DRIEHAUS
CAPITAL MANAGEMENT

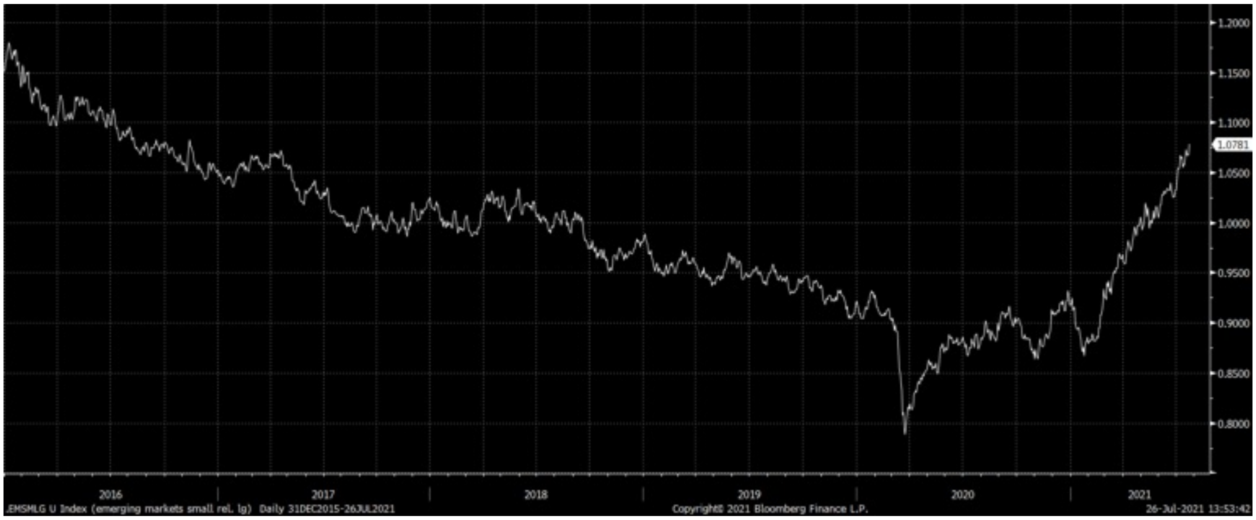
Driehaus Emerging Markets Small Cap Equity Strategy Summary

JULY 2021

This month's commentary presents our favorite charts across emerging markets (EM), showing the themes represented in the portfolio.

One of the defining trends of 2021 thus far within EM has been the relative outperformance of small caps (Exhibit 1). After struggling between 2016-2019, small caps bottomed out amid the onset of COVID-19, staging a v-shaped recovery that has followed through into 2021 behind the enormous liquidity support of global central banks. As certain large cap companies have faced increasing regulatory scrutiny in recent months, a large portion of the small cap universe finds itself outside the associated crosshairs, further supporting relative performance trends.

Exhibit 1. EM Small Caps vs. Large Caps



Source: Bloomberg

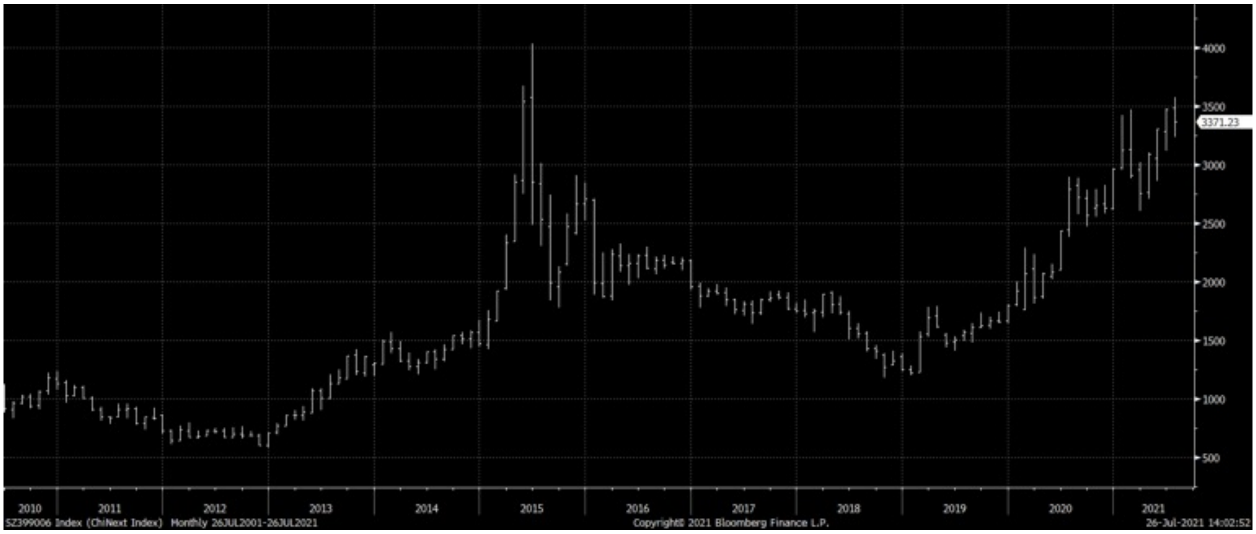
Not only have small caps performed better on a relative basis, but this segment of EM has begun to post strong absolute returns as well, breaking out of a 13-year trading range, and outperforming their US and EAFE counterparts year-to-date (Exhibit 2).

Exhibit 2. EM Small Breakout of 13-Year Range

Source: Bloomberg

Within the EM small cap universe, we find a compelling opportunity set in China, which we believe is underrepresented in the MSCI EM Small Cap benchmark. Despite the struggles of some of the large state-affiliated companies and industries that have recently succumbed to regulatory pressure, local small cap indices continue to perform well (Exhibit 3).

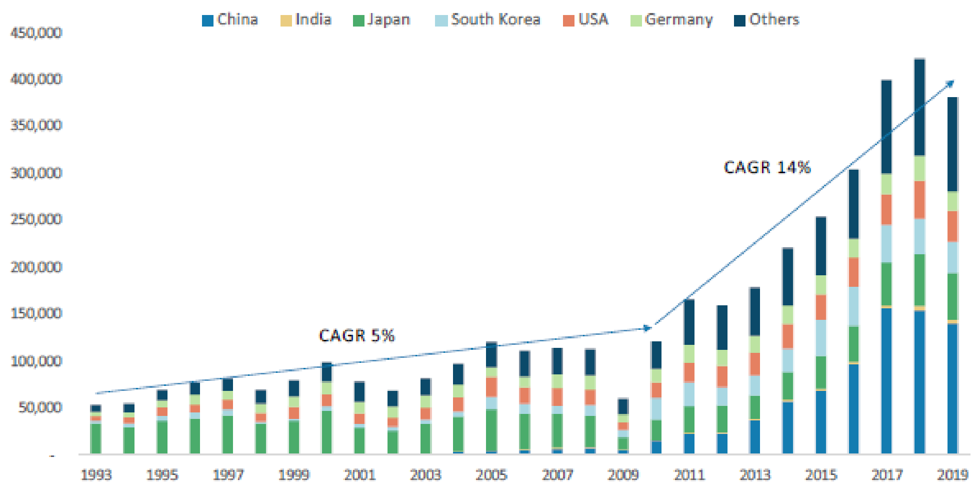
Exhibit 3. ChiNext Index



Source: Bloomberg. The ChiNext Index comprises the 100 largest and most liquid A-share stocks listed and trading on the ChiNext Market of the Shenzhen Stock Exchange.

One of the strategy's highest weightings is a manufacturer of industrial robots in China, which is benefiting from the compelling macro trends shown below (Exhibits 4-6).

Exhibit 4. Global Robotics Annual Installations



Source: IFR, Morgan Stanley Research

Global trends in robot penetration are most closely linked to demographics, and as China's population ages, while younger cohorts increasingly prefer to work in high tech jobs, the demand for robots in China is poised to accelerate.

Exhibit 5. China's Aging Population

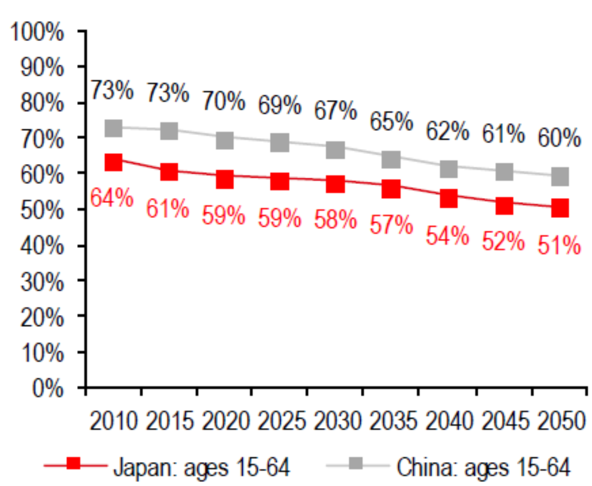
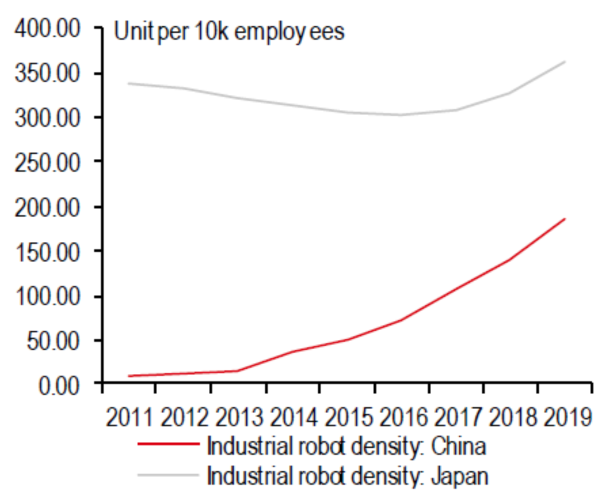


Exhibit 6. China's Robot Density Catching Up to Japan



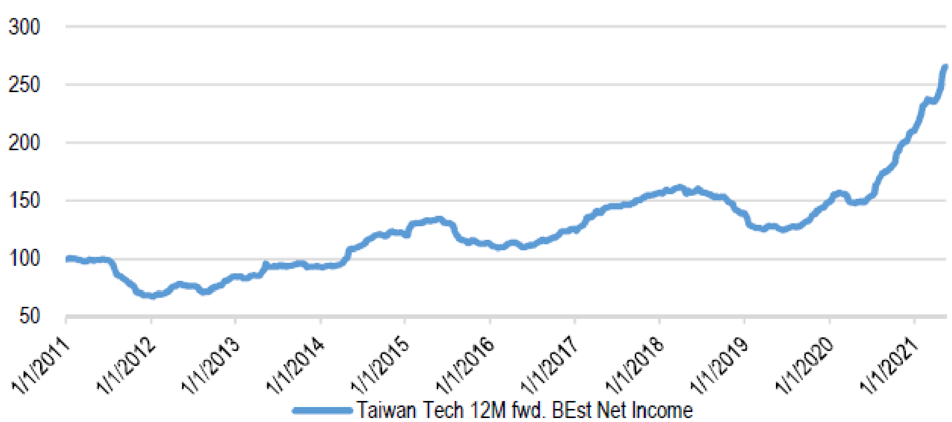
Source: UN-2019 World Population Prospects forecasts, HSBC Qianhai Securities, Wind, MIR

The robotics company held by the strategy is the largest domestic player, but holds only 3% market share. We expect that as this company's product offering continues to improve, its attractive price point and proximity to end customers will help it take significant market share in the years ahead.

Elsewhere in Asia, Taiwan's technology sector continues to flourish, with some of the strongest earnings revisions across EM (Exhibit 7). In the past, many Taiwanese technology companies produced commoditized components and were inherently price takers with little bargaining power with their customers, who tended to be industry behemoths in search of the lowest cost supplier.

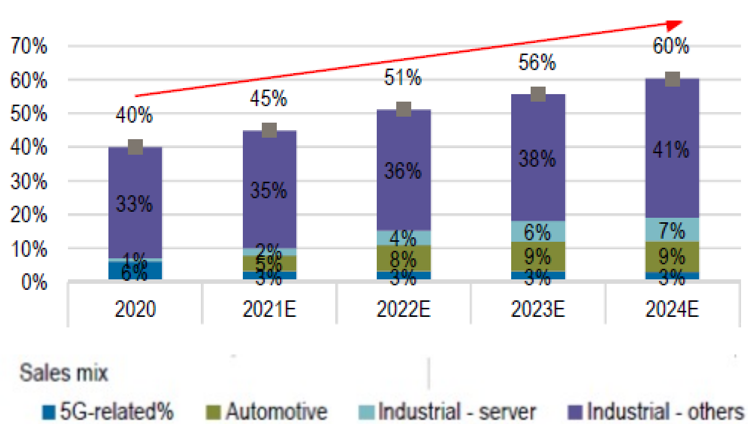
These days, the increasing electrification of our daily lives is creating demand linked to end markets such as auto electronics, the Internet of Things, 5G, and cloud computing, providing structural tailwinds outside of the core cyclical end markets of PCs and smartphones. The chart below shows the increasing representation of these end markets in one of the strategy's long-time holdings, a Taiwan-listed producer of power management integrated circuits (PMICs; Exhibit 8).

Exhibit 7. Taiwan Technology Bloomberg Earnings Estimate Revisions



Source: J.P. Morgan, Bloomberg Finance LP. Released on January 1, 2011

Exhibit 8. End Market Breakdown of Taiwanese PMIC Company

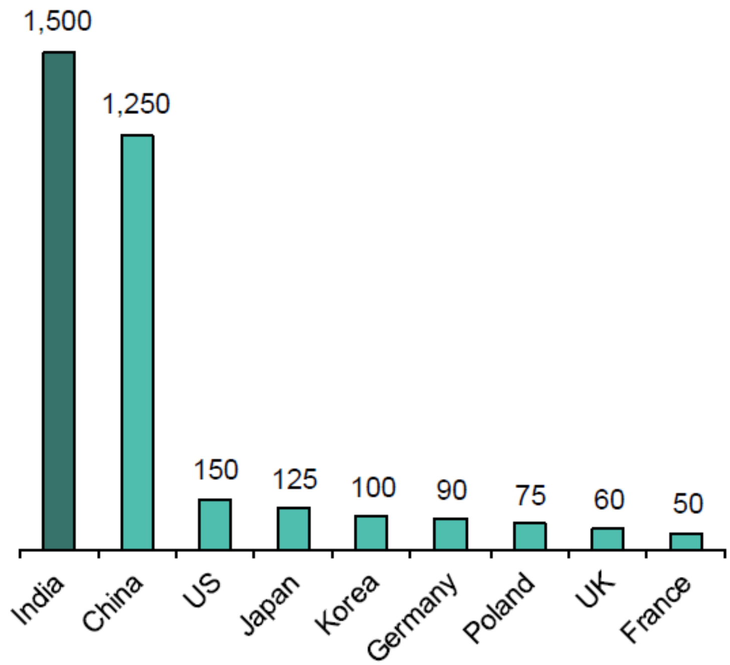


Source: J.P. Morgan estimates. Note: In 2020 GP mix, "industrial-server" is not separated

India has also been a prominent player in technology over the years. However, in contrast to Taiwan, India's growth has largely stemmed from information technology (IT) services, rather than hardware. There have been three structural tailwinds working in favor of Indian IT service companies. First, US and European companies are facing labor constraints and have suffered from relatively high labor costs. Second, the shift from offline to online, which accelerated during the pandemic, has led to a swift reaction by enterprise clients who want an immediate solution. Third, enterprises had been moving gradually to cloud over the past seven years, and since June 2020, this accelerated rapidly.

India generates 3-4x the number of software engineers as the rest of the world, graduating over 1.5 million engineering students annually (Exhibit 9). By some estimates, over 80% of software is coded by Indian engineers.

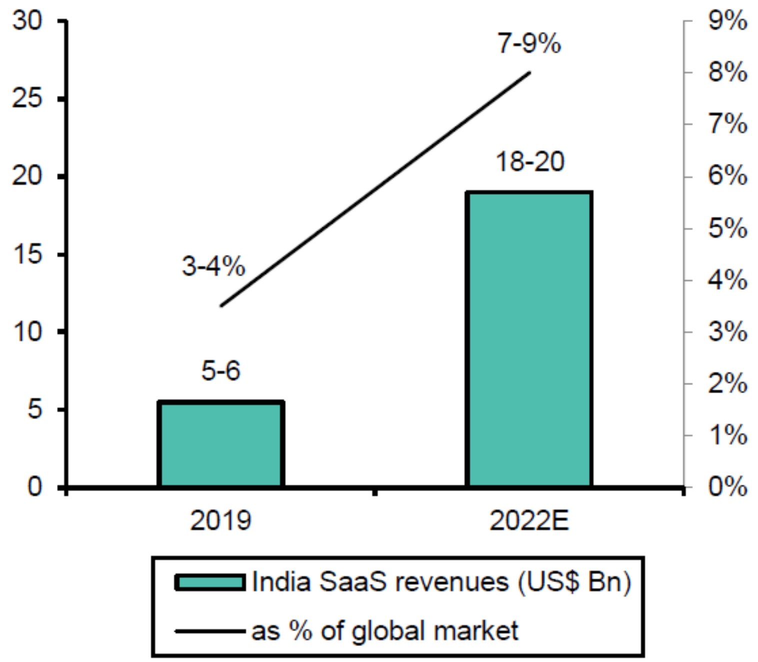
Exhibit 9. Number of Engineering Graduates Per Year ('000)



Source: PwC, Bernstein analysis

Increasingly, India is leveraging its domestic talent pool in related parts of the technology sector. In particular, these advantages have helped the Software as a Service (SaaS) ecosystem flourish in India, where over 7,000 such companies exist today (Exhibit 10). Over the last five years, venture capital funding for Indian SaaS companies has grown by 5x. By some estimates, India has at least 10 unicorn SaaS companies that could conduct IPOs in 2022.

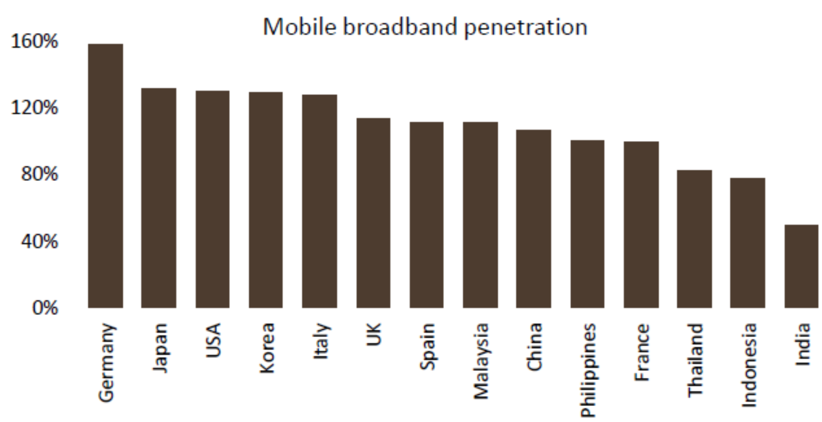
Exhibit 10. India Becoming a Larger Part of the Global SaaS Market



Source: Bain, Bernstein analysis, Includes SaaS revenues of software & IT firms and pure play SaaS companies

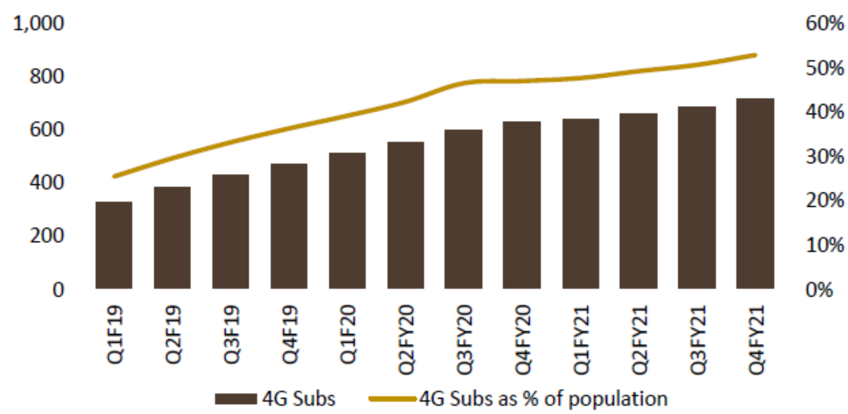
A lengthy period of heavy investment in data infrastructure culminated a few years ago, and has also helped usher in the accelerating growth of India's tech sector. As shown below, there is more room for this trend to expand, as penetration of 4G remains low in India relative to other countries, despite 4G subscribers having doubled over the last three years (Exhibits 11-12).

Exhibit 11. India's 4G Penetration is Low



Source: Company data, news reports, TRAI, ITU data, UBS

Exhibit 12. India's 4G Subscriber Growth

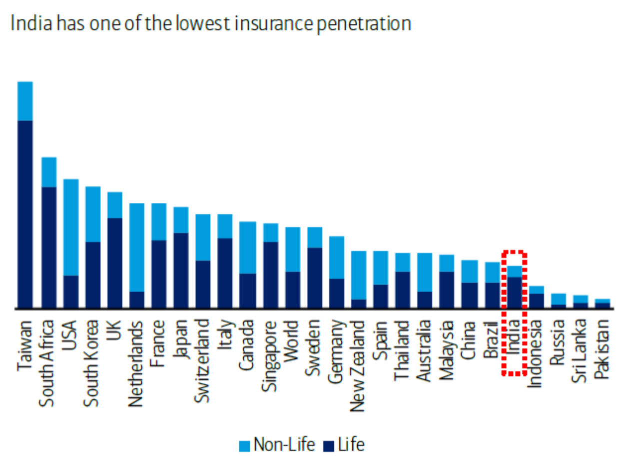


Source: TRAI, UBS

Insurtech platforms, one of which is owned by an Indian technology company held in the strategy, represent an example of the type of business that is benefiting from improved connectivity and data usage in the country. Through these platforms, customers can easily compare products from multiple insurers at the same time and purchase one in less than ten minutes.

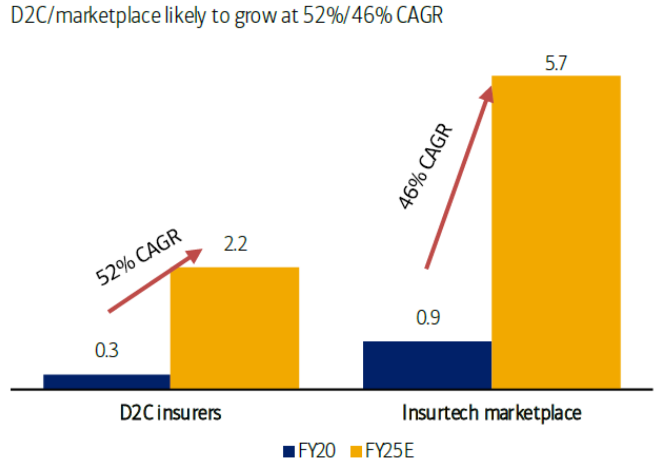
The low penetration of insurance in India is partly a function of the high degree of paperwork necessary to purchase a policy (Exhibit 13). Digitization will help speed up and simplify the process, leading to significant growth in the industry (Exhibit 14). Digital insurers do not have physical sales offices and tend to have small sales forces, lowering their total operational costs. Companies pass on these cost savings to customers in the form of lower premiums relative to traditional players. The digital insurer that comprises a segment of the technology company owned within the strategy is the leading player in the industry in India with 50% market share and has been growing at a 100% compound annual growth rate.

Exhibit 13. India's Insurance Penetration is Low



Source: IRDAI, BoA Global Research

Exhibit 14. India's Insurtech Market Expanding Rapidly

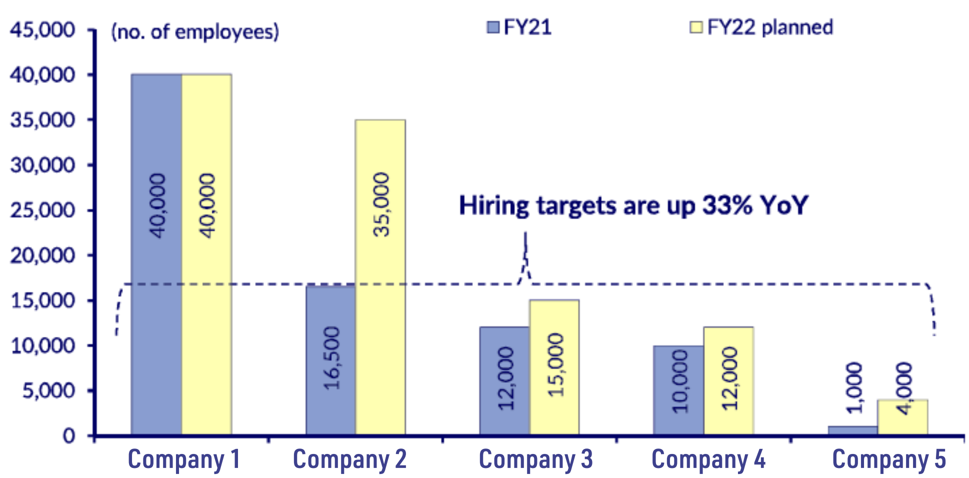


Source: Redseer, BoA Global Research estimates

The impact of India's tech boom is not just confined to a single sector, but rather is proliferating throughout the economy. The top five Indian IT companies plan to increase their hiring by a collective 33% in the next 12 months (Exhibit 15). This has led to a housing boom in Bangalore, the primary IT hub in the country, as some 50% of demand is driven by employees of the IT industry (Exhibit 16).

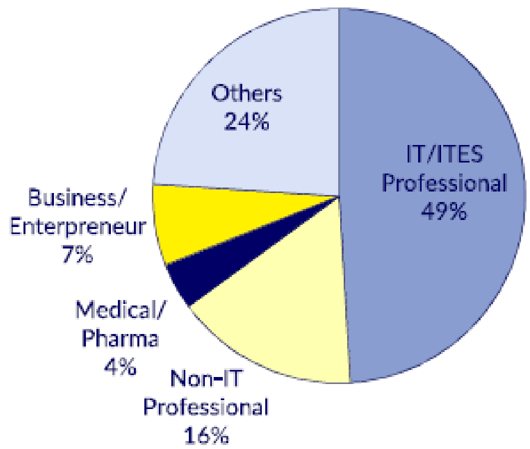
The strategy owns two Indian property developers as well as a cement company, which recently posted historically high sales volume and is running at 90% capacity utilization. Inevitably, such high levels of demand growth and utilization will spur capacity additions, creating a better backdrop for private sector capex, which has lagged for many years in India.

Exhibit 15. Hiring Targets for Top Five Indian IT Companies



Source: Companies' data

Exhibit 16. Bangalore Property Market Breakdown

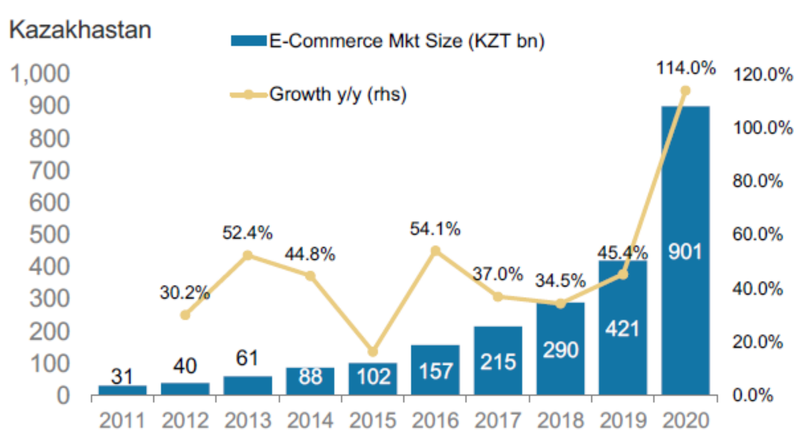


Source: Sobha

In past commentaries, we have consistently emphasized the broad trend of innovation in emerging markets. As the above charts show, there is a strong backdrop for innovation across a number of countries in Asia. However, by no means is this trend confined to just one region within EM. One of the strategy's strongest stocks year-to-date has been a fintech/e-commerce company based in Kazakhstan. The company maintains a dominant payments platform within the country, as well as 40% market share of e-commerce transactions, most of which occur through the company's Super App, which had over 1.5x more downloads than the second most popular app in Kazahkstan in 2020.

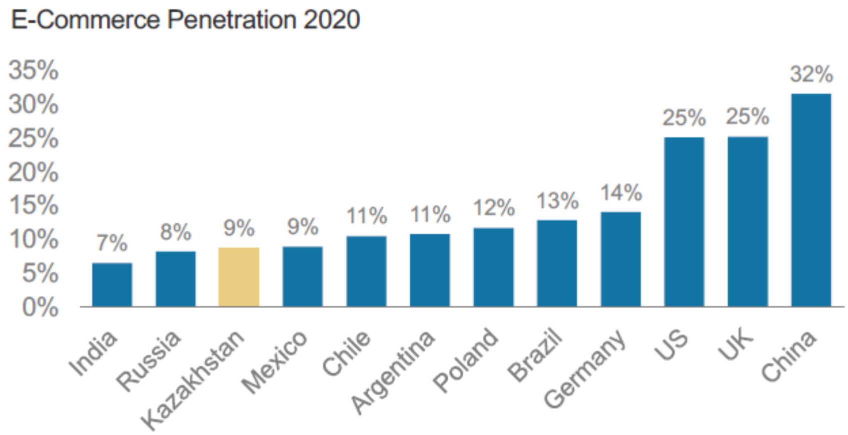
E-commerce in Kazakhstan has been growing by 55% per year over the last five years, yet remains underpenetrated at only 9% (Exhibits 17-18). This is below other EM countries such as Brazil (12%) and more developed markets in terms of e-commerce, such as the US and China (25-32%). Given high internet penetration of 89% in Kazakhstan as of 2020, the backdrop remains strong for e-commerce in the country.

Exhibit 17. E-Commerce Growth in Kazakhstan



Source: Euromonitor, Morgan Stanley Research

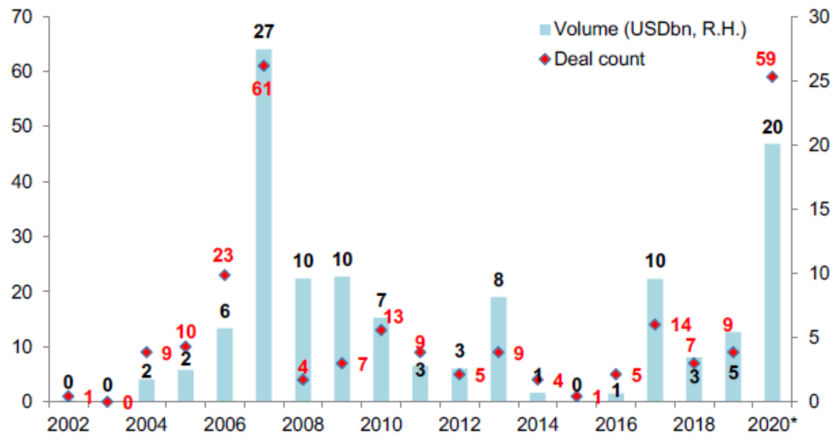
Exhibit 18. E-Commerce Penetration in Kazakhstan



Source: Euromonitor, Morgan Stanley Research

Turning to Latin America, Brazil has been amid an IPO boom over the last year (Exhibit 19). While the makeup of the Brazilian equity index has historically been largely concentrated in banks and commodity producers, the rapid changes in the composition of the equity market have opened up a new opportunity set for investors.

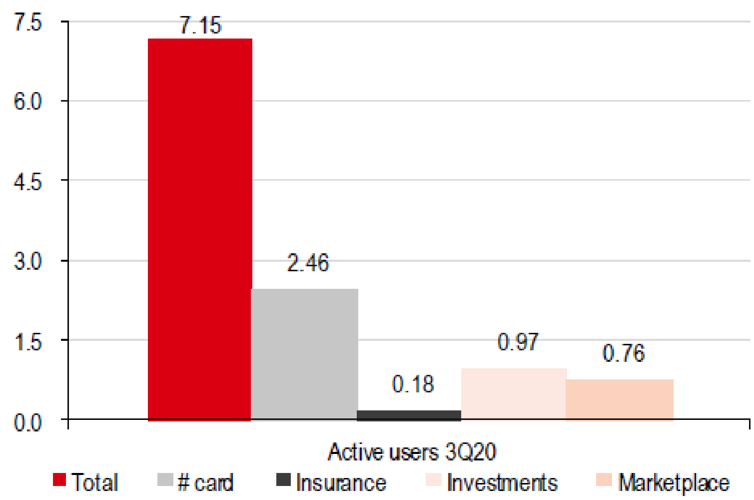
Exhibit 19. Brazil IPO Deal Count and Volume



Source: CVM, Bloomberg, company data and Morgan Stanley Research
Note: 2020 forward deal volume is an estimate based on year-to-date average deal size

One of our holdings in Brazil operates a digital bank. Brazil has a young population with 62% below the age of 29, while also ranking in the top 3 for users of virtually every major global social media platform. Meanwhile, the incumbent Brazilian banks generate roughly 30% of their total revenues from fee income, a sizable amount. This has led to digital banks offering free or cheaper solutions like digital checking accounts, debit and credit cards, bank transfers, and bill payments. The banking sector in Brazil is highly concentrated with the top five banks accounting for more than 80% of total loans. In other words, this is a sector that is primed for disruption. Nearly 40% of Brazilians are unbanked, and the digital bank owned by the strategy has gained over 13 million customers in a matter of a few years, yet is still only scratching the surface of its potential (Exhibit 20).

Exhibit 20. Low Penetration Across Major Segments of Brazilian Digital Bank

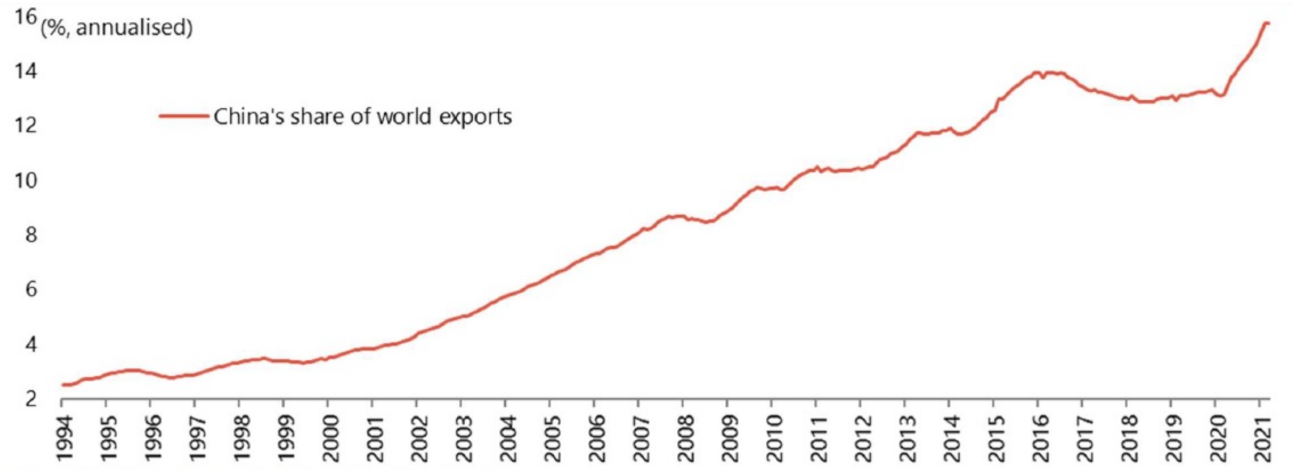


Source: Company data, HSBC

Lastly, we leave you with a chart that may be surprising in the context of the geopolitical tensions between the US and China, as well as demographic changes and supply chain shifts that have occurred in recent years. As shown below, China's share of world exports saw only a modest decline following the US election of Donald Trump in 2016, and has subsequently increased to new all-time highs (Exhibit 21).

This was supported by the shift in global consumption baskets from services to goods during the pandemic, but also reflects China's ongoing efforts to move higher value manufacturing. In 2020, China accounted for 32% of global manufacturing value added. While lower end manufacturing has indeed shifted to neighboring countries over the last decade, the notion of supplanting China's position as a manufacturing leader appears unlikely. The common expression from firms that are focused on supply chain diversification is "China +1," reflecting a desire to complement, not replace China.

Exhibit 21. China's Share of Annualized World Exports



Source: IMF – Direction of Trade Statistics, Datastream

As this year's summer chartpack shows, we are excited about the opportunity set across small caps within emerging markets. We are encouraged by recent performance trends of the asset class and continue to find many interesting growth stocks across a number of countries and sectors.

Until next month,

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