinary Indian companies in our portfolio, which illustrate our fundamental, bottom-up investment approach. As volatility increases in the Indian equity market, and global equity at large, we remain focused on finding such companies, paying appropriate prices for them and constructing a durable portfolio that is well-positioned to outperform.

Summary of fund objective

The Fund aims to achieve long term capital growth. The Fund seeks to achieve its objective by investing a minimum of 80% of the NAV of the Fund in equity and equity-related securities of companies, whose principal activities are in or are economically tied to a developing market. For the full objectives and investment policy please consult the current prospectus.

Investment risks

The value of investments and any income will fluctuate (this may be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

As a large portion of the fund is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the fund. The fund may invest in certain securities listed in China which can involve significant regulatory constraints that may affect the liquidity and/or the investment performance of the fund. The fund invests in a limited number of holdings and is less diversified. This may result in large fluctuations in the value of the fund.

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