Global Themes for 2019 *and beyond*

China and the Belt and Road Initiative: Indivisible from geopolitics and the global trade war – threats and opportunities • When the tide goes out... Macro headwinds expose vulnerability across FM & EM equities
• Financials: Positioning for diverging interest rates in 2019 • Industrials: Egypt, Nigeria likely to outperform in 2019 • Consumers: The debt bomb is ticking

EXOTIX

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Global themes for 2019 and beyond

As 2019 gears up, we present our key themes for the year (and beyond). This edition focuses on what our analysts regard as the two biggest issues facing emerging and frontier markets today: 1) the threats and opportunities around China's Belt and Road Initiative and 2) the rising level of vulnerability across developing market equities, with higher (albeit more slowly rising) US rates and monetary policy tightening elsewhere in the developed world meaning that excess indebtedness will remain a big risk.

Belt and Road Initiative is too complex to characterise as 'good' or 'bad'

In our first theme – '*China and the Belt and Road Initiative – indivisible from geopolitics and the global trade war; threats and opportunities*' – Hasnain Malik, Head of Strategy and Equity Research, and Christopher Dielmann, Senior Economist, unpick some of the conventional understanding of the costs and benefits of China's huge infrastructure development plan, identifying complexities that, they argue, many mainstream commentators miss. Rather than characterising the scheme as inherently 'good' or 'bad', their view is that Chinese capital tends to accelerate a recipient country along its existing development path, whether that path is positive or negative, and that some forms of Chinese investment, like infrastructure, have a greater ability to do this than others, like natural resources.

Winners and losers in FM & EM equities

Our second theme – '*When the tide goes out… Macro headwinds expose vulnerability across FM & EM equities*' – explores the difficult environment for FM & EM equities, driven in part by interest rate dynamics both in the developed world and in developing markets themselves. We explore this by looking at three main sectors: financials, industrials and consumers. Our equity research sector heads have been able to draw out the key trends and investment implications across the many markets covered by Exotix Capital's growing partnership network and translate them into actionable ideas.

In financials, Rahul Shah assesses the potential winners and losers in 2019 from diverging interest rates in developing markets. In industrials, Vahaj Ahmed has sliced and diced 108 companies across our coverage universe to create an Exotix Industrials Ranking, which lists companies based on their resilience over the next 12 months. In consumers, Nirgunan Tiruchelvam's Teflon Test identifies those names most at risk if the 'debt bomb' explodes.

We hope you enjoy reading the report. We would be grateful for your feedback about how relevant and useful these themes are to you, or indeed if there are key issues that you feel we are missing and would like to see reflected in our research in 2019 and beyond. These themes will help drive our research agenda throughout the year and we will take deeper dives into both of them, with more investment recommendations.

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China and the Belt and Road Initiative: Indivisible from geopolitics and the global trade war – threats and opportunities

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Theme 1: BRI – indivisible from geopolitics and the global trade war; threats and opportunities

For the frontier and small emerging markets (FM-EM), China was, historically, mainly a competitor supplier of cheap manufacturing exports or a customer of natural resources. More recently, China has become a major provider of capital, a supplier of construction services, an investor in real estate, a customer for tourism and an acquirer of corporate assets.

Five years have passed since the formulation of, what is now referred to as, the Belt and Road Initiative (BRI); a catch-all term for what is best understood as Chinese capital investment and project construction capability in return for geopolitical alignment.[1]

Here, we put forward five initial conclusions and two risk factors on the general impact of China on FM-EM. We will look to refine these as 2019 unfolds.

Complexity missed by most

Most existing mainstream coverage of China in emerging-frontier markets (FM-EM):

- Fails to provide the wider context of geopolitical competition between China and the US (unhelpfully compartmentalising analysis of BRI from the US-China trade war or the holdings of US treasuries by China);
- Tends to characterise China's strategy as a modern iteration of East India Company-style imperial mercantilism;
- Unfairly pits Chinese capital as inherently in conflict with foreign, independent providers of capital (implicitly contrasting 'bad' Chinese capital with 'good' capital provided by traditional multilateral 'Western' institutions or bilateral 'Western' sovereigns);
- Tends to ignore the impact of rising wages in China. This is driving growth in tourists and overseas real estate purchases in the likes of Dubai and Mauritius, and is also driving a shift of market share in labour-intensive industries to rival locations, such as Vietnam and Bangladesh (with Egypt and Pakistan maybe next). Indeed, the US-China trade war could accelerate this shift; and
- Does not differentiate between the most and least important geographies, from a China perspective, of BRI: the economic catch-up of China's western provinces with the growth enjoyed by its eastern provinces, which is necessary for their sustainable inclusion in China's centralist political model, requires the establishment of import and export logistics infrastructure, particularly through the Indian subcontinent (ie BRI investments in this geography are likely strategically a higher priority than others in the event of a cutback on overseas Chinese investment due to any domestic economic slowdown).

The examples of Venezuela and Ecuador in Latin America, Egypt, Kenya, Mauritius, Nigeria, Zambia and Zimbabwe in Africa, Bangladesh, Malaysia, the Philippines, Pakistan and Sri Lanka in Asia and Dubai and Oman in the GCC all offer different, nuanced, lessons on the impact of China for private institutional investors.

In this brief report, we put forward five initial conclusions and two key risk factors on the general impact of China on FM-EM.

Our five initial conclusions are as follows:

1. Chinese capital accelerates a recipient country down its existing development path – it does not, on its own, transform that country;
2. Chinese capital is not always 'bad', 'Western' capital is not always 'good' and the two are not always mutually exclusive;
3. Chinese logistics investments are likely more useful for the recipient country's broader economy than its natural resource investments;

[1] *See page 15 for a definition of what BRI is or seems to be…*

4. Chinese middle-class growth drives the shift of low-cost jobs to cheaper locations and grows discretionary consumption in FM-EM;
5. Chinese M&A is positive in the short term, but its entry (particularly in technology-based markets) will disrupt sleepy FM-EM incumbents.

The two main risks we identify are as follows:

1. As with all capital-intensive projects, BRI, increases the financing burden of recipient countries and, in a debt default scenario, it is unclear how China would behave (and, particularly, how it would be treated relative to other creditors);
2. The response of the US (and its geopolitical allies) to increased Chinese engagement may be destabilising for the recipient country.

An investor, but bigger and more geopolitically motivated than most others

BRI is not a Marshall Plan or an East India Company. It is best understood as capital investment and project construction capability in return for geopolitical alignment.

China's BRI, the US Marshal Plan following WW2 and Great Britain's East India Company are all examples of geopolitically motivated deployment of capital: the security benefits are as important to the provider of capital as the future financial returns on that capital.

However, BRI is not based on the Marshall Plan model of financial grants ('free capital' in return for geopolitical alignment) or the East India Company's model of imperial conquest (ownership and extraction of economic dividends).

BRI is best understood as capital investment (with an economic return for that capital) and project construction capability (with, at least thus far, selection of mainly Chinese contractors) in return for geopolitical alignment (ie the recipient country chooses whether or not to engage China).

Table 1: Countries involved in BRI

Region	Countries		
East Asia	China	Mongolia	
Southeast Asia	Brunei	Malaysia	Thailand
	Cambodia	Myanmar	Timor-Leste
	Indonesia	Philippines	Vietnam
	Laos	Singapore	
Central Asia	Kazakhstan	Tajikistan	Uzbekistan
	Kyrgyzstan	Turkmenistan	
South Asia	Afghanistan	India	Pakistan
	Bangladesh	Maldives	Sri Lanka
	Bhutan	Nepal	
MENA	Bahrain	Jordan	Qatar
	Egypt	Kuwait	Saudi Arabia
	Iran	Lebanon	Syria
	Iraq	Oman	UAE
	Israel	Palestine	Yemen
Europe	Albania	Estonia	Poland
	Armenia	Georgia	Romania
	Azerbaijan	Hungary	Russia
	Belarus	Latvia	Serbia
	Bosnia & H'govina	Lithuania	Slovakia
	Bulgaria	Macedonia	Slovenia
	Croatia	Moldova	Turkey
	Czech Republic	Montenegro	Ukraine

Source: Exotix Research

Global geopolitical contexts: The 'Scramble for Frontier'

A 'Scramble for the Frontier' is underway and China's BRI should be understood in the context of this competition, mainly with the US but also with India, Japan and Russia for alliances with and access to FM-EM.

Geopolitical projection of power in this manner is a natural ambition of any country and this is the core of foreign policy. Military and trade policies are subsets of foreign policy. And foreign policy is driven by interests, not ethics.

Some countries have been blessed with the natural geographic advantages to develop and sustain a superpower base. These include:

- Sufficient scale in navigable territory to foster population growth, a common set of laws and internal trade;
- Either easily defendable borders or a large enough territory to defend a strategic core; and
- Sufficient natural resources to fuel the economic engine. Geography is the key ingredient here, not religion, ideology or genetics (these are, rather, the ingredients of propaganda).

The nature of China's foreign economic engagement is not constant; it has already evolved from trade access focused on commodity imports and manufactured goods exports to the construction of faster supply chain access to trading destinations.

The US has this geographic 'secret sauce' and Great Britain once did in the heyday of its empire; Russia and China (as well as India, Iran and Turkey) less so (and perhaps that drives their more urgent scramble).

It may be too late for other countries to catch up, build their own superpower base and join the scramble on a global scale. Perhaps in a coming decade India, Iran or Turkey are the emerging world's likeliest candidates, but the global village may be too small now to allow them the space.

It could be that only those able to insulate themselves from outside influence for a prolonged period of time, to allow their domestic political economy institutions to develop, are able to create this space. But the paradox in this approach is the very isolation that enables this also comes at a great cost to economic development. Iran is the test case here.

Table 2: Global and regional power strategies

Global/regional power	Investment, trade and diplomatic strategy	Military/territorial strategy
China	"Belt and Road Initiative", RCEP, "South-South Solidarity" with LatAm	Nine-Dash Line, String of Pearls
US	"International Liberal Order" via "America First" rather than "Pivot East" and TPP	Global military bases and advisors, naval fleet
Japan	"Free and Open Indo-Pacific"	Naval fleet, port infrastructure
Russia	"Eastern Dream", OPEC-cooperation	Ukraine, Syria military intervention
India	"Act East", Chabahar port in Iran	Afghanistan, Iran, Maldives engagement
South Korea	"Eurasia Initiative"	n/a

Source: Exotix Research

China's global power strategy – BRI is merely one element

BRI (investment, finance and construction) represents merely one subset of policy tools available to China in its foreign engagement. Trade, diplomacy, military and, perhaps ultimately, currency are other policy tools. BRI in no way represents the peak of that engagement. The nature of China's foreign economic engagement is not constant; it has already evolved from trade access focused on commodity imports and manufactured goods exports to the construction of faster supply chain access to trading destinations, and will next evolve to the growth of Chinese multinationals (often state-owned) in all sectors, the greater use of Chinese military assets to protect the Chinese supply chain and multinational assets and the push for greater global adoption of the Chinese currency as a form of exchange.

BRI (which largely covers projects in Eurasia) certainly does not represent the geographic limit of China's past or future foreign engagement. Latin America and large parts of Sub-Saharan Africa do not yet fall under BRI, but we expect no change in China's long-standing deep engagement in these geographies with all the same policy tools and ambitions described above.

We acknowledge risks, but think consensus has swung to an overly negative view on the impact of BRI on FM-EM

Below, we lay out our views on the impact of China, some of which are substantially more positive than those we increasingly hear from international institutional investors (or read in mainstream media).

1) Chinese capital is an accelerator, not a transformer

Injecting more capital, whether Chinese or 'Western', into a badly run economy, in terms of its institutional governance, does not improve that economy, it merely creates a bigger liability for that economy to repay or reward in future. In reverse, injecting capital into a well-run, or increasingly better-run, economy, but one with deficient infrastructure, can be very positive. China's capital does not make or break an investment case in an emerging or frontier economy, it merely accelerates its existing trajectory.

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- Malaysia (under Razak) and Sri Lanka (under Rajapaksa) were examples of the former. Chinese capital reinforced crony capitalism and corruption in each regime, as did 'Western'-style capital (eg Malaysia's 1MDB scandal).
- Pakistan is more likely to be an example of the latter because of the alignment, after many decades of division, of army, judiciary and civilian political leadership and the reform of security and governance, which is underway. Pakistan, of course, has its own long history of institutional weakness and the overly generous (onerous) government-guaranteed returns on equity for power generation projects, for example, are a reflection of this (recall that the China Pakistan Economic Corridor, CPEC, started in 2014, before the unprecedented clean-up of some of the most corrupt elements in the military and civilian politics). Nevertheless, we do not see in CPEC the sort of egregious "white elephant" projects seen in Hambantota in Sri Lanka (a port and airport that remain substantially under-utilised years after construction was completed).

Where China's presence can matter is when an emerging or frontier market country has a debt problem and China is a significant creditor. And, as China's role in frontiers increases, it will only become more of an issue. It is not clear (because it is untested) if and how China would participate in a debt workout (involving multiple creditors) and what this would mean for traditional debt relief mechanisms and best practice, and in turn what it would mean for private creditors. But we think, possibly because of issues arising in the context of some specific country cases (such as Venezuela, Mozambique and the Republic of Congo), that the issue may have assumed added importance for the traditional international financial institutions and bond investors.

We analyse the risks around a default scenario in more detail below (on page 10).

2) Chinese capital is not always 'bad', 'Western' capital is not always 'good'

Recipient countries take on unsustainable debt, regardless of whether the creditor is China or more traditional 'Western' sources (eurobonds, project finance, multinational FDI attracted by tax incentives and long-term offtake purchasing contracts, IMF and other multilateral funding). To argue otherwise is tantamount to ignoring all the precedents for FM-EM sovereign distressed and defaulted debt (one needs to look no further than the precedent of Brady Bonds and HIPC debt treatments to see this), and contract re-negotiations with multinational corporate direct investors.

China's engagement with a particular country market often provokes the instinctive reaction that China's interests will not closely align with those of foreign private capital investors because the availability of China strategic support and capital will reinforce unfriendly behaviour and policies by host sovereigns towards foreign private capital investors. We disagree with this reaction for three reasons:

1. China has engaged deeply with governments of all hues: politically liberal and economically orthodox governments (Chile, Peru), authoritarian and populist governments (Argentina under Fernandez, Ecuador, Venezuela, Zimbabwe), military-dominated democracies (Egypt, Pakistan, Myanmar, Thailand) and crony-capitalist, one-party democracies (Bangladesh under the Awami League, Kenya under Jubilee and Sri Lanka under Rajapaksa);

2. Those investors with this fearful reaction often cling to a romanticised memory of investing in the era of Asian Tigers, when the US was the dominant global power engaged. US engagement was not a guarantor of the alignment of sovereign and private foreign capital interests; low tariff access for exports to the US and US security guarantees certainly drove the macroeconomic story, but that is not the same as claiming that US engagement systematically creates the best conditions for foreign private capital investors. Some of the most notorious instances of crony capitalism came to light in the Asian Tigers following the East Asian Crisis of 1998. Also, consider the example of Saudi Arabia and the GCC, where the US has been deeply engaged but foreign private capital investors have not always seen their interests prioritised by sovereigns;
3. The example of Sri Lanka's deal with the IMF in 2009, by which time China was the key interested international superpower, suggests China is not opposed to the involvement of one of its client states with the IMF. Another example is Pakistan's IMF deal in 2013, just over a year after China first formalised its CPEC commitment.

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However, China's geopolitical and economic interest in a market or region may lead to a retaliatory response from the US (particularly when the US is, at least for the duration of the Trump administration, so forthright in its use of the economic tools in its foreign policy kit). The US response can have negative (potential financial and trade sanctions and a diplomatic squeeze on Pakistan, which looked likely particularly before the start of US-Afghan Taliban negotiations at end-18) or positive (more open trade access and security cooperation for Vietnam) repercussions.

Risks are lowest in countries with authoritarian political structures, where both China and the US are forced to engage with the same entity (eg Bangladesh, Myanmar, the Philippines, Vietnam), as opposed to playing off domestic political competitors (eg Sri Lanka with the more China-leaning UPFA/SLPP under Rajapaksa pitted against the more India-leaning UNP under Wickremasinghe, or Thailand with the more US-, military-, southern-aligned 'yellow shirts' pitted against the more China-, Shinawatra-, northern-aligned 'red shirts').

We analyse this risk in more detail below (on page 11).

Separately, there is also a behavioural bias in the system of foreign private capital investors, with which we have less sympathy. A generation of private portfolio managers whose first professional exposure to emerging markets was, almost by definition, in those markets that transitioned to more capitalist, rather than command, economic models, have become far more confident that their prospects are brightest when the US is the dominant scrambler, and agencies – where the US exerts the strongest voice – such as the IMF are providing an umbrella structure for macroeconomic policy. A new generation of private portfolio managers in FM-EM will have to get used to less clear-cut shifts from command to capitalist economies, because China does not make this a part of its approach.

Figure 1: Multilateral agency voting rights

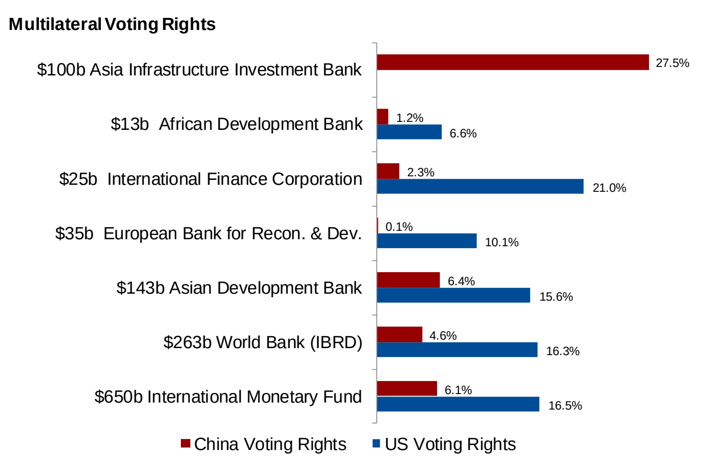
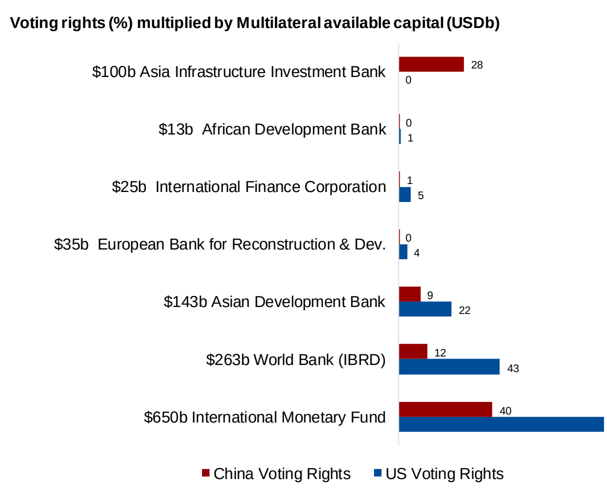


Figure 2: Multilateral agency capital



Source: AIIB, AfDB, IFC, EBRD, AsDB, WB, IMF, Exotix Research

3) Chinese logistics investments are likely more broadly useful for the recipient country than natural resource investments

In tandem with China's greater focus on its relatively undeveloped western provinces is its attempt to shift from an economic growth model led by domestic infrastructure investment and low value-added exports to developed markets to one led by domestic consumption, higher value-added exports and a broader geographic spread of export destinations. This means facilitating the growth of its largest enterprises domestically and internationally.

And all of this is taking place in a context where the preservation of China's political system requires both strong central government and the realisation of economic growth across its very heterogeneous provinces.

Changes to China's economic model are driving a shift in its engagement with FM-EM from one centred on natural resource procurement to one focused on constructing international logistics, supply chain and security infrastructure.

These changes to the Chinese economic model are driving a shift in its engagement with FM-EM from one centred on natural resource procurement to one increasingly focused on constructing international logistics, supply chain and security infrastructure.

The growth of China's western provinces requires logistics infrastructure through the Indian sub-continent (to short-cut by c20 days the navigation through mainly US-controlled waters around the Straits of Malacca and across land from China's eastern seaboard). To a lesser degree, better access to East Africa (eg Djibouti-Ethiopia, Kenya-Tanzania, Mozambique) and the Arabian/Persian Gulf (eg Oman), too, are extensions of this same supply chain.

In the event of a slowdown in Chinese domestic growth that, in turn, reduces capacity for overseas investment, we regard the infrastructure investments in the Indian sub-continent as materially more economically valuable and important strategically from a China perspective (and, therefore, more likely insulated in the event of any overall international investment pull-back).

Engagement focused on international logistics is more likely (but not guaranteed) to benefit the broader indigenous economy; infrastructure assets, which are quasi-public utilities, should benefit most corporate enterprises in recipient countries. As such, this contrasts with the investment in resource extraction (which dominated Chinese international project investment prior to 2015), where the recipient country's benefits are more easily and commonly captured by more narrow vested interests (which is a description of the experiences of a number of Sub-Saharan Africa countries – eg DR Congo, Guinea, Niger, Sierra Leone, Uganda, Zambia and Zimbabwe – and Latin America countries – eg Ecuador and Venezuela.

To the degree that the recipient country (for the infrastructure type of investment) has its own building materials sector and transportation of building materials from China is costly (eg Pakistan), there should be a benefit that was absent in those countries that lacked an indigenous building materials sector (eg Ethiopia in Sub-Saharan Africa) or where transportation costs from China are low (eg Indonesia).

4) Chinese middle-class growth is positive for all

The growth of China's own middle class has unequivocally positive benefits for those economies that should capture the relocation of the jobs that their middle class previously fulfilled (eg Bangladesh, Cambodia, Laos, Myanmar, Pakistan and Vietnam in Asia and, perhaps, Egypt in Africa). Indeed, the US-China trade war likely, ultimately, accelerates this (although the transition involving slower global growth and Chinese FX devaluation may be painful, as discussed below).

The increase in overseas discretionary consumption (tourism and real estate purchases) by this middle class also straightforwardly benefits recipient markets (eg Malaysia, Sri Lanka, Thailand in Asia, Dubai in the GCC and Egypt, Kenya and Tanzania in Africa).

5) Chinese M&A is positive short term, but likely disrupts incumbents

Although the Chinese entry via corporate M&A can crystallise substantial unrealised valued in indigenous companies (eg Ant Financial's purchase of BRAC's bKash in Bangladesh or Shanghai Electric's bid for K-Electric in Pakistan), it can also lead to disruption of capacity and pricing (eg Anhui Conch's entry into Indonesia cement) or it can threaten to capture market segments through technology-led disruption (eg Ant Financial's potential ultimate capture of the consumer mobile payments and banking addressable market, instead of the local banks, following its acquisitions of Telenor Microfinance and Daraz in Pakistan).

Risk 1: China's behaviour in a default scenario

All large infrastructure requires large amounts of finance

BRI is based on Chinese investment, not Chinese grants. Therefore, the recipient country takes on financing risk when participating in BRI. This risk is not always well managed (in terms of total debt burden, repayment timeline or interest cost for a particular project, or in terms of total debt profile at the sovereign level) by the recipient country, as demonstrated by a number of examples and data points, and frequently not well disclosed, prompting critics to cite a lack of transparency as a grave concern regarding BRI lending.

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- **Montenegro** had its credit rating downgraded by Moody's in 2016, after borrowing nearly one-quarter of its GDP to finance the first stage of a BRI highway project.
- **Djibouti** saw its debt/GDP ratio nearly double in 2016 alone (it currently approaches 100%) on the back of significant borrowing from the Export-Import Bank of China.
- **Ecuador** is restructuring bilateral loans with China.
- **Malaysia** is reviewing three BRI-related projects valued at US$23bn (the East-Coast Rail Link and two gas pipelines), following the 2018 electoral victory of the Mahatir-led coalition, explicitly to avoid incurring additional (unsustainable) debt.
- **Pakistan's** government guarantees for returns on equity in power projects under CPEC has provoked concern by the IMF on likely future fiscal liabilities.
- **Sierra Leone,** after extensively reviewing the terms of Chinese loans, has decided to forgo US$300mn that had been earmarked for the construction of a new airport near the capital of Freetown (according to press reports).
- **Sri Lanka's** debt to China associated with the construction of the Hambantota port was restructured, effectively, into Chinese equity.
- **Venezuela** has restructured bilateral loans with China.
- **Zambia's** power utility, ZESCO, has been effectively subsumed into Chinese ownership following a dispute over payment terms.
- 38 BRI-related projects were cancelled or suspended in 2018 compared with 12 in 2016, according to Fitch (and quoted in the FT); we note that the number of gross cancellations is not that useful a metric (the US$ value of cancelled BRI projects would be more useful, particularly as a percentage of the total value of new planned projects in these years).
- RWR Advisory Group, a Washington-based consultancy, has found that 32% of BRI projects, by value, since 2013, have run into "trouble" – facing cost overruns, delays, and questions about debt and fiscal sustainability.

Do growth benefits outweigh financing risks?

Ultimately, the growth benefits of BRI projects need to outweigh the increased financing burden (as is the case with any capital-intensive project, whether funded by Chinese capital or not).

For example, with regards to Pakistan's current concerns regarding its deteriorating trade balance and subsequent request for an IMF program, Wang Yi, China's foreign minister, said that "CPEC has not inflicted a debt burden on Pakistan" and that "when these projects get completed and enter into operation, they will unleash huge economic benefits".

Although this may be true in a general sense, the questions that many economists are trying to answer are: when is Pakistan and, in a more general sense, all countries participating in BRI, likely to see these benefits begin to accrue, and will they be sufficient to repay their incurred liabilities?

The worrisome risks that differentiate Chinese from traditional finance

There are four aspects of BRI-related financing that we find worrisome.

1. **The lack of transparency in many of the signed agreements** – Often we simply do not know the size, cost or timeline of many loans.

   Although there has been a great deal of criticism of the lack of transparency of Chinese lending, we believe that it would be unrealistic and unreasonable to expect perfect transparency, especially in the cases of private lending.

   We point to the case of Pakistan, where there is data made available on breakdown of CPEC projects by type, location, state of progress and financial structure. Given the IMF provides a lens for the entire macroeconomic picture whereas, in the case of CPEC, the data available is merely for Chinese projects, the comparison on visibility is unfair.

   When it comes to Chinese capital flows not related to CPEC but to sovereign credit (eg ad hoc assistance for the Pakistan government, similar to, for example, that provided by members of the GCC to Egypt between 2011 and 2016, ie fiscal transfers, bank deposits, subsidised products and low-cost debt finance to the central bank or the government), this usually becomes apparent publicly only after the event, in the latest published central bank bulletin or government budget.

2. **Default scenarios involving other international creditors** – In the Sri Lanka and Zambia examples mentioned above, China was the sole creditor.

   Although not directly BRI-related, the Republic of Congo could provide a test case of China's behaviour as creditor in cases where there are a range of international creditors. The Republic of Congo government is restructuring most of its external liabilities, including debt owed to China, while it seeks an IMF programme.

   An official sector debt restructuring historically would have taken place in the forum of the Paris Club, a formal organisation of bilateral creditors, in conjunction with the World Bank and IMF; however, as China is not a formal member of the Paris Club, any restructuring agreement would need to be on an ad-hoc basis or outside of the Club altogether, although lack of transparency over bilateral restructuring terms could raise issues for the IMF over programme design and financing assurances.

   Another looming debt restructuring of this type is the comprehensive renegotiation of Venezuelan debt (which dwarfs the Chinese bilateral mentioned above). In Venezuela, China's cooling of support suggests it places greater weight on a commercial relationship, which is aligned with investors, but the relatively lower visibility on its lending could present an issue when it comes to understanding a workout process in the event of debt distress.

3. **Nearly all BRI-related funding is done using US dollars rather than Chinese renminbi** – If China's current account surplus continues to decline, as the IMF currently predicts, then, ultimately, China will not be sufficiently liquid, in US dollar terms, to continue financing BRI on the same terms.

   Note that, as reported by the FT, "while the renminbi was used to settle about 30% of China's trade back in 2015, for example, it is now used to settle only half that amount".

4. **c90% of all BRI contracts have been won by Chinese contractors**, according to a recent study by the Center for Strategic and International Studies, suggesting the majority of hard currency being spent by countries will likely be repatriated away, ultimately leading to further deterioration in the recipient country's current account – which looks at not just the trade balance, but also at net primary and secondary flows of income from nationals living and working abroad.

The Republic of Congo could provide a test case of China's behaviour as creditor in cases where there are a range of international creditors.

Risk 2: China-US geopolitical cross-fire

There are two aspects of China-US geopolitical cross-fire that impact FM-EM and this is most evident, in our view, in the South Asian arena:

1. Direct conflict between the two global powers, with the prime example currently of the trade war; and

2. Competition between these two global powers for influence and control of 'client states', or, more politely, 'aligned states' across the region (particularly at trade route choke points, of which there are many in South Asia).

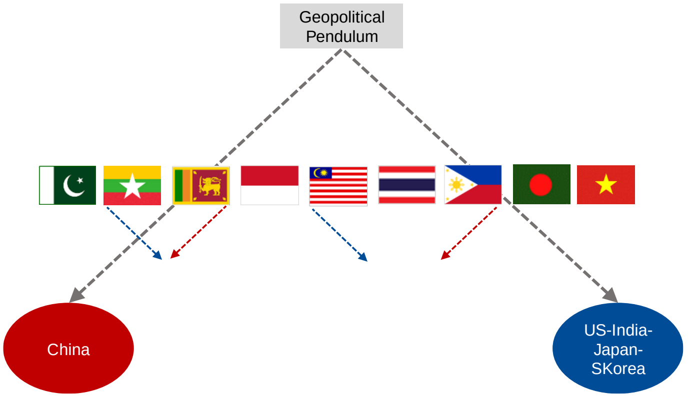
The countries we see as most vulnerable to the negative effects of China-US competition for influence and control are Pakistan, Sri Lanka and Thailand.

The first type of cross-fire has straightforward implications across the region and the negatives outweigh the positives. In the ongoing trade war, the negatives are the dampening impact on global growth, the potential Chinese FX rate devaluation in response to higher US tariffs (which most of South Asia would have to mirror, over time) and the reduction of demand from China for intermediate and finished goods from the rest of South Asia. The positive implications are the potential shift of US purchases to South Asian countries competing directly with China in the same finished products or the re-location – should the trade war persist and intensify – of more of the value-add in manufacturing supply chains that span both China and the South Asian countries in favour of the latter.

The second type of cross-fire has much more nuanced implications and this is what we discuss below. In our view, the lowest risk for investors is when the geopolitical influence of China and the US is in a stable equilibrium. This stable equilibrium can exist either with a balance between the two global powers or an alignment with one of them (and, as argued below, we do not regard closer relationships with one, eg the US, as necessarily more beneficial than relationships with the other, eg China).

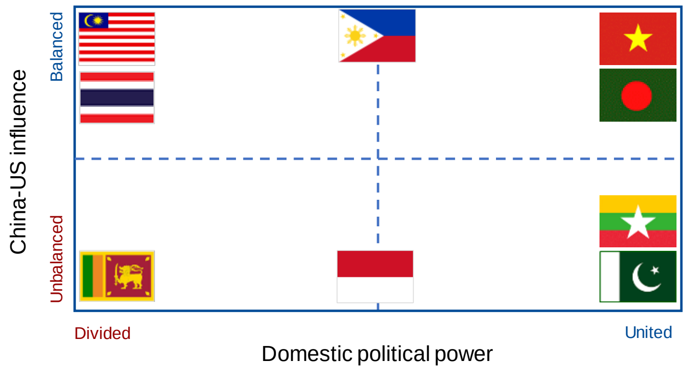
The countries we see as most vulnerable to the negative effects of China-US competition for influence and control are Pakistan, Sri Lanka and Thailand. The countries that are most immune are Bangladesh, the Philippines and Vietnam.

Figure 3: Geopolitical alignment in South Asia



Source: Exotix Research. Red/blue dotted lines depict the recent momentum of the pendulum.

Figure 4: China-US balance versus domestic political unity



Source: Exotix Research

High-risk situation #1: Swinging from one geopolitical sponsor to another

An unstable equilibrium could result from an incomplete transition from a historically much closer relationship with one to a new much closer relationship with the other.

- Pakistan's ongoing shift from the orbit of the US to that of China could trigger damaging responses from the US, such as pressure at the IMF or FATF, targeted sanctions, the increase of non-tariff barriers to trade and/or delays in payments. Relevant here also is the [US Senate's letter in August] to Secretary of State Pompeo and Treasury Secretary Mnuchin urging them to block an IMF program for Pakistan on the basis that it wold amount to a US bailout of China – arguably the most overt indication of US-China tension over BRI/CPEC/Chinese lending.
- This contrasts with a more modest, but nonetheless distinct, shift by the Philippines from complete alignment with the US (evidenced by the permanent US military bases and the high share of trade taken up by the US) to a practical détente with China (centred mainly on establishing a pragmatic arrangement for collaborative offshore oil and gas exploration).

High-risk situation #2: Unresolved, deep domestic political rivalries

An unstable equilibrium can also result from deep, unresolved divisions (perhaps, created and compounded by institutional shortcomings) in domestic politics, which the US or China could exploit in order to advance their own interests (thereby exacerbating those divisions and their disruptive impact).

- Sri Lanka is an example of this, with its divisions within the Sinhalese majority where the largest factions are led by Rajapaksa, historically closer to China, and Wickremasinghe, historically closer to the US-India camp.
- Thailand is another example with its divisions between 'yellow shirts' (closer to the military, the royal family, the judiciary, the central region, the urban elite and, historically at least, the US) and 'red shirts' (closer to the rural population, the north and north-east regions and, historically at least, China).
- Malaysia, which completed its elections in May 2018 for parliament's five-year term, has, in our view, important domestic divisions in the ruling Pakatan Harapan coalition and the potential catalyst for these becoming acute is the succession to the leadership role occupied by 93-year-old Prime Minister Mahatir Mohamad. There are two aspects to succession risk: first, whether Mahatir smoothly hands over to Anwar Ibrahim (71), who leads the PKR, a 40% member of the ruling coalition, and second, the jockeying for position between younger rivals in the PKR behind Anwar, eg Azmin Ali (54) and Rafizi Ramli (41). These fault lines within the ruling coalition make Malaysia vulnerable to geopolitical turbulence, in our view.
- Bangladesh is a counter-example to Sri Lanka, Thailand and Malaysia: politics is deeply divided between interests aligned with Hasina's Awami League and Zia's Bangladesh National Party, but the Awami League has so comprehensively succeeded in cultivating a de facto one-party state that it is able to balance both China and the US-India-Japan-South Korea camps.
- Vietnam has some echoes of Bangladesh as a counter-example, with tensions between a northern camp, which, historically at least, was more wedded to communism and a closed economy, and a southern camp, which, historically, at least, was more capitalist-leaning and more outward-looking economically. But it is very different because it has fought wars with both the US and, more briefly, China, and because these domestic tensions are managed within the framework of the de jure one-party state.

It is inconceivable for FM-EM to chart a course independently from the influence of China or the US.

It is inconceivable for FM-EM, particularly in South Asia, to chart a course independently from the geopolitical influence of China, on the one hand, or the US ('US plus' in combination with its strategically aligned powers of Japan, India and South Korea), on the other. These geopolitical rivals simply make up too large a share of trade and take too strategic a view of territorial control and political alignment of nation states.

China versus 'US plus' share of trade and investment in South Asia

Figure 5: Exports – China versus US-India-Japan-S Korea

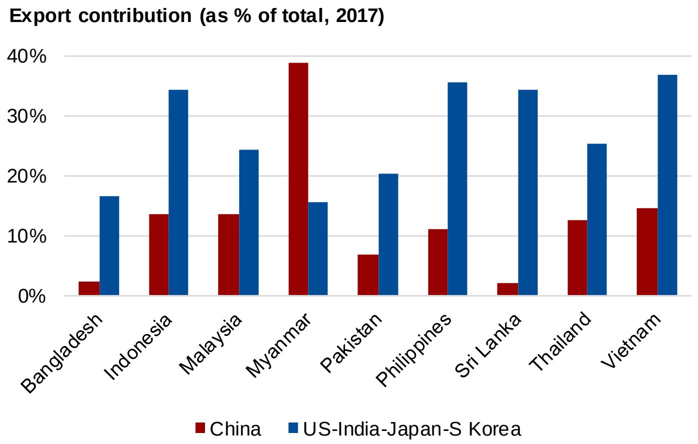
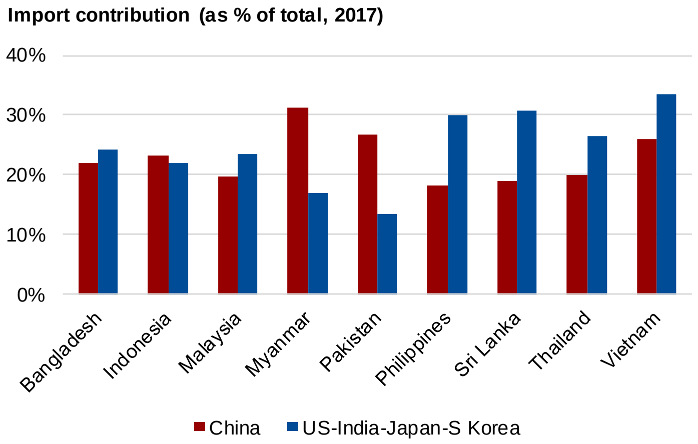
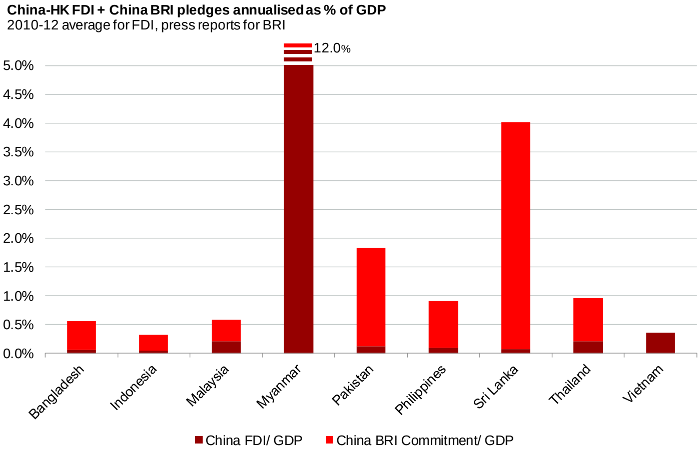


Figure 6: Imports – China versus US-India-Japan-S Korea



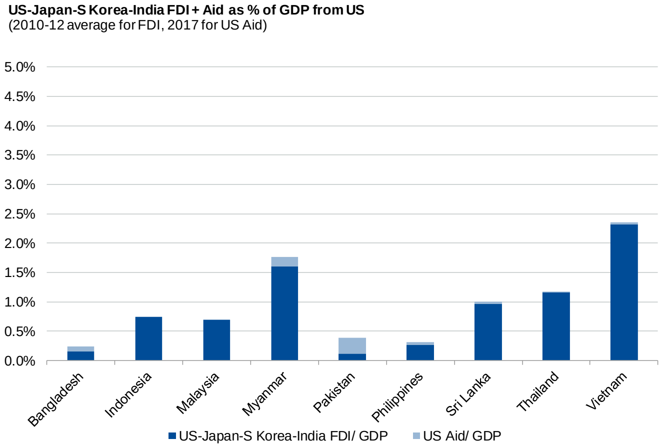
Source: IMF

Figure 7: FDI and BRI pledges from China in FM-EM



Source: UNCTAD, WB, press reports, Exotix Research

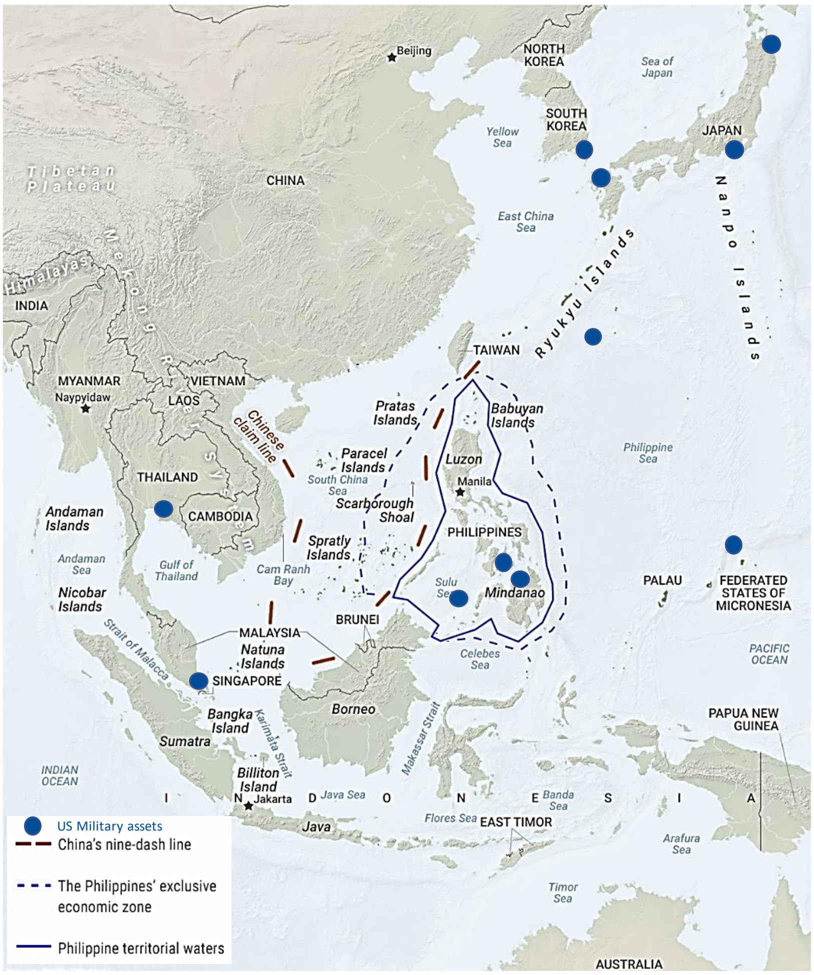
Figure 8: FDI and aid from US-India-Japan-S Korea in FM-EM



Source: UNCTAD, WB, Exotix Research

China versus 'US plus' territorial rivalry in South Asia

Figure 9: Asia-Pacific – China's territorial claims and US military assets



Source: Geopolitical Futures, Exotix Research

Defining BRI

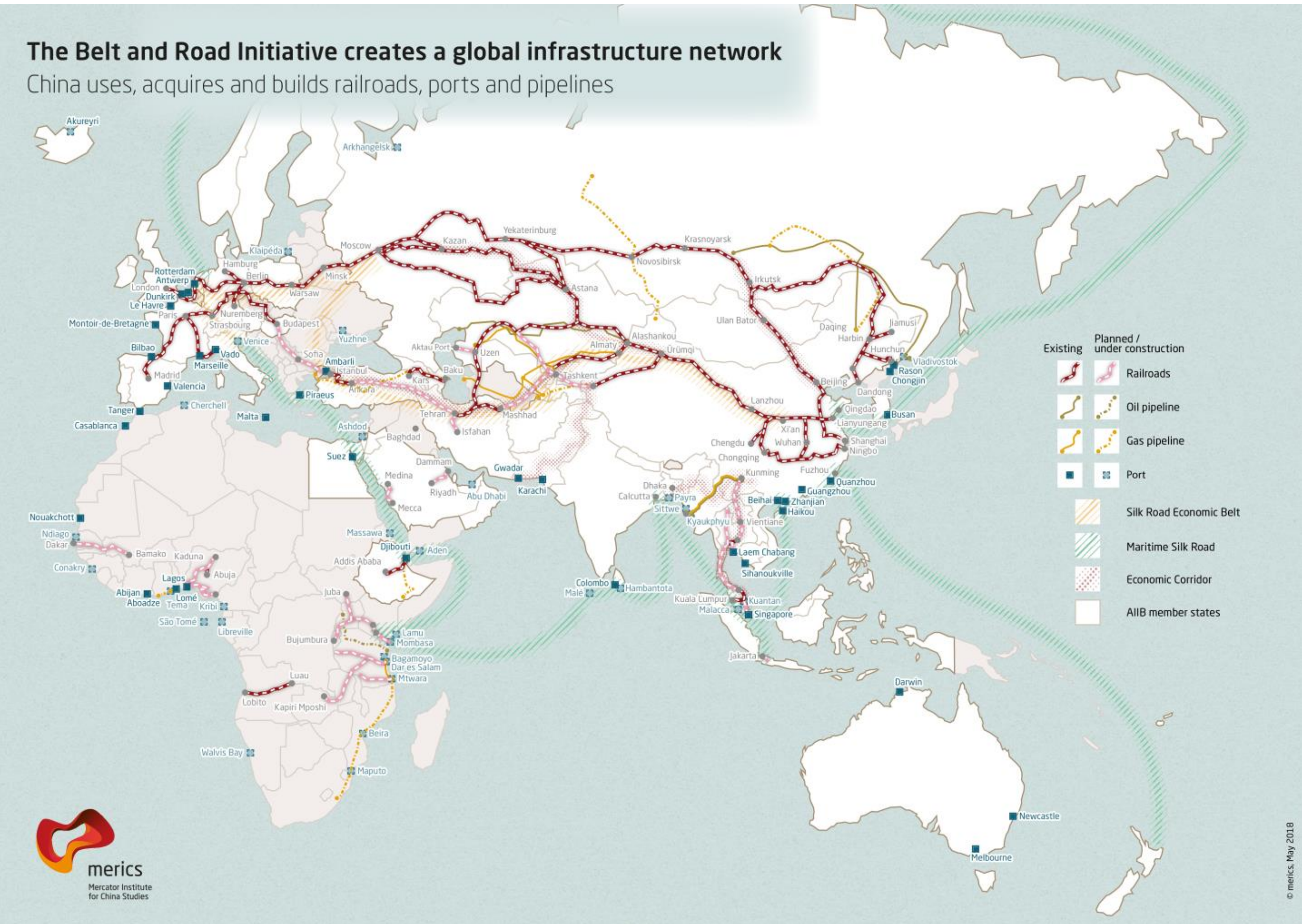
BRI was originally known as the Silk Road Initiative, later renamed One Belt, One Road (OBOR). It is a vast infrastructure development plan that was first unveiled by Xi Jinping in late 2013, roughly one year after he assumed office, and began operating in earnest throughout 2014. The latest iteration of the name combines two existing infrastructure plans: the “Belt”, referring to the proposed overland trading routes and infrastructure projects – as originally laid out in the Silk Road Economic Belt; and the “Road”, referring to the maritime trading routes laid out in the 21st century Maritime Silk Road (MSR).

> The countries in which BRI will operate account for nearly two-thirds of the world’s population and one-quarter of global GDP.

It is important to understand that the exact details of BRI – that is what countries are included, what specific projects there are or are not – are all very nebulous. The official government statement outlining BRI does not add a great amount of detail. In fact, as recently reported by the FT, “one of the reasons Chinese officials struggle to explain the BRI in plain language is the catch-all nature of the concept first outlined by Xi in September 2013. Suddenly projects that had been under way for years were transformed into BRI-related initiatives. “We had been working on projects across Asia and Africa for years before Xi’s announcement,” says one senior Chinese state bank executive. “Then they became BRI-related investments. It was great for us.””

When completed (at least as we currently understand BRI in its current iteration), the entire project will encompass roads, maritime channels and infrastructure projects in 65 countries (including China), although many more countries will likely be involved in varying degrees of officiality. These projects will primarily be based throughout the Eurasian continent, but also include parts of Africa and Australasia, and there has been recent discussion around the inclusion of Latin and South America as well. Ultimately, the countries in which BRI will operate account for nearly two-thirds of the world’s population and one-quarter of global GDP.

Figure 10: The BRI network



Source: *Mercator Institute for China Studies (merics)*

When the tide goes out... Macro headwinds expose vulnerability across FM & EM equities

Theme 2: When the tide goes out… Macro headwinds expose vulnerability across FM & EM equities

We assess the most exposed companies, industries and countries across Financials, Industrials and Consumers to the changing global environment.

Our growing network of research partners, both specialist local brokers and independent research providers, enables us to bring you wider coverage and an expanded knowledge base. Uniquely, our sectoral lead analysts draw out the key trends and investment implications across this expanded universe of developing markets and distil them into actionable ideas.

We bring this to bear in our second theme, which explores the rising vulnerability across FM & EM equities. In good times, weaknesses can be hidden. But, when the tide goes out, things look very different.

Although EM headlines in 2018 were dominated by a wide variety of risk factors, including trade tensions, commodity prices and rising levels of debt, increasing US interest rates were a key driver of EM underperformance, exacerbating the impact of rising debt levels and rollover risks. US monetary policy normalisation drove up borrowing costs on USD-denominated liabilities and also led to relative appreciation of the US dollar, making dollar repayments even costlier.

We expect the pace of US rate rises to slow in 2019, although monetary policy normalisation is expected to continue in many other developed markets. The combination of higher, albeit more slowly rising US rates, and monetary policy tightening elsewhere in the developed world in 2019 mean that excess indebtedness will remain a significant risk.[2]

To assess which countries, segments and companies may be most vulnerable, we look at FM & EM equities across three broad sectors:

In Financials (page 18), Rahul Shah assesses the potential winners and losers in 2019 from diverging interest rates in developing markets. Banks in GCC and Pakistan look best placed to benefit from improved margins, while Egypt, Uganda and Ghana could see margins decline.

In Industrials (page 25), Vahaj Ahmed has sliced and diced 108 companies across our coverage universe to create an Exotix Industrials Ranking, assessing the most resilient (and potentially the most rewarding) names over the next 12 months. Overall, he likes Egypt and Nigeria top down, but there is plenty more to digest.

In Consumers (page 30), rising rates could have a severe impact on indebted companies. Nirgunan Tiruchelvam's Teflon Test identifies those consumer names most at risk if the debt bomb explodes in 2019.

Contact radsales@exotix.com for our detailed stock-level conclusions.

[2] *For our interest rate outlook, including outlooks for individual markets, please see the Appendix on page 34.*

Financials: Positioning for diverging interest rates in 2019

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Rohit Kumar
Nkemdilim Nwadialor

- **We expect a mixture of rate hikes and cuts across our coverage markets** (see page 34 for a breakdown). Based on these expectations, we think bank margins are most likely to benefit in the GCC and Pakistan, but Nigeria and Vietnam should also see some support. In contrast, margins in Egypt, Uganda and Ghana could decline. Our top-down model suggests there could be upside risk to analyst margin forecasts in Nigeria, Zimbabwe and Kenya, and scope for disappointment in Uganda and Pakistan.
- **The net interest margin is a key driver of sector earnings.** Across our coverage universe, net interest income generates over two-thirds of total operating revenue. A 10bps improvement in margins typically adds 5% to earnings. Vietnam is one of the more sensitive markets to margin shifts.
- **Positioning for divergent rate trends in 2019.** Rising US rates had a profoundly negative impact on EM and FM banking shares in 2018, but the pace of tightening is expected to moderate. We think the GCC and Pakistan are likely to experience further interest rate increases in 2019. In contrast, several African markets (notably Uganda, Ghana, Nigeria, Egypt, Kenya) are forecast to see rate cuts. We believe our detailed re-pricing analysis can help investors position their banking sector portfolios to benefit from these divergent interest rate trends.
- **Most banks have a positive structural mismatch to interest rates.** Shareholders' equity and demand deposits mean that a large portion of banks' funding can be free of financing costs. If the stock of interest-earning assets exceeds that of interest-incurring liabilities, banks should be able to lift their financing margins when interest rates increase.

We assess winners and losers among banks in our coverage by looking at the portion of the balance sheet that reprices within one year and identifying interest sensitivities based on this more focused perspective.

- **Banks are not passive observers of interest rate moves,** but over time will optimise their balance sheets. Accordingly, we think the structural mismatch is not actually the best metric by which to rank the banks. Instead, we focus on the portion of the balance sheet that reprices within one year and identify interest sensitivities based on this more focused perspective.
- **Country views.** We think banks in Pakistan and Saudi will enjoy further margin tailwinds next year, with the former also benefiting from a shift to shorter-dated sovereign paper and more current account funding. In contrast, expected rate cuts mean there should be downward pressure on bank margins in Egypt, Ghana and Uganda. However, here we see some mitigation from balance sheet shifts (eg more lending activity) and increased fee generation.
- **Highlighting disconnects between top-down and bottom-up models.** Our top-down model does not incorporate shifts in business mix or changes in competitive dynamics. Flagging differences between our top-down and bottom-up models can help identify cases where such factors may be playing a role.

Contact radsales@exotix.com for our detailed stock-level conclusions.

Margins are a key driver of sector earnings

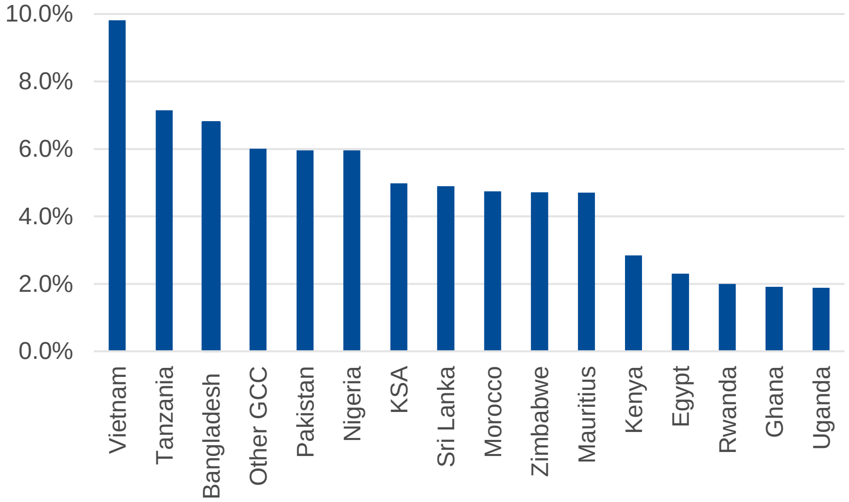
On average for our coverage, net interest income accounts for c68% of total operating income, and a 10bps expansion in margins lifts sector earnings by 5%.

Banks that are most dependent on net interest income (ie have limited reliance on fee income or investment returns), and also have low margins, high operating gearing and high credit risk costs, will typically exhibit the most sensitivity to margin trends.

Banks that are most dependent on net interest income, and also have low margins, high operating gearing and high credit risk costs, typically exhibit the most sensitivity to margin trends.

Our analysis suggests the earnings of banks in Vietnam are the most exposed to margin shifts.

Figure 11: Impact on bank earnings from 10bps margin improvement (2017)

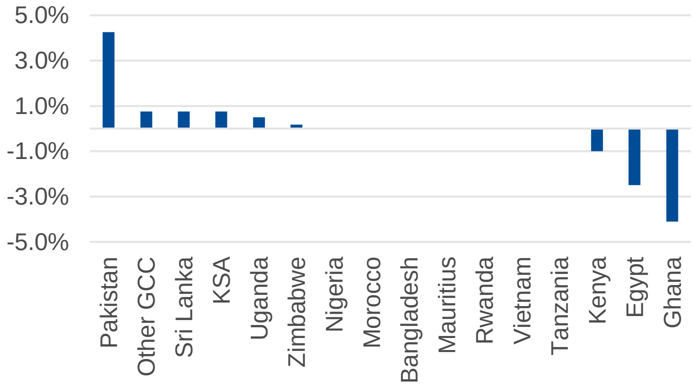


Source: Exotix Research

Rising US interest rates not translating cleanly into the EM world

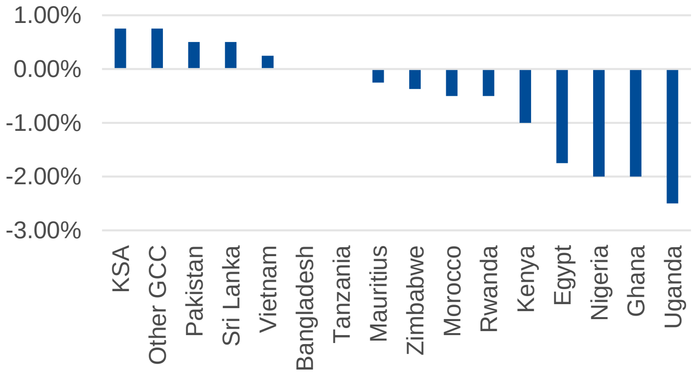
Despite the trend of rising US interest rates in developed markets and increasing pressure on emerging market currencies, our coverage markets have experienced a range of monetary tightening and easing so far this year (Figure 12); rates in Pakistan have risen sharply, but they fell substantially in Ghana and Egypt. Forecasts indicate this dispersion in interest rate conditions is likely to widen further in 2019 (Figure 13); the GCC and Pakistan are likely to experience further monetary tightening, while rates in Uganda, Ghana and Nigeria are expected to fall.

Figure 12: Interest rate movements YTD



Source: Trading Economics, Exotix and Partners Research

Figure 13: Forecast interest rate moves (2019f)



Source: Trading Economics, Exotix and Partners Research

Net interest income drives c68% of the sector's revenue, and a 10bps widening in margins adds 5% to the typical bank's bottom line. Positioning equity investment portfolios appropriately for future interest rate moves can be a key driver of sector investment performance.

Estimating the margin implications of forecast interest rate changes

In this report, we analyse the impact of interest rate changes on banks margins, focusing on both the structural (long-term) and near-term (one-year) implications.

Long-term sensitivity: Here, we consider the structural mismatch in the balance sheet (ie the volume gap between interest-earning assets and interest-incurring liabilities) to identify the long-term impact of any interest rate change on margins. In general, the banks in our coverage have a surplus of interest-earning assets over interest-incurring liabilities (due primarily to the cushion being provided by cost-free demand deposits and shareholders' equity), meaning that there is a positive relationship between interest rates and margins.

Near-term sensitivity: While the structural mismatch to interest rates described above can help to identify the long-term impact on margins, we recognise that banks also have the ability to reposition their balance sheets to benefit from expected interest rate moves. However, such rebalancing can take time to execute. Therefore, we also consider the volume gap of assets and liabilities that re-price within one year. Together with our interest rate forecasts, this can help us to gauge the likely near-term margin outlook for our coverage.

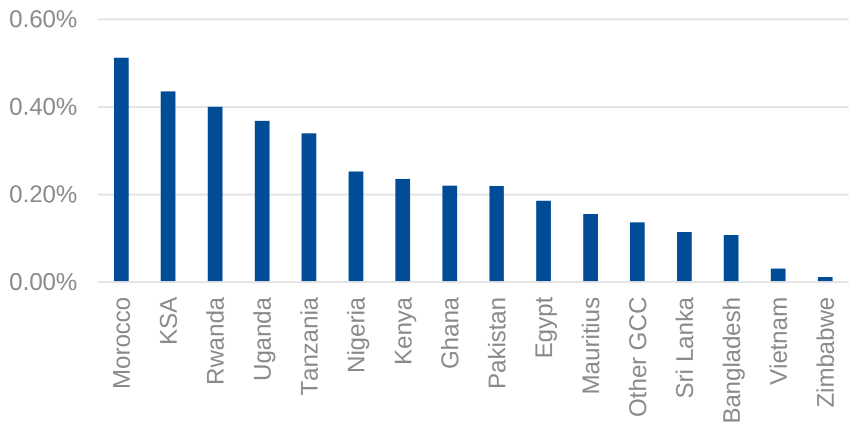
We accept that other factors also play a key role in margin evolution (competitive dynamics, mix shifts, liquidity conditions and risk appetite, to name a few). However, we believe this top down model can provide a basis against which the importance of these other factors can be gauged.

Structural sensitivity to interest rate changes

Banks in our coverage generally have a positive structural mismatch to interest rates, meaning that their margins tend to expand when rates rise. This is because their interest-earning assets are normally larger than their interest-incurring liabilities, principally because of the cushion provided by their demand deposits and shareholders' equity balances.

Figure 14 shows the expected margin expansion for every 100bps rate hike, based on the structural mismatch of assets and liabilities. We highlight that margins for many MENA and East Africa banks appear to be more structurally positively geared to rate hikes. The structural sensitivity of banks in Vietnam and Zimbabwe seems much less.

Figure 14: Margin impact of a 100bps interest rate hike (structural mismatch)



Source: Exotix Research

Near-term sensitivity to interest rate changes

Although the structural mismatch highlighted above signals the potential long-term impact on margins of interest rate moves, we also recognise that the banks are not passive observers of shifts in monetary policy. For example, they can, over time, restructure their assets and liabilities to reap maximum advantage of prior and expected interest rate moves. However, such changes take time to execute.

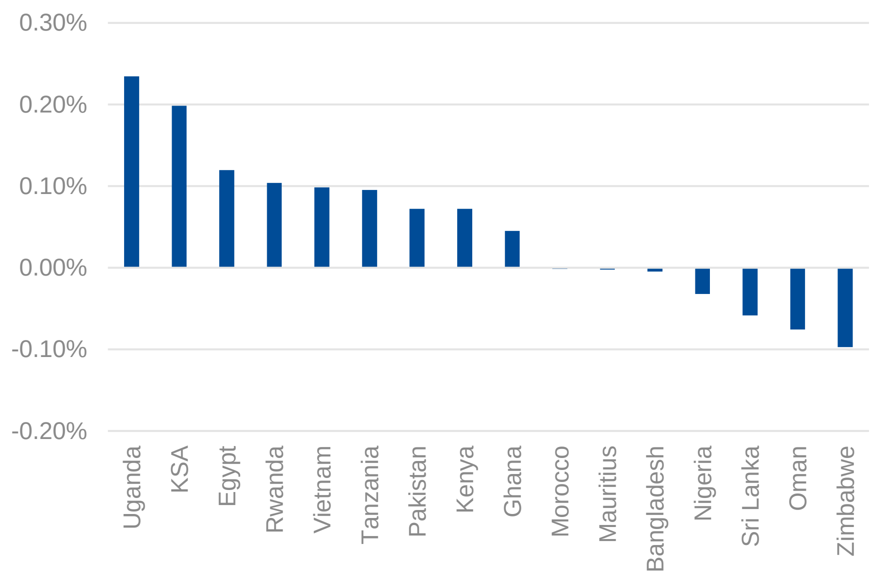
To better account for this long-term flexibility, we focus below purely on the volume gap of assets and liabilities that re-price within one year in order to calculate the margin impact of a 100bps increase in interest rates.

Uganda and Saudi banks have a greater positive sensitivity to interest rate increases.

Among our covered markets, Uganda and Saudi banks have a greater positive sensitivity to interest rate increases. Conversely, our calculations suggest banks in Zimbabwe and Oman would experience a margin squeeze if interest rates were to rise as the bulk of assets are repricing after one year; these banks have a combination of interest rate insensitive central bank/ retail loan assets and short-term time deposit funding.

The magnitude of the changes shown in Figure 15 are typically less than those shown in Figure 13, as we are here just focusing on the assets and liabilities that reprice within one year.

Figure 15: Margin impact of a 100bps rate hike (near-term mismatch, 2017)



Source: Exotix Research

Identifying attractive markets across the rate cycle

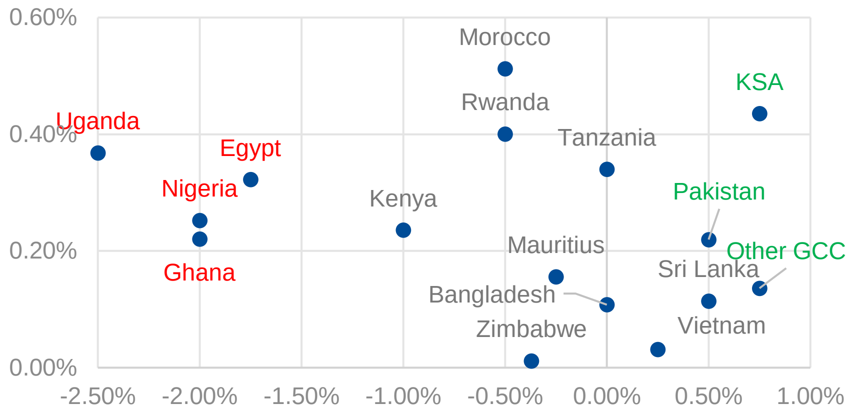
As highlighted in Figure 12, there is likely to be a wide dispersion in the interest rate outlook across our coverage markets. Further, as we have seen, there is a wide dispersion in the margin sensitivity of our banks coverage universe to interest rate changes. Combining these two metrics should therefore allow us to identify those banking sectors and markets that should benefit most in the year ahead.

Structural sensitivities

Ghana, Egypt, Uganda and Nigeria banks could experience a margin squeeze from expected interest rate decline.

Below, we plot the expected change in interest rates in 2019 on the x-axis and calculated long-term margin sensitivity to a 100bps increase in interest rates. Banks in the top-right of the chart, such as those in Pakistan and GCC, should benefit most from expected rate rises. Banks in the upper left of the chart could experience a margin squeeze from expected interest rate decline; Ghana, Egypt, Uganda and Nigeria banks fall into this category.

Figure 16: Structural interest rate sensitivity (y-axis) and expected 2019f interest rate move (x-axis)

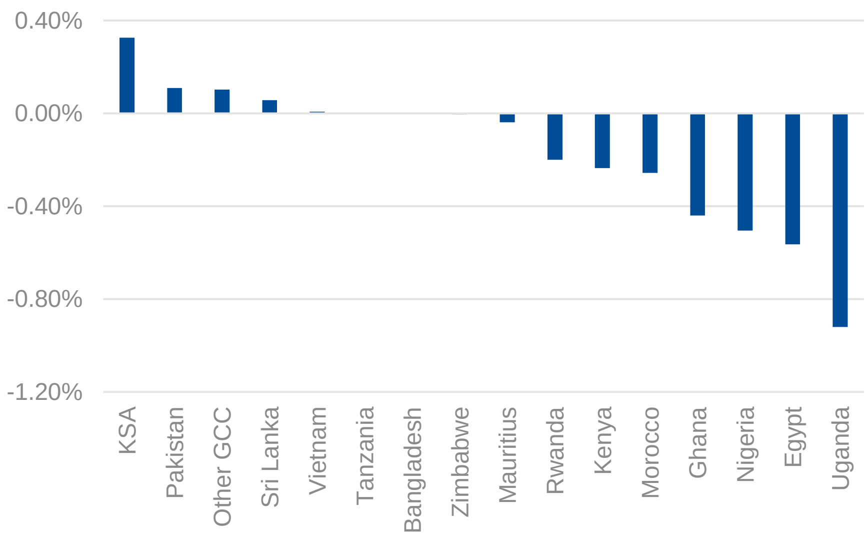


Source: Exotix Research. Green = best-positioned, red = worst-positioned.

Combining this data gives the following expected long-term margin moves. GCC and Pakistan are likely to see the largest move in the long term from expected 2019f rate changes, while Uganda and Egypt could suffer the largest fall.

GCC and Pakistan are likely to see the largest move in the long term from expected 2019f rate changes.

Figure 17: Long-term margin improvement from 2019f rate changes

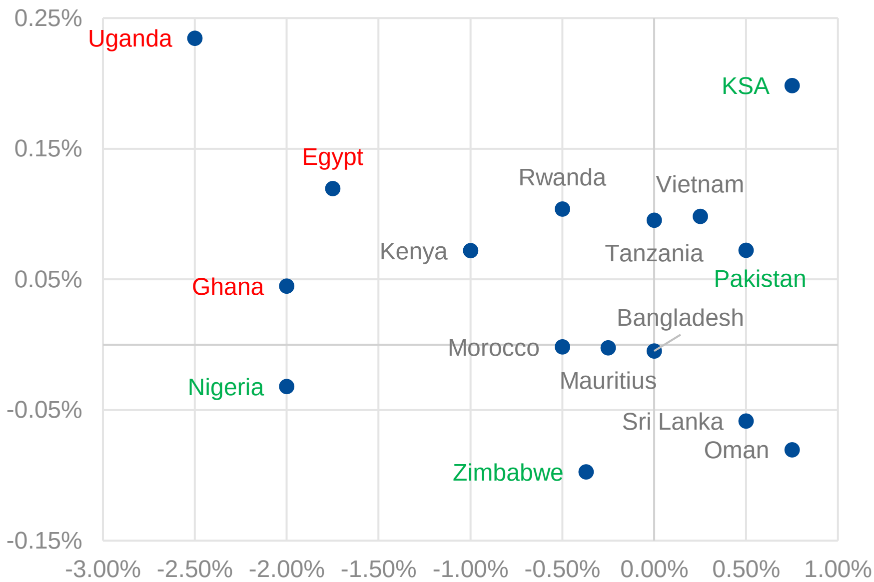


Source: Exotix Research

Near-term sensitivities

Focusing instead on the near-term sensitivity of bank margins to a 100bps rise in interest rates produces the chart shown in Figure 18. Our calculation once again highlights Pakistan and Saudi banks as being likely beneficiaries of higher interest rates, with Nigeria also benefiting, but this time from falling interest rates. Expected rate declines in Uganda, Ghana and Egypt could put downward pressure on bank margins in those markets.

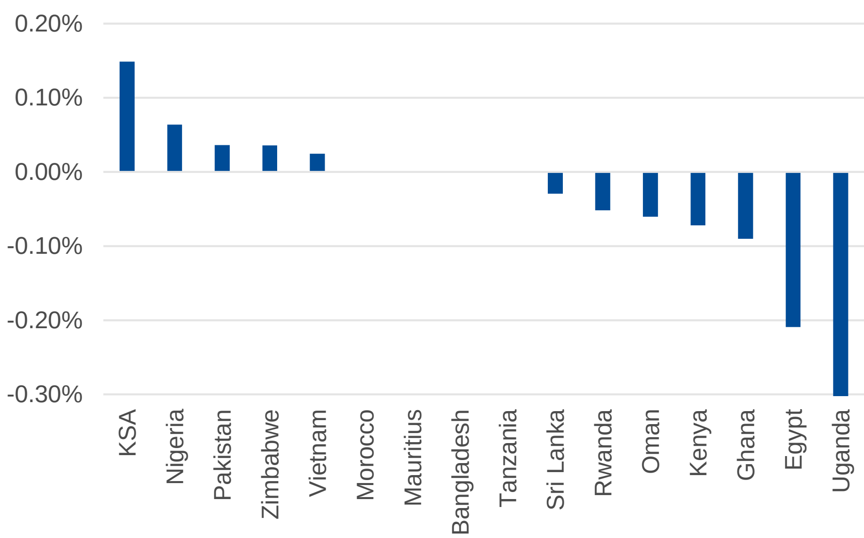
Figure 18: Near-term interest rate sensitivity (y-axis) and expected 2019f interest rate move (x-axis)



Source: Exotix Research. Green = best-positioned, red = worst-positioned.

In Figure 19 below, we combine both these variables to provide an estimate of how our expected interest rate changes could translate into margin shifts, based on one-year repricing. Saudi banks are positioned well to benefit from interest rate moves, while Uganda, Ghana and Egypt banks are likely to see falls in margins in the near term.

Figure 19: Near-term margin improvement from 2019f rate changes



Source: Exotix Research. Uganda = -59bps.

Highlighting top-down/bottom-up disconnects

Despite its importance to bank earnings, correctly forecasting likely margin expansion or contraction may still not translate into an investable conclusion if such expectations have already been factored into share prices.

In order to help us identify potential anomalies, we compare below the results of the interest rate margin sensitivity analysis presented earlier with our analysts' own margin forecasts, to help identify whether there are any sizeable differences in view between the top-down and bottom-up approaches.

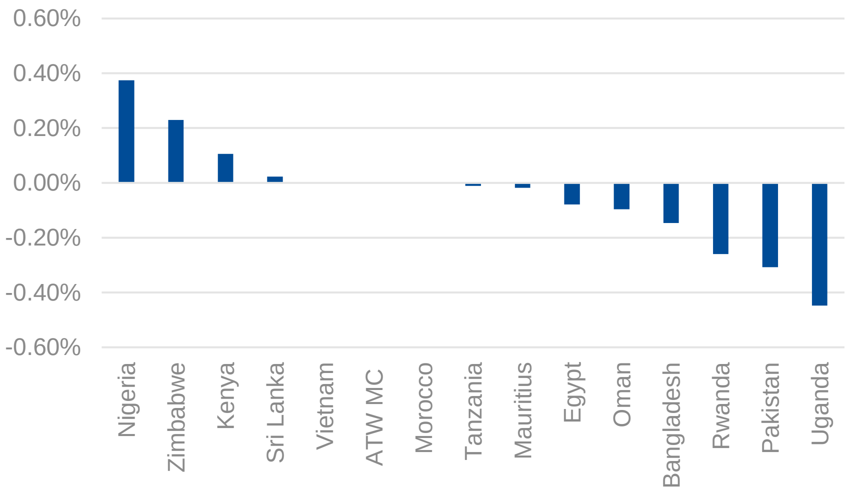
For the purposes of this exercise, we use the near-term interest rate margin sensitivity analysis. We apply this to a 50/50 blend of actual interest rate moves in 2018 and expected change in 2019 (since rate change moves need time to take effect, and since the 2019 margin is an average of the whole year).

Our top-down model is less bullish than the analyst view in Uganda and Pakistan.

In aggregate, our top-down and bottom-up views are broadly aligned. However, there are some sizeable differences at the country and stock level. Key reasons for the difference include valid ones such as changes in the competitive environment, product mix, liquidity conditions or risk appetite. However, the differences could also reflect a natural inertia to project big changes in trend.

As highlighted in Figure 20, the top-down model is more bullish than analyst forecast in Nigeria as the analyst expects rising competition on both loans and deposits front along with certain eurobond liabilities maturing next year, which will be re-priced at higher rates. Our model is less bullish than the analyst view in Uganda (analyst expects aggressive loan growth to improve margins) and Pakistan (rapidly improving asset mix towards short-term securities increasing the near-term sensitivity to rate changes)

Figure 20: Top-down margin model results versus bottom-up analyst forecasts (2019f minus 2018f margin)



Source: Exotix Research. Positive difference indicates that sensitivity-driven estimates are higher than analyst forecasts.

Contact radsales@exotix.com for our detailed stock-level conclusions.

Industrials: Egypt, Nigeria likely to outperform in 2019

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We study our industrials universe of 108 companies to identify the most resilient (and potentially the most rewarding) names over the next 12 months.

- **Our new industrials ranking of 108 companies in six countries, suggests that names in Egypt are likely to outperform in 2019.** The drivers of this outperformance should be Egypt's falling debt (we expect it to have the largest drop of the six countries), its high coverage ratio and lower competition. Egypt's 2019 economic outlook is also attractive (higher GDP growth than 2018 coupled with lower inflation, current account deficit and average interest rates).
- **Our preferred industries are commodity chemicals, fertilisers and oil & gas exploration and production,** of these, oil & gas exploration and production has underperformed in the past 12 months.
- **The slowdown in cement demand will be more evident in net oil importing countries** and where government expenditure makes up a larger proportion of total domestic consumption. As for the net oil exporters, higher oil prices should be positive for cement sales. In our universe, the cement sectors in Egypt and Nigeria show that overall debt (as a multiple of EBITDA) has remained unchanged, the coverage ratio has improved and EBITDA growth has outpaced the growth in input costs.
- **The pricing power of local fertiliser companies should improve in 2019,** with little or no impact on actual consumption. Pakistan and Egypt are relatively less competitive, and their companies could do well if average global oil prices move higher in 2019. On the other hand, Vietnamese fertiliser producers may continue to underperform as local players face challenges from cheap imported urea despite import duties introduced in early 2018 by the Ministry of Industry and Trade to safeguard local producers.
- **We expect utilities to be less profitable due to a stronger US$ and higher oil price in 2019.** Given the unavailability of alternatives, the demand for electricity and gas in the FM and small EM universe remains relatively inelastic to price. Most utilities continue to add capacity to address the growing demand while leveraging their balance sheets. Therefore, the declining profitability weighs on their interest coverage (at least during periods of stronger US$ and high oil prices). In our universe of stocks, gas utilities and independent power producers fare better than integrated electric utilities. Our preferred countries in the utilities space are Vietnam, Pakistan and Saudi Arabia.
- **Upstream oil & gas companies fare better than marketers.** Higher global oil prices in 2019 (versus 2018) are positive for upstream oil and gas companies that have revenues linked to global oil prices (and denominated in US$). We remain cautious of the oil refining and marketing companies. Refined fuel sales have begun to slow as retail customers switch to cheaper alternatives, such as indigenously produced compressed natural gas (in Pakistan) or public transport (in Sri Lanka).

Contact radsales@exotix.com for the detailed stock-level rankings.

Investment summary

The stronger US dollar and rising interest rates in the developed world have had a negative impact on the FM and small EM materials industries (such as cement) due to a significant portion of their input costs being denominated in US$. On the other hand, industries such as fertilisers and oil & gas companies have fundamentally improved owing to their US$-denominated revenues.

The share price performance of these sectors has been mixed in the past 12 months, with upstream oil and gas companies underperforming the universe by 36%, while global oil prices have increased 44% since October 2017. For industries such as cement (where demand is relatively price elastic), we think there has only been a partial impact on profitability and the decline in demand growth remains to be seen. The opposite is true for the producers of building and construction materials in countries that are net oil exporters, such as Nigeria and Saudi Arabia. Higher oil prices have alleviated the fiscal deficit issues in these countries and we expect government expenditure to pick up.

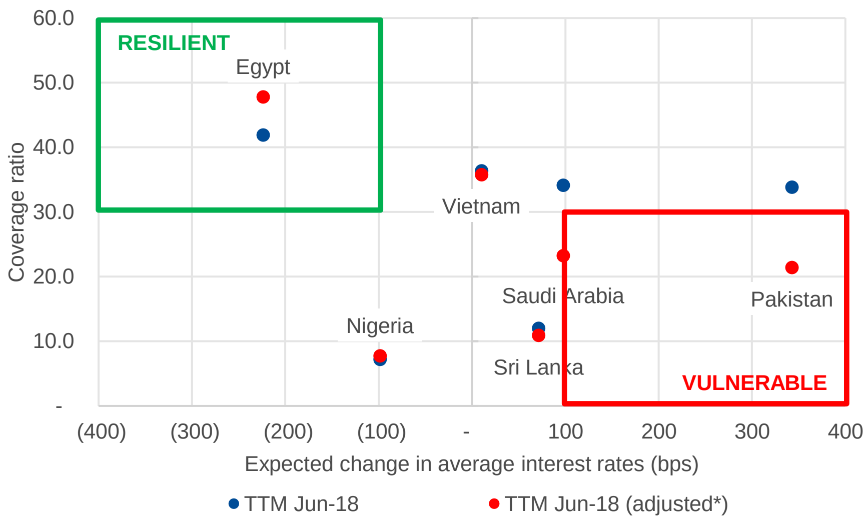
Across our universe, we think industrial names in Egypt are likely to stay the strongest in 2019.

The case for net oil importers (such as Pakistan) is quite the opposite. Falling reserves and rising deficits have already led to currency devaluation, higher inflation and a rising interest rate cycle. The immediate impact has been on profit margins as the ability of the manufacturing industry to pass on higher input costs has weakened. In the countries where rates have already risen, coverage ratios have dropped, but not to distressed levels.

Across our universe, we think industrial names in Egypt are likely to stay the strongest in 2019 owing to the change in debt level (we expect it to have the largest drop across six countries in our industrials coverage), its high coverage ratio and lesser competition, in addition to an attractive 2019 economic outlook (higher GDP growth rate versus 2018 and lower inflation, current account deficit and average interest rates).

In this report, we study our industrials universe of 108 companies to identify the most resilient (and potentially the most rewarding) names over the next 12 months. In order of preference, we like commodity chemicals, followed by oil & gas exploration and production, and fertilisers (of these, oil & gas exploration and production has underperformed in the past 12 months).

Figure 21: Pakistan, Saudi Arabia most vulnerable to interest rate changes



*Source: Bloomberg, Exotix Research. * For interest rate changes TTM to June 2019.*

The macro impact

For markets that have undergone a currency devaluation in recent years, with a resulting pass-through to inflation, the pressure on prices is now beginning to ease and there is the potential for continued rate cuts. These markets include Egypt and Nigeria. Another driver for an easing in inflationary pressures is the potential for a weakening of the dollar relative to local currencies.

For markets that have undergone a currency devaluation in recent years, with a resulting pass-through to inflation, the pressure on prices is now beginning to ease.

Other markets are affected differently. In Pakistan, for example, there are likely to be continued rate increases as inflationary pressures are just starting to build as a result of sequential devaluations of the rupee since December 2017.

Table 3: Key macroeconomic indicators (2019f)

	GDP growth (%)		Inflation (%)		C/A (% of GDP)		
	Apr-18	Oct-18	Apr-18	Oct-18	Apr-18	Oct-18	Rank
Saudi Arabia	1.9	2.4	2.0	2.0	3.6	8.8	1
Nigeria	1.9	2.3	14.8	13.5	0.4	1.0	2
Egypt	5.5	5.5	13.0	14.0	-3.9	-2.4	3
Vietnam	6.5	6.5	4.0	4.0	2.4	2.0	3
Sri Lanka	4.5	4.3	4.8	4.8	-2.5	-2.7	5
Pakistan	4.7	4.0	5.2	7.5	-4.4	-5.3	6

Source: IMF WEO Database (April & October 2018)

Table 3 above summarises the key macroeconomic indicators of the six countries. We rank each country in the context of its 2019 GDP growth, inflation and current account balance as reported by the IMF in October 2018. We also rank each country based on the change in IMF's estimates (versus the April 2018 database).

Cement

We think that the slowdown in cement demand will be more evident in net oil importing countries and where the government expenditure makes up a bigger proportion of total domestic consumption. But the other important factor is the timing of the local currency devaluation. For example, cement volumes in Egypt are now rising, having declined in 2017 (following the 57% currency devaluation in 2016). On the other hand, cement demand in Pakistan has just started to show weakness (after a 21% currency devaluation since December 2017 and a 12% increase in cement prices to pass on higher input costs); domestic consumption in Q3 18 declined for the first time since Q2 11.

We think the slowdown in cement demand will be more evident in net oil importing countries and where the government expenditure makes up a bigger proportion of total domestic consumption.

As for the net oil exporters, higher oil prices should have been positive for cement sales. However, although consumption in Nigeria increased 12% yoy in 9M 18 (versus a 17% decline in 2017), volumes in Saudi Arabia declined 13% yoy in 9M 18 (versus declines of 10% and 15% in 2016 and 2017, respectively). We think the growth in Nigeria is driven by private consumption, which accounts for c85% of local demand. In Saudi Arabia, c60% of total consumption has been driven by government expenditure, which has dropped significantly since its peak in 2015. However, the government aims to increase its spending by 7.4% in 2019.

In our universe, the cement sectors in Egypt and Nigeria show that the overall debt (as a multiple of EBITDA) has remained unchanged, coverage ratio has improved, and EBITDA growth has outpaced the growth in input costs

Fertilisers

The pricing power of local fertiliser companies should improve in 2019, with little or no impact on actual consumption. However, this varies with the contribution of the agricultural sector to the economy in different countries. In most agrarian economies, fertiliser prices are quasi-regulated, whereby the fertiliser industry gets natural gas at favourable prices as a quid pro quo for a discounted urea price; the discount narrows with the decline in imported urea price (and vice versa), which effectively depends on global oil prices.

Other than Saudi Arabia (in the table below), all other countries are net importers of fertiliser or natural gas (which is the key raw material for fertiliser production), and higher oil prices (and, in turn, higher regional fertiliser prices) are positive for indigenous fertiliser companies. The positive profit elasticity for Pakistan and Egypt also suggests that these countries are less competitive, and their companies could do well if average global oil prices in 2019 move higher. On the other hand, Vietnamese fertiliser producers may continue to underperform as local players face challenges from cheap imported urea in spite of import duties introduced (in early 2018 by the Ministry of Industry and Trade) to safeguard local producers.

We expect utilities to be less profitable due to a stronger US$ and higher oil prices in 2019.

Utilities

We expect utilities to be less profitable due to a stronger US$ and higher oil prices in 2019. While the regulated return structures vary across different countries, the existing capacities become less efficient over time.

Given the unavailability of alternatives, the demand for electricity and gas in the FM and small EM universe remains relatively inelastic to price. Consumption continues to grow with a rising population and new connections to the electricity (or gas) transmission network. Most utilities continue to add capacity to address the growing demand while leveraging their balance sheets. Therefore, the declining profitability weighs on their interest coverage (at least during stronger US$ and high oil prices).

In our universe of stocks, gas utilities and independent power producers fare better than integrated electric utilities. Among countries, we like Vietnam, Pakistan and Saudi Arabia in the descending order of preference.

Oil and gas

Since the start of the US rate hike[3] in December 2015, global oil prices have more than doubled and may remain flat in 2019 (versus the 2018 average). This is positive for upstream oil and gas companies which have revenues linked to global oil prices (and denominated in US$) while most of the costs are denominated in local currency.

We remain cautious of the oil refining and marketing companies, which have shown rising EBITDA margins on the back of inventory gains.

However, we remain cautious of the oil refining and marketing companies (especially in Pakistan) which have shown rising EBITDA margins on the back of inventory gains, while refined fuel sales have just started to slow down as retail customers switch to cheaper alternatives; indigenously-produced compressed natural gas (in Pakistan) or public transport (in Sri Lanka).

Ranking summary

Table 4 below summarises the valuation multiples across 23 countries (including 17 countries outside our universe). Argentina, Egypt and Pakistan are the three countries that screen well based on the operating metrics (discussed earlier) and trade at a significant discount to their five-year average multiples.

Contact radsales@exotix.com for the detailed stock-level ranking.

3 *Although no two cycles are identical, commodities generated positive returns in four of the five periods one year after the Fed's initial rate hike.*

Table 4: Valuation multiples for FM and small EM industrials

	MCap (US$m)	PE (x) TTM	PE (x) 5y average	P/BV (x) TTM	P/BV (x) 5y average	EV/EBITDA TTM	EV/EBITDA 5y average	Rank
Country								
JORDAN	2,229	11.7	17.8	1.4	1.8	6.3	7.9	1
ARGENTINA	2,140	16.5	41.2	5.7	12.2	6.3	12.0	2
PERU	3,486	10.2	17.0	1.6	2.4	7.2	7.5	3
PHILIPPINES	6,286	11.2	14.9	1.8	2.6	8.6	9.7	4
COLOMBIA	1,909	25.6	22.0	0.9	2.7	3.3	3.6	5
POLAND	1,566	38.6	15.8	0.5	1.1	5.9	8.4	5
PAKISTAN	13,968	9.1	11.0	1.9	2.2	5.7	6.2	7
EGYPT	9,974	7.0	14.2	3.4	2.8	9.0	12.4	8
MALAYSIA	1,314	11.7	19.7	1.1	2.3	13.1	12.0	9
TURKEY	2,459	17.7	23.5	2.0	3.0	10.5	13.1	10
SRI LANKA	2,192	10.1	13.3	1.3	1.7	10.5	10.3	11
GREECE	879	13.3	36.2	1.6	0.9	7.1	6.9	12
OMAN	1,065	26.5	16.0	1.1	2.0	8.9	9.4	13
THAILAND	48,736	14.3	17.9	1.7	2.0	9.0	9.3	14
NIGERIA	8,273	17.6	18.9	3.6	5.1	8.8	10.2	15
MEXICO	12,880	14.4	36.1	2.1	2.1	9.8	9.7	16
KUWAIT	1,037	20.7	15.9	1.2	1.4	10.8	12.3	17
VIETNAM	13,142	11.5	12.9	2.9	2.6	9.6	9.6	18
MOROCCO	4,057	20.7	23.4	4.2	5.2	12.8	15.1	19
SAUDI ARABIA	160,336	16.8	15.2	2.0	1.9	9.4	9.6	20
UAE	883	50.2	20.0	0.6	0.8	17.9	17.3	21
CHILE	27,432	19.1	24.9	3.1	2.4	10.8	11.7	22
INDONESIA	12,862	62.6	26.5	2.5	2.8	19.3	21.8	23
Top 10 industries								
Electrical components	2,242	2.6	22.7	0.3	1.7	1.0	5.0	1
Independent power producers	41,951	13.6	22.6	1.6	2.3	9.1	10.1	2
Oil & gas exploration & production	23,518	7.5	9.4	1.7	1.4	5.1	5.3	3
Metals	5,128	6.5	8.7	1.8	1.8	8.2	7.3	3
Industrial conglomerates	1,662	10.9	14.4	1.1	1.4	12.3	11.6	5
Commodity chemicals	129,040	15.7	14.8	2.1	1.7	8.3	8.6	6
Integrated electric utilities	16,793			0.8	1.2	10.4	10.4	7
Construction materials	75,354	24.3	19.6	2.4	3.1	11.9	12.7	8
Gas utilities	7,420	13.9	13.0	4.0	3.3	11.2	11.3	9
Fertilisers & agricultural chemicals	30,640	22.3	20.2	4.3	3.7	12.9	13.8	10

Source: Bloomberg, Exotix calculations. Data as at 9 January 2019.

Consumers: The debt bomb is ticking

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- **Developing market consumer companies could be on the cusp of a rapid interest rate hike and currency depreciation in 2019.** The prospect of this double whammy could be dangerous. Net debt has risen by a CAGR of 15% among the peer group of consumer companies in frontier and emerging markets.
- **In our 'Teflon Test', we have tested 42 consumer companies to assess their ability to withstand a potential interest rate hike and currency depreciation.** We use six metrics including the net debt ratio, the ratio of foreign debt to total debt and the proportion of COGS in foreign currency. For full details of our methodology see page 32 and contact radsales@exotix.com for the detailed stock-level results of the test.
- **Our test indicates that multinational corporations (MNCs) that have a tight grip on the bottom of the pyramid are relatively immune to the twin shocks.** These companies are highly cash generative and their leverage is low. Also, MNCs are intensely branded, enjoy high margins and sell in small units at high volumes. These factors help insulate them.
- **By contrast, companies that are low margin, lightly branded and have thrived on leverage are particularly vulnerable.**

We test our universe of 42 consumer companies to assess their ability to withstand a potential interest rate hike and currency depreciation.

Key questions

Has there been a rise in frontier debt in the consumer sector?

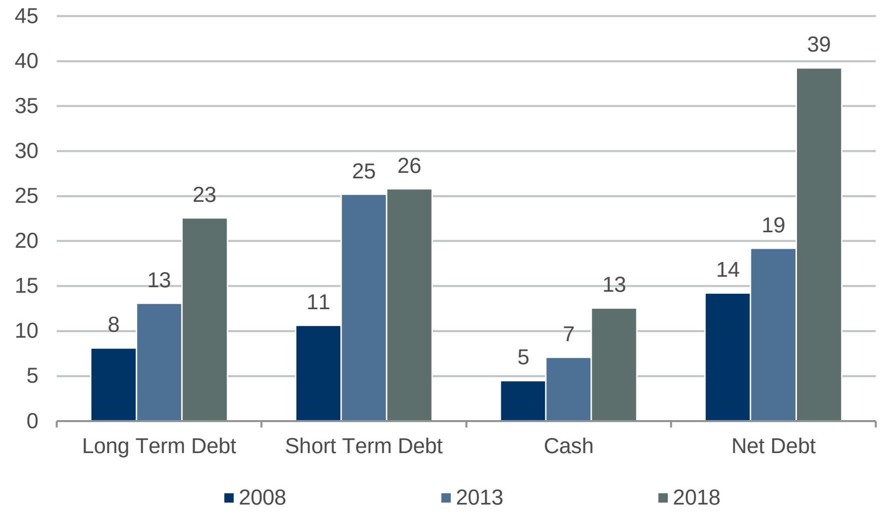
Yes. Among the 42 companies in our peer group, net debt has risen by a CAGR of 15% in the past five years. In absolute terms, net debt levels are the highest they have been since the global financial crisis in 2008.

The drivers have been historically low interest rates and a credit expansion in key markets such as Nigeria, Indonesia and Vietnam.

In absolute terms, net debt levels are the highest they have been since the global financial crisis.

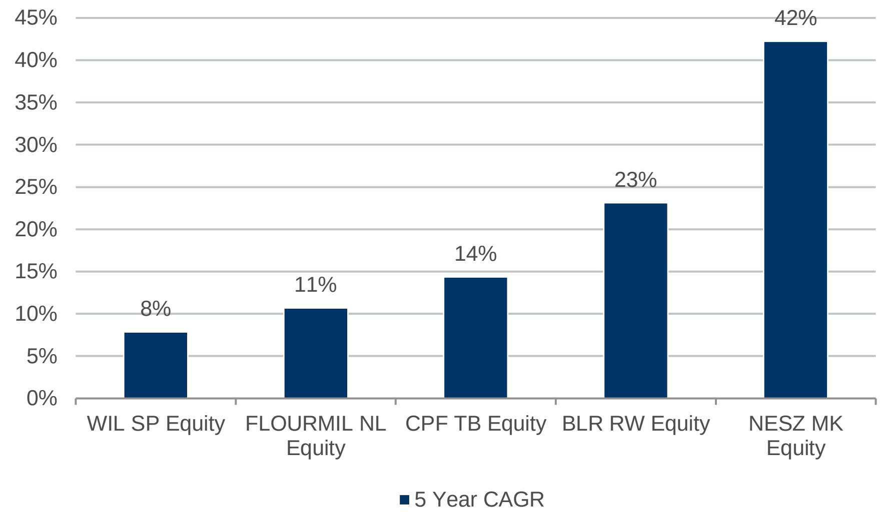
The rise in long-term debt has been particularly pronounced among the consumer stocks in 2013-18. Long-term debt has risen by a CAGR of 13% in this period, while short-term debt has been flat.

Figure 22: Debt in frontier and small emerging market consumer stocks



Source: Bloomberg

Figure 23: Five-year net debt CAGR



Source: Bloomberg

The companies that have seen the most dramatic rise in long-term debt include those that have a business model that is skewed towards commodity processing. These businesses are more capital intensive and less brand oriented.

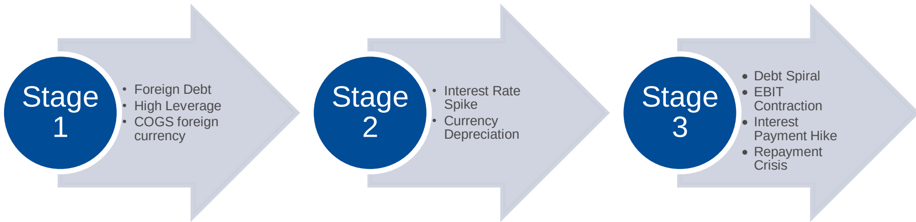
The companies that have seen the most dramatic rises in long-term debt include those with business models skewed towards commodity processing.

How does a debt spiral affect consumer stocks?

Foreign currency debt in a rising rate environment presents three pernicious problems for a consumer company.

1. It can drive up the interest payments, as these are denominated in foreign currencies. In any case, higher rates would drive up interest payments for locally denominated debt.
2. Operating earnings could contract. Several of these companies have costs in foreign currency. These include internationally traded commodities, such as corn and soybean for meat producers. They also include barley and molasses for brewers.
3. Repayment of debt could become problematic. For instance, if there is a bullet repayment of a foreign or domestic loan.

Figure 24: Debt crisis in consumer stocks



Source: Exotix Research

The Teflon Test

We have assessed the potential impact of currency depreciation on 42 frontier and small emerging market consumer companies using the following metrics:

Interest coverage ratio

The interest coverage ratio is the company's pre-tax operating income divided by its interest obligations for a given period.

This is a vital indicator for the consumer sector at this juncture, as it provides insight into a company's ability to service its debt.

Net debt/EBITDA

The net debt/earnings before interest depreciation and amortisation (EBITDA) ratio is a measurement of leverage. It is a company's interest-bearing debt minus cash or cash equivalents divided by EBITDA.

The net debt/EBITDA ratio is important because it accounts for a company's ability to decrease its debt. Ratios over 4.0x are generally alarming and could expose a company in a rising rate environment.

Net debt ratio

This is the net debt/shareholders' equity ratio. It is a measure of a company's book leverage.

Foreign debt/total debt

The foreign debt/total debt metric is a useful sign of exposure to depreciation and rate hikes. It is a fundamental credit metric. Foreign debt is typically cheaper than domestic debt in developing markets; however, this may not be the case in a depreciating currency environment.

Ratio of COGS in foreign currency

The proportion of the cost of goods sold (COGS) that is foreign denominated is a measure that requires careful inspection of a company's income statement. We define foreign-denominated costs to include costs that could be procured locally, but are linked to internationally traded commodities.

Price elasticity

We measure the price elasticity by dividing the three-year average gross margin by the three-year average COGS. This measures the extent to which a company can pass through a hike in sugar prices to the end consumer. Typically, liquor and tobacco producers are able to pass through input price increases. Others that are strong in this category are highly branded consumer MNCs.

We construct our Telfon Index by normalising the six metrics. The higher the Teflon score, the more vulnerable the company is in a rising interest rate and depreciating currency environment. In the case of interest coverage ratio, we use the inverse of the metric for the purposes of the index. The higher the inverse of the interest coverage ratio, the more vulnerable the company.

Contact radsales@exotix.com for the detailed stock-level results of the test.

Who will be protected from higher rates and depreciation in 2019?

Developing market subsidiaries of multinationals are relatively immune from higher rates and depreciation in 2019.

Our Teflon Index indicates that the developing market subsidiaries of MNCs are relatively immune. These companies are typically highly cash generative and have limited long-term debt.

The business model of these consumer companies is driven by the imperative to penetrate the bottom of the pyramid. There are three features of the model that lend itself to insulation.

1. They sell in small unit packages. To target the bottom of the pyramid, consumer firms must be nimble and enterprising. The unit price needs to cater to people whose daily disposable spending is less than US$2.

2. They have low margins per unit. Instead of fleecing the poor by imposing a steep premium, operating successfully in developing markets requires a willingness to accept a low margin. The gross margin derived on a unit of shampoo may be just 10% compared to 20% derived from high-end customers.

3. MNCs sell in massive volumes. The sheer scale of the bottom of the pyramid means that firms can achieve very high volumes. For instance, shampoo consumption in Nigeria is 80ml per capita, which is very low by Western standards. However, Nigeria's vast population (180mn people) means that the total shampoo market is equal to a small high-income country such as the Finland.

MNCs also sell branded products, customer loyalty to which means that an escalation in the COGS due to depreciation can be passed on. Hence, several of them score well on the elasticity metric.

Who are the losers?

The recipe for difficulty in a rising interest rate and depreciating currency environment are thin margins, high leverage and foreign-denominated debt. Companies that are low-margin, lightly branded and thrive on leverage are especially vulnerable.

Appendix: Our interest rate forecasts

2018 proved to be a very challenging year for many EM investors for a variety of factors that included issues of trade, commodity prices and rising levels of debt. However, many markets underperformed as a result of a faster-than-expected rate of US monetary policy normalisation that drove up borrowing costs on USD-denominated liabilities and also led to relative appreciation of the US dollar, making dollar repayments even costlier.

As global conditions change and US growth rates and inflationary pressures begin easing, we may now be approaching the end of the monetary tightening cycle.

As global conditions change and US growth rates and inflationary pressures begin easing, it appears that we may now be approaching the end of this monetary tightening cycle, with perhaps one-to-three more rates hikes possible, followed by a period of relative stability. If this view becomes reality, there is a strong likelihood of increased capital flows into emerging markets as investors look to take advantage of higher yields. Equity investors, in particular, will likely look to put more capital to work as operating environments improve and may become more willing to take on local FX exposure as currencies are less likely to be hurt by continued dollar-strengthening.

Unfortunately, it is very difficult to say what will happen to local rates in many of our markets as local rates are driven by idiosyncratic variables such as growth, inflation, and unemployment figures; while some endogeneity exists, these factors remain mostly exogenous from US monetary policy. Many markets that have witnessed a currency devaluation in recent years and a subsequent pass through to inflation are beginning to see inflationary pressures ease and are likely to see continued rate cuts as a result. These markets include Egypt and Nigeria. Inflationary pressures are also likely to ease based on the potential weakening of the dollar relative to local currencies.

Other markets, however, could respond in various different ways. Pakistan, for example, is likely to see continued rate increases on the back of inflationary pressures that are just starting to build as a result of sequential devaluations of the rupee since December 2017. Kenya would likely see a rate cut if the much-derided interest rate cap were to be lifted, thus allowing monetary policy to be set in accordance with economic fundamentals rather than political pressures.

Table 5: Interest rates change and sources

Country	2018TD	2019f	Source
Bangladesh	0.00%	0.00%	Trading Economics
Egypt	-2.50%	-1.75%	Exotix
Ghana	-4.10%	-2.00%	Trading Economics
Kenya	-1.00%	-1.00%	Exotix
Saudi Arabia	0.75%	0.75%	Trading Economics
Mauritius	0.00%	-0.25%	Trading Economics
Morocco	0.00%	-0.50%	Trading Economics
Nigeria	0.00%	-2.00%	Exotix
Other GCC	0.75%	0.75%	Trading Economics
Pakistan	4.25%	0.50%	IMS
Rwanda	0.00%	-0.50%	Trading Economics
Sri Lanka	0.75%	0.50%	Trading Economics
Tanzania	0.00%	0.00%	Trading Economics
Uganda	0.50%	-2.50%	Trading Economics
Vietnam	0.00%	0.25%	RongViet
Zimbabwe	0.17%	-0.37%	Trading Economics

Source: Trading Economics, Exotix Research

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