The Case for Selective Investments in Southeast Asia[1]

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Thesis

For investors with a long-term horizon seeking to generate growth from equity securities, Southeast Asia offers a large and diverse universe in which to find attractive investment opportunities.

Our thesis is built around three pillars:

(i) economic and business growth are strong and their fundamental drivers should remain in place for several decades;

(ii) Southeast Asian equity markets are inefficient, volatile and not well researched, making it possible for active investors to find quality growth companies trading below their intrinsic value; and

(iii) investments by China in Southeast Asia and the relocation of businesses from China to the region provide strong tailwinds.

The macroeconomic dynamics in Southeast Asia are relatively attractive, but the region presents macro risks typically associated with emerging markets. We believe that these should not derail the opportunity.

Summary

Growth is plentiful. After the emergence of Japan in the 1950's and 1960's, followed by the so-called "Asian Tigers"[2] in the 1970's and 1980's, and then China since the 1990's, Southeast Asia is now experiencing a wave of social and economic transformations on a massive scale. The populations of Vietnam, the Philippines, Thailand, Indonesia and their neighboring countries are transitioning from traditional agriculture to "modern" industry and from rural areas to urban centers. In turn, the region is modernizing rapidly, following a similar development path to that taken earlier by the more economically advanced northern Asian countries. Economic productivity is increasing, people are earning more and spending more, fueling the growth of companies that provide them with increasingly sophisticated goods and services. At the same time, the development of physical and digital infrastructure across the region is enabling and strengthening the overall growth trends, while providing opportunities for many businesses.

These social and economic transformations should continue for at least a couple of decades. Southeast Asia's urbanization level is only 44%, mid-way between 34% in India and 58% in China, still at a very low level compared with 82% in the United States. About 30% of the population is still involved in agriculture, compared with only 2% in the United States. At current urbanization rates, the region should provide growth opportunities over a long investment horizon.[3]

Markets are inefficient. Growth is plentiful but equity markets in the region are not well researched, generally inefficient and relatively volatile. There are more than 4,400 companies trading on stock exchanges in the region, as many as in the United States, and the number is growing every year. At the same time, the percentage of stocks covered by equity analysts ranges from only 8% in Bangladesh to no more than 42% in Thailand, compared with more than 80% in the United States.[4] In every market in Southeast Asia, the median number of equity analysts per company is effectively zero!

This creates pricing inefficiencies and in turn, plenty of opportunities for active investors to buy shares of quality companies at times when they trade meaningfully below their intrinsic value. In turn, Southeast Asia offers an attractive environment to generate long-term returns on equity securities from a combination of earnings growth and a re-rating of valuation multiples.

Industries are relocating to the region. Many companies are relocating their manufacturing operations from China to Southeast Asia, as China's cost advantage has declined and the country is now focused on manufacturing higher value-added goods. The impact of this ongoing shift is already visible as China's share in global exports is falling while Vietnam's and Thailand's shares have increased.[5] This process is now accelerating in the context of tensions between China and the United States, and will provide significant economic tailwinds to the whole region for years to come.

Southeast Asia is also a significant beneficiary of China's Belt and Road Initiative. Countries in the region, Indonesia and Vietnam in particular, have received large infrastructure investments from China and are now much better integrated to the regional economy and global supply chains.

The macroeconomic dynamics are relatively attractive. With 845 million people, Southeast Asia's population is larger than the United States' and the European Union's combined![6] For the most part, the population is young and growing, and demographics are generally favorable, specifically in the Philippines, Malaysia, Indonesia, and Vietnam.

In 2018, Southeast Asia's aggregate GDP reached $3.1 trillion.[7] If it were a single country, its economy would be the 5th largest in the world, only surpassed by the United States, China, Japan and Germany.

From a macroeconomic perspective, Southeast Asia is in a much better position today than it was during the 1997 Asian Financial Crisis or during the 2013 Taper Tantrum. Reliance on external debt has been reduced, the countries have built larger foreign exchange reserves, exchange rates are broadly floating, and current accounts are either in modest deficit or in surplus, and are in part funded by long-term FDI investments. There are some notable exceptions to these otherwise positive macro observations. For instance, Malaysia still has a relatively high level of external debt; the Philippines and Indonesia have negative current accounts; all countries in Southeast Asia except for Malaysia would suffer from higher oil prices.

Conclusion

We are mindful of other risk factors associated with investing in the region. These include market volatility and illiquidity, which in many cases also represent the source of investment opportunities; political turbulence, which has been a negative in Thailand, Malaysia and Indonesia in recent years; as well as corruption and poor corporate governance. These issues, typically associated with emerging markets, will be partially addressed by investing through active managers with a local presence and a long experience in the region. Overall, based on several decades working and investing in Asia, we believe that the risks do not alter our long-term investment thesis.

Endnotes

[1] Southeast Asia defined as the combination of (from west to east): Bangladesh, Sri Lanka, Myanmar, Thailand, Cambodia, Laos, Vietnam, Malaysia, Singapore, the Philippines and Indonesia. All of these countries have economies and populations relevant to the investment thesis, although not all of them offer direct investment opportunities.

[2] "Asian Tigers" defined as Korea, Taiwan, Singapore and Hong Kong.

[3] The World Bank, World Development Indicators (2019). Density & Urbanization, Urban Population (%), Agricultural Employment (%), 2017. Available from https:\\data.worldbank.org.

[4] Panah Fund, AIMS Asset Management Sdn Bhd (October 2017). Southeast Asia defined here as the Philippines, Vietnam, Thailand, Malaysia, Singapore, Indonesia, Bangladesh, and Sri Lanka.

[5] Goldman Sachs: "Potential implications of U.S.- China trade tensions for Southeast Asia and India" (February 2019).

[6] The World Bank, World Development Indicators (2019). Population, Total, 2018. Available from https:\\data.worldbank.org.

[7] The World Bank, World Development Indicators (2019). GDP (current U.S.$), 2017. Available from https:\\data.worldbank.org.