



RECENT DEVELOPMENTS IN EMERGING MARKETS

Panel Discussion

Columbia Business School

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Over the past five years, stocks in emerging markets have outperformed all others with average annual returns in excess of 33 percent. For the first time, Americans are investing more abroad than they are domestically. Nevertheless, concerns remain about transparency, political risk and volatility, as many investors recall the contagious financial crises that shook Asia, Latin America and Russia during the last decade. On February 12, 2007, Columbia Business School's Office of Alumni Relations—in collaboration with the Asian Alumni Club, Hispanic Alumni Club and African American Alumni Club—held a panel discussion to explore the risks and rewards presented by emerging markets. The panel featured three leading professionals in Africa, Asia and Latin America, who shared their perspectives on the political, regulatory and professional opportunities and challenges faced while doing business across emerging markets.

The panelists were

- *Li Li, Founder and CEO of International Strategic Group*
- *Thomas Mims, Founder and CEO of Emerging Africa, Ltd.*
- *Eddie Ramos '93, Executive Director of Morgan Stanley Investment Management*

Genevieve Sangudi '04, investment officer for Emerging Markets Partnership Africa, moderated the panel and delivered opening remarks.

What Are “Emerging Markets”?

The World Bank defines an emerging market as a country having a gross domestic product of less than \$10,000. (Certain countries that exceed this income threshold, such as Israel, are considered emerging markets due to such factors as engagement in economic reforms and political instability.) Emerging markets account for 80 percent of the world's population and 50 percent of its gross domestic product. They are defined by a number of characteristics, such as changing programs of economic and political development, a high degree of volatility, reliance on foreign sources of capital, comparative advantage through natural resources and relatively inexpensive labor. Another important characteristic is their

dependence on developed export markets as customers for their product, which makes them susceptible to those economies. The fortunes of the Chinese economy, for example, are largely dependent on the American consumer and business cycle. Finally, legal and physical infrastructure and the role of government in business are also important factors in emerging markets.

Perspectives on Doing Business in China

As panelist Li Li explained, the dramatic growth witnessed recently in China is being driven largely by changes taking place at the level of its private firms. China has two types of companies and corporate cultures: state-owned enterprises (SOEs) and private companies. SOEs are more mature and highly regulated, with senior officials typically appointed by the government. Private companies, on the other hand, tend to be family-owned and highly independent. While private companies are growing rapidly, their growth is constrained by the availability of professional managers, as well as the reluctance of family owners to relinquish control over their businesses and trust outsiders. Private companies in the Chinese economy were characterized by “5-6-7-8-9” in 2006, insofar as they accounted for 50 percent of gross domestic product, 60 percent of national employment, 70 percent of exports, 80 percent of technological inventions and 90 percent of registered companies. Despite these impressive numbers, private companies remain small in terms of assets relative to SOEs.

While business is becoming increasingly Westernized in China, distinctly local customs continue to define the experience of doing business there. Ownership structures of private companies are becoming more diverse with the recent emergence of holding companies and partnerships with outsiders. At the same time, these companies are improving corporate governance and beginning to adopt Western management techniques. Nevertheless, business continues to depend upon personal relationships, transactions are conducted primarily through personal meetings and the decision-making process regarding investment is based on criteria different from those typically used in the West. Chinese business people tend to make investment decisions quickly, first considering the nature of the business in question and the relationships involved, before taking into account the financial projections and proposed equity share.

Certain aspects of doing business in China may baffle those who are new to the market. Understood relationships or implicit regulations may be critical to the success of a deal or an entire business. In addition to being hidden from view, these understood aspects of doing business tend to vary both geographically and ethnically. Similarly, China features a single body of law that is formulated by the central government, but those laws are

interpreted and enforced differently across regions, provinces and cities of the country. Furthermore, exceptions to these laws tend to be widespread. Like the law governing business, ethics and the mentality of business people tend to vary by region, especially between the industrial cities of southern Guangdong province, and the commercial and political capitals of the northeast. Finally, there are many hidden costs of doing business in China. Business tends to be conducted in cash, while companies typically maintain two or even three sets of books (i.e., a conservative case for the banker, an aggressive case for the investor and an accurate case for the owner).

“Democratization of Capital” in Africa

Unlike China, Africa is overachieving but undervalued. Over the past five to six years, the African capital markets have outperformed those in most of the rest of the world. Returns on most of these markets have risen meteorically, with countries such as Mauritius and Zambia posting dizzying average returns over the past three years of 527 and 406 percent, respectively. The average gain across the region has been 140 percent, while the S&P 500 recorded a relatively modest gain of 26 percent. Nevertheless, Africa has on average received less than five percent of foreign direct investment bound for developing regions of the world over the past 10 years. Market capitalization is a multiple of gross domestic product in the United States. In Africa, it is a fraction.

Access to capital markets in Africa is limited. As of year-end 2005, the 16 stock exchanges of Africa comprised 1,853 companies with a market capitalization of approximately \$616 billion, less than that of Intel or Microsoft alone. South Africa accounts for the majority of market capitalization at \$421 billion, while Egypt accounts for the largest share of issuers at 793. These 16 markets cover approximately 25 countries, leaving 29 countries without access to any capital market.

According to panelist Thomas Mims, certain components need to be put into place or improved upon to improve capital market accessibility and “democratize capital” in the region.

First, the cost of transacting must be lowered. The cost of buying and selling stocks in highly developed markets is negligible. Transacting stocks in Africa, on the other hand, currently averages 2 to 3 percent of the value of the trade. In addition, the time to execute a trade can vary anywhere from 20 minutes to buy a stock up to approximately one week in some markets to sell.

Second, the liquidity and depth of the markets must be increased, especially as liquidity plays such a large role in the aforementioned cost of transacting.

Third, the fragmentation of markets must be reduced. Africa would benefit from the consolidation of its stock markets, as it would create more liquidity and help countries that do not have a stock market. Africa should take advantage of the current trend of consolidation across global stock exchanges to consolidate its own exchanges. Given recent technological advances, such consolidation is easier than ever before.

Finally, financial intermediaries should take greater initiative to facilitate access to capital markets, especially by taking advantage of American Depository Receipts (ADR). Currently, 75 ADRs currently have been issued in Africa, the majority of which come from South Africa. A certain type of ADR, known as the 144A, allows the issuance of depository receipts in countries that do not have their own stock market. This could be helpful for creating market access for African companies.

While attention tends to focus on the potential contribution of American and European investors to Africa, China is playing an increasingly important role in the development of the African capital markets. Over the period 2002–04, foreign direct investment in Africa has averaged \$17 billion. In 2005, that number jumped to \$29 billion due entirely to investment from China.

Bull Markets and High Valuations Across the Board

Emerging markets are currently at the height of their most recent bull market but may be exhibiting the signs of weakness that have typically heralded their periodic crises. The current bull market for emerging markets began at the end of 2002, with the Morgan Stanley Capital International (MSCI) Emerging Market Index rising 33 percent per year on average since that time. While emerging markets have generally done well, there are significant disparities in performance across regions and particular countries. Latin America has been the best-performing region in that index, with average gains of 47 percent per year, despite the fact that India and China receive the lion's share of coverage from the financial press. The best-performing emerging market has been Egypt, which is up 85 percent, while the worst performing has been Taiwan, which is up 15 percent.

Attracted by such outsized returns, American investors are increasingly investing abroad. American investors placed more money in international funds than domestic funds for the first time in 2005. By 2006, that trend accelerated dramatically, with Americans investing 10 times more in international funds than in domestic funds. For example, the Fidelity China Fund has grown from \$500 million to more than \$6 billion over the past 18 months. This being the case, it is not surprising that 10 of the top 20 international stocks held by American investors are

emerging market stocks, including such companies as Russia's Lukoil, Mexico's America Móviles and Brazil's Petrobras.

If we observe year-to-date performance, however, we see some weaknesses in these markets. While countries such as Pakistan are already up 22 percent, others such as Thailand and Venezuela have suffered significant losses. Similarly, average valuations tend to be low, but the valuations of particular countries and firms appear to be speculatively high. According to the MSCI U.S. Index, the U.S. market is trading at a price-to-earnings ratio of 16.5x. Meanwhile, emerging markets are trading at 15.5 times price-to-earnings. Such an undervaluation of emerging markets, which are typically characterized by their superior growth prospects and high valuations, is historically unprecedented.

On the level of individual countries, however, there is some significant overvaluation. India is trading at 5 times price-to-book value, 18 times cash flow and 23 times price-to-earnings, which is a 40 percent premium to the United States and a 60 percent premium to emerging markets. Similarly, Chile and other countries rich in natural resources are currently trading at price-to-earnings ratios of 22x to 25x. Such rich valuations are also seen at the level of individual transactions. For example, Vodafone has recently agreed to buy Hutchinson Essar, India's fourth-largest mobile operator, for 10 times revenue, 30 times earnings before interest, tax and depreciation (EBITDA) and 39 times operating earnings.

Under such circumstances, panelist Eddie Ramos suggested that we ask, "When is this party going to end?" because "emerging markets parties always end."

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