Driehaus Emerging Markets Small Cap Equity Strategy Summary

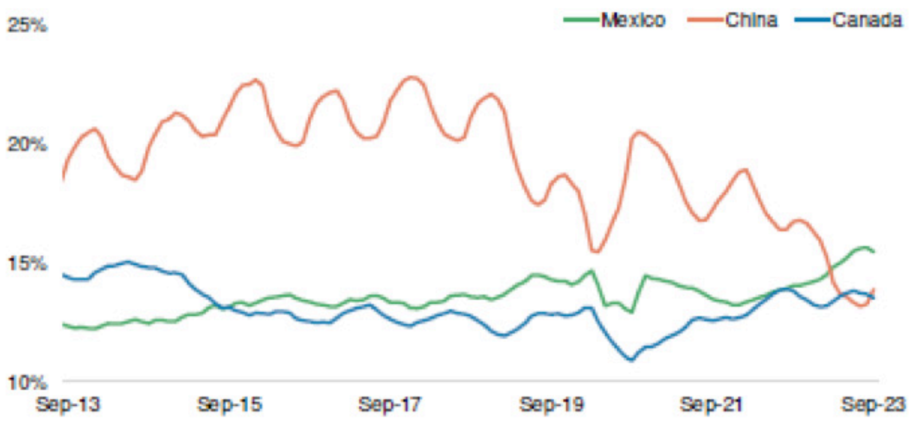
FEBRUARY 2024

Over the last few years, we have been emphasizing the theme of a shifting emerging markets (EM) opportunity set, reflecting factors such as changes in relative growth dynamics, emerging technologies, shifting supply chains, and demographic change. Alongside this theme, one of our core views over the years has been that these opportunities are often underrepresented or completely missed by conventional EM equity indices. The case of Mexico is a prime example of this.

Nearshoring is Mexico's primary long-term structural growth trend, as the country has been at the forefront of the supply chain shifts that have transpired over the past decade. Morgan Stanley expects Mexican manufacturing exports to grow by 35%, or $156 billion, through 2027, increasing the demand for labor, electricity, and investment in manufacturing capacity.

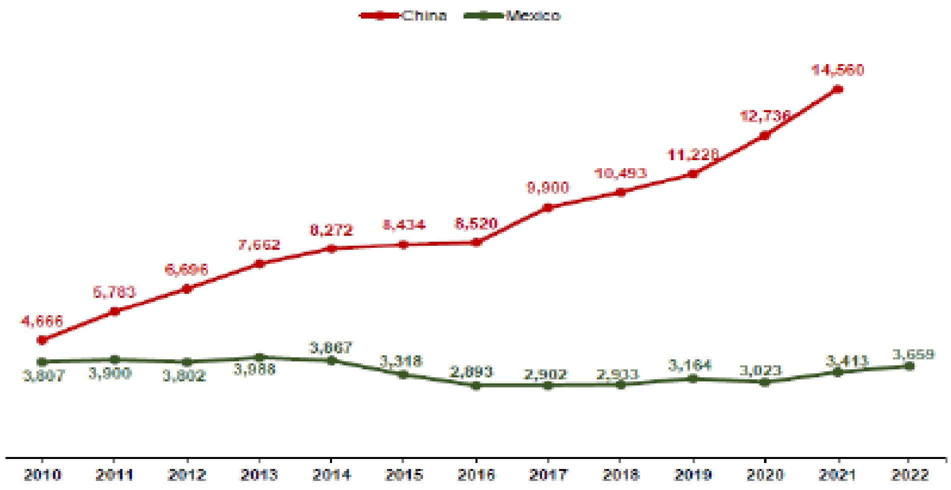
Notably, Mexico overtook China as the top trading partner of the US in 2023, representing 15% of US imports (Exhibit 1). Mexico has become an increasingly attractive destination for manufacturing capacity, as the country maintains close geographic proximity to the US, as well as an attractive cost structure relative to Chinese counterparts (Exhibit 2). However, there is a meaningful difference in the composition of Mexico's exports to the US relative to China's, in that Mexico largely exports intermediate goods, while 80% of China's exports are finished goods.

Exhibit 1. Market Share of US Imports



Source: US Trade Census and Morgan Stanley Research

Exhibit 2. Average Annual Manufacturing Salary (US$)



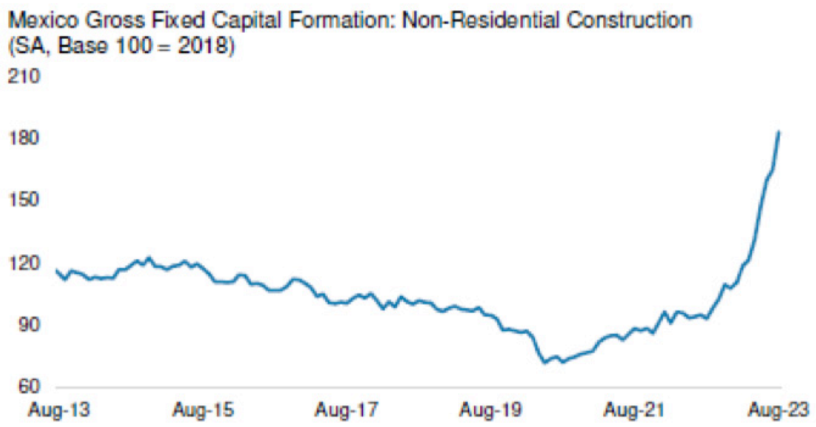
Source: Mexican National Institute of Statistics and Geography (INEGI), Statista

The exercise of disaggregating the export data also reveals a significant contribution from the automotive industry, which represents 37% of US imports from Mexico, and as of the most recent data releases, was one of the few categories actually growing year-over-year.

Tesla announced a large investment in manufacturing capacity in the country in March 2023, while Kia Motors followed suit with a $6 billion expansion later in the year. In aggregate, Santander identified 141 investment announcements totaling $68 billion in 2023, of which 32% are within the automotive industry. Overall, nearshoring has brought on a bona fide investment cycle, as fixed investment inflected positively in 2022 (Exhibit 3).

Another notable trend is the presence of Chinese companies taking part in the wave of nearshoring investments. 23% of the announced investment in 2023 came from China. More on this below.

Exhibit 3. Mexico Gross Fixed Capital Formation: Non-Residential Construction



Source: INEGI, Morgan Stanlet Research

2024 features a heavy election calendar across the world, with Mexico set to elect a new president in June, following the expiration of current President Andres Manuel Lopez Obrador's term. AMLO, as the outgoing president is known, has been controversial, but popular, retaining a 60% approval rating, albeit largely influenced by fiscal spending on things like gasoline subsidies, while also reaping the benefits of the nearshoring wave. AMLO's successor in the incumbent Morena party, Claudia Sheinbaum, currently has a comfortable lead in polls.

However, the current focus of market participants is on whether Morena and its allies can reach the constitutional (two-thirds) majority in Congress. Should this occur, Morena looks likely to attempt to pass wide-ranging constitutional reforms, encompassing 20 proposals in areas such as pensions, wages, electoral laws, and the Supreme Court. For this reason, Mexico's congressional elections will be closely watched in the months ahead.

The strategy maintains an overweight position in Mexico, with 7.3% of its assets invested in the country, well in excess of the MSCI Emerging Markets Small Cap Index weighting of only 2.0%[1]. We maintain significant exposure to the nearshoring theme, through investments in several industrial real estate companies and a cement producer. Additionally, the strategy is invested in two consumer companies.

Mexico's industrial real estate industry has witnessed strong growth, driven by nearshoring, with gross leasable area (GLA) rising by 7.5% in 2023, alongside mid-teens price increases. Inflation has supported the investment case for companies in this industry, as leases include an annual inflation adjustment. Despite the strong growth, much more investment is needed in additional space. Morgan Stanley believes an additional 17 million square meters of space is needed to accommodate the growth of nearshoring and e-commerce, well above the 6 million square meters under construction today. Consequently, the outlook for both pricing and GLA remains strong.

In the consumer space, the strategy holds a position in a company which holds the master franchisee of Starbucks, Domino's, Burger King and several other brands in Mexico. Same store sales across the company's Mexico operations grew by 13.5% in the most recent quarter, supported by healthy job creation and real wage growth in the economy, alongside the appeal of the company's formats.

Additionally, the strategy holds a recent IPO in the consumer space, which operates hard discount food retail stores, a massively underpenetrated category representing less than 3% of Mexican food retail. This company strikes the right balance between high quality and affordable prices, while generating high return on invested capital, and as consumer awareness improves in this segment, we expect rapid growth in the years ahead.

Mexican small caps have performed extremely well over the last two years, returning 63%, well in excess of the 11% return of the MSCI Emerging Markets Small Cap Index over the same period. That said, no investment is without risk, and there are several potential risks that could disrupt Mexico's momentum.

First, going back to the heavy 2024 election calendar and noting the presence of Chinese companies making investments in Mexico, the election that could prove to be the biggest risk to Mexico is the US presidential election in November. A February 21st article in the Financial Times ("China Circumvents US Tariffs by Shipping More Goods Via Mexico") notes that some Chinese goods that would have been shipped directly to the US have made their way into the country without facing the tariffs instituted by former President Trump and retained by President Biden. Chinese cars and auto parts are subject to a 25% tariff, whereas the same goods exported from Mexico face much lower tariffs ranging from 0-6%. While the nearshoring trend is likely here to stay, there is a growing risk that it becomes a political football in the lead up to November.

Second, Mexico likely needs substantial investments and a clearer regulatory framework for its electricity sector. As the country seeks to scale up its manufacturing capacity to support nearshoring related demand, a necessary ingredient is access to affordable, reliable power, and Mexico arguably lags behind here.

Third, Mexico could become a victim of its own success to some degree. The Mexican peso has been among the strongest performing EM currencies, and is currently at levels last seen in 2015. That said, an export-oriented economy that is in need of significant foreign direct investment (FDI) faces a potential loss of competitiveness and erosion on the prospective returns on FDI, should its currency become too strong.

Overall, Mexico's future looks promising, as the economic benefits of nearshoring are clear, and this trend creates a virtuous circle, improving the outlook for job creation, wages, and productivity. Gradually, we have seen an expansion in the investable opportunity set in the country, driven by recent new listings, as well as the expansion of the industrial real estate market, which is directly linked to the growth of nearshoring. Amid this backdrop, we believe Mexico's strength is belied by the disproportionately low weighting in the benchmark, creating a strong opportunity for active management.

Until next month,

Chad Cleaver, Lead Portfolio Manager
Driehaus Emerging Markets Small Cap Equity Strategy

[1]The performance data represents the strategy's composite of emerging markets small cap equity accounts managed by Driehaus Capital Management LLC (DCM) (the composite). These returns are estimated for the period as the underlying accounts' data is yet to be reconciled to the custodian bank. Net of fee returns reflect the payment of advisory fees and in some instances, other fees and expenses such as administrative and custodian fees while the gross of fee returns do not. Both are net of brokerage commissions charged to the accounts and reflect the reinvestment of income and other earnings. The performance data shown above represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted.