Barings Emerging EMEA Opportunities

BEMO has had a strong year, and offers multiple layers of value...

Update
16 May 2024

Overview

Barings Emerging EMEA Opportunities (BEMO) is the largest investment trust focussed on the diverse and uncorrelated EMEA universe . These countries figure only lightly in the broad emerging market indices and funds, yet have high growth potential with idiosyncratic drivers that could improve risk-adjusted returns on many portfolios.

Managers Matthias Siller and Adnan El-Araby have built a portfolio which maintains a large exposure towards the Gulf countries of Saudi Arabia, the UAE, Qatar, and Kuwait. The region is undergoing an exciting economic revolution as its rulers seek to prepare their countries for a global reduction in demand for fossil fuels, using their vast sovereign wealth to invest in education and infrastructure and foster the development of other sectors and industries. Other key themes in the **Portfolio** include the recovery story in Turkey, which has seen its markets soar in early 2024, and the growth of manufacturing in Eastern Europe as companies "near-shore" operations.

BEMO has delivered a strong year of **Performance**, with contributions coming from stock picks in Turkey, Saudi Arabia, and among Eastern European banks. Matthias and Adnan aim to offer broad exposure to the varied growth drivers in the region whilst adding alpha through stock selection rather than major macro calls. Performance was also helped by the trust managing to realise value in three of its Russian holdings, which had been written down to zero in the NAV after the imposition of sanctions. The remaining holdings bring major upside potential but no further downside.

BEMO's shares trade at a 22% discount at the time of writing. Yet there is a performance-related tender offer due at the end of 2025, and the board have said they will consider all options in the interim, raising the possibility of the value in the discount being realised.

The historical yield of 3.1% means the trust offers diversification potential to income investors as well as growth investors.

The trust's website address is www.bemoplc.com and investors can receive updates directly from the manager by signing up at www.bemoplc.com/preferencecentre.

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Analyst's View

After a strong year for developed market equities, thoughts are likely turning to consider where is next. BEMO offers exposure to a number of growth trends which are not directly correlated to US interest rates, developed world inflation, or China's GDP growth, the key factors driving markets over the past year, and as such we think offers an interesting diversification opportunity. As the West decouples from China economically, many of the countries in the EMEA universe are beneficiaries, including the Eastern European countries which are seeing rising international investment. Meanwhile, Saudi Arabia and the Gulf states are undergoing radical economic reform, a non-cyclical trend which should see investment and economic activity grow in certain areas irrespective of global GDP growth. These are just two of the uncorrelated growth drivers which we think could deliver attractive returns over the medium term.

These countries are not without risk, of course, and political instability in Turkey, the Middle East, and South Africa all have to be borne in mind. However, BEMO's shares trade at a wide discount of 22% to NAV. On top of this, the team estimate there is a further discount of c. 20% in the declared NAV when considering the Russian holdings, should they become saleable once more. A tender offer in 2025 is one way some of the value could be unlocked in this discount, although it may see the value in the Russian holdings foregone. With the board aware of the small size of the trust and considering its options if the conditions for a tender offer are met, a full continuation vote may end up being on the table too. In our view, BEMO is a highly attractive NAV story with the potential for shareholders to achieve attractive returns if the NAV does well, or even if the NAV does not.

BULL
Offers attractive diversification to the typical exposure of a global or global emerging markets trust
Has devoted considerable resources to the trust's under-researched markets
Can invest in both fossil fuels and materials with a role to play in the green energy revolution

BEAR
Political and liquidity risks can be higher in the smaller emerging markets
High materials and energy exposure could make the trust vulnerable to a global recession
The small size of the trust may deter professional investors

Portfolio

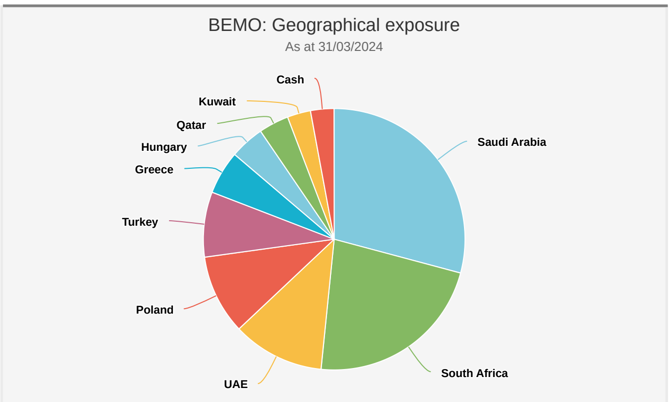
Barings EMEA Opportunities (BEMO) is the largest investment trust focussing exclusively on the Emerging EMEA universe; this is a diverse collection of countries across Eastern Europe (including Turkey), the Middle East, and Africa. It is a little-owned region within mainstream emerging markets funds, with a number of exciting markets with differentiated growth opportunities.

Managers Matthias Siller and Adnan El-Araby are a market-leading team in this niche and take a growth-at-a-reasonable-price (GARP) approach to selecting stocks which means they look first for companies which have high and sustainable earnings growth potential. They then assess a fair price for a company based on a five-year earnings forecast and an appropriate discount rate.

The approach places emphasis on proprietary research, aiming for the majority of alpha to be derived from stock selection, although clearly macroeconomic analysis is a critical input given the diversity of the universe and its exposure to global economic currents. Stock selection uses a consistent analytical framework with a scorecard approach, awarding companies ratings of one to five on metrics across growth, quality, and valuation aimed at determining relative attractiveness across sectors and countries. Matthias has managed the trust since 2008, using a consistent approach, now applied to a different universe. Adnan joined him as co-manager in 2018.

The objective is to offer exposure to the broad set of growth drivers across various countries whilst adding alpha through stock selection. The key countries in the portfolio and the benchmark are Saudi Arabia and South Africa, which account for half the current holdings by weight but only 7% of the MSCI Emerging Markets Index. The other Gulf states and Turkey are important allocations, whilst the portfolio has exposure to Greece, Poland, and Hungary in Europe.

Fig.1: Largest Country Weights



Source: Morningstar

This is a disparate group of countries, but what unites them is the growth potential, and importantly the diverse set of factors behind this potential. These are largely endogenous drivers, and so the markets of these regions offer the potential to deliver returns uncorrelated to US inflation and interest rate expectations, the AI boom, or the health of the Chinese economy, which have been the main factors dominating equities' performance in the recent past.

Saudi Arabia and the Gulf states have huge wealth thanks to their petrochemical industries, and this wealth is being invested to develop the rest of the economy as the world attempts to wean itself off fossil fuels. Matthias and Adnan have been looking for companies that are less directly exposed to the volatility and cyclicality of the oil price. They have an overweight position in the largest company in the MSCI EM EMEA Index benchmark, Al Rajhi Bank (of Saudi Arabia), as well as an overweight to Saudi National Bank. They find these banks to be increasingly well-managed, and able to provide a steadier long-term earnings profile as the economy diversifies . They also own Saudi Basic Industries, a chemicals manufacturer majority-owned by Saudi Aramco, the world's largest energy company. Benefitting from lower-cost feedstock from its parent, it has a lower-cost base and can expand its profitability when oil prices move higher, earning it a greater spread. In Saudi Arabia, they also have an overweight to Saudi Telecom, which as well as mobile telephony services, operates in the cloud computing, online payments, and fintech spaces amongst others. BEMO also owns a position in Tadawul, the Saudi Stock Exchange, benefitting from the opening up of the market to domestic and international investors.

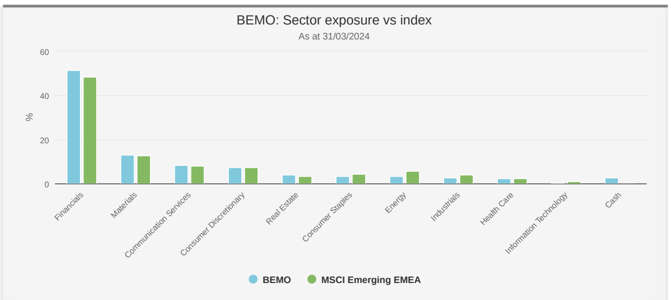
Top Ten Holdings

HOLDING	%
Al Rajhi Bank	6.7
Naspers	5.0
Powszechna Kasa Oszczednosci Bank Polski	3.8
National Commercial Bank	3.8
Saudi Basic Industries	3.6
Capitec Bank	3.1
FirstRand	3.1
Qatar National Bank	3.1
Saudi Telecom	3.0
OTP Bank	2.6
TOTAL	**37.8**

Source: BEMO, as at 31/03/2024

Banks feature heavily for exposure to the rest of the Gulf region and contribute to the 51% weight to financials as of the end of March (versus a c. 48% benchmark allocation). The managers note that a highly concentrated financial sector in EMEA contributes to a very sticky retail and corporate deposit landscape. Additionally, banks have a key role in driving growth by issuing credit, and as such should be fairly direct beneficiaries of high GDP rates across the region.

Fig.2: Sector Allocations



Source: BEMO, MSCI

Also in the Gulf, and bringing some less cyclical exposure to the oil and gas industry, is ADNOC Drilling, an off-benchmark UAE company whose revenue line is not dependent on the oil and gas prices but clear growth in production, where the business is the sole drilling company for the state. It is majority-owned by the state-owned ADNOC oil producer. In general, the managers have a very positive outlook on the region, with its economic growth supported by healthy demographics, and some stability provided by dollar-pegged currencies. Political risk is high across the EMEA region at present, and in the case of the Gulf states, the potential for the broadening of the conflict in Gaza has to be borne in mind. However, in our view over the medium to long term, the rapid development of Saudi Arabia, whose markets only opened up enough to be included in MSCI Indices as late as 2019, is a highly attractive secular growth story that investors are unlikely to have much exposure to via a broad emerging markets fund.

A very different story, but arguably one which also has the potential to deliver strong stock market returns, is the nascent recovery in Turkey, a major overweight for BEMO. Turkey has seen its currency collapse in recent years as inflation escaped control. President Erdogan's unconventional monetary policy exacerbated the effect of a large current account deficit and high foreign currency-denominated debt. However, Matthias and Adnan think a corner may have been turned. Recent local elections were a clear note of support for the more orthodox monetary policy of the current central bank, which has hiked interest rates to 50% to get inflation under control. This has seen overseas investors get increasingly interested from a low base, and the MSCI Turkey Index is up c. 31% in sterling in 2024 at the time of writing (c. 43% in local currency). The managers think there are legs to this rally, although they acknowledge that there will come a test of resolve when these high interest rates do slow the economy.

One Turkish company of conviction in the portfolio is Koç Holdings. This is a local conglomerate which includes automobile manufacturer Ford Otosan, which is Europe's largest producer of commercial vehicles. Matthias and Adnan note that this company is well positioned and builds units agnostic of what type of motor is utilised so that changing demand for electric vehicles and traditional cars is not damaging to it. It is also a beneficiary of the US/China trade tensions which have seen the decoupling of China from Western economies and tariff regimes.

In fact, Turkey has a privileged place in the new world order. It is, along with a number of countries like Mexico, Indonesia, and Vietnam, well positioned geographically, and able to export finished goods to the US and Europe . Eastern Europe is another beneficiary of this trend, with the banks seeing loan book expansion as companies invest in manufacturing away from China and within the European/US orbit. Matthias notes this can be seen in the good performance of the currencies, with Poland, Hungary, and the Czech Republic all amongst the beneficiaries. This region has a highly educated workforce which is significantly cheaper than Western Europe, making it attractive for foreign investment. Polish and Hungarian banks feature in the top ten holdings as of the end of March, both significant overweights versus the benchmark.

When it comes to South Africa, the managers are more cautious about its outlook. The country's economy has struggled, with high unemployment and blackouts amongst the issues. Upcoming elections are likely to lead to some controversy with the ANC likely to lose its majority for the first time since the end of apartheid, indicating how deep the dissatisfaction has gone. Matthias and Adnan are highly selective with their picks in the country. In particular, they like Naspers for its discounted exposure to Tencent, of which it is a major shareholder, FirstRand bank, which they view as relatively well-governed, and Capitec, the country's largest digital bank. The managers view exposure here as having a high degree of optionality: the news has been so bad, and the market so weak, that any improvement in the situation could see a significant rerating of the market. It would have to be an endogenous development driving this rerating given the weights on sentiment are from home. As such, this is another very different potential driver of returns and another source of the low correlation across the portfolio's holdings. In the meantime, South Africa is rich in minerals and metals, in particular the platinum group metals (PGMs). As such, the country brings some exposure to the energy transition. Whilst electric vehicles remain a practical solution for the passenger auto industry to decarbonise, larger, more commercial vehicles, such as trucks, require greater power to support the weight of the vehicle and the distances they travel. This makes hydrogen fuel cells an important piece of the net zero emissions puzzle. Here PGMs play a crucial part, often used as a catalyst, conducting electricity, and crucially, ensuring the cell remains stable.

Finally, it's worth noting that an even more extreme optionality exists in the Russian holdings. BEMO had around 28% invested in Russia prior to its invasion of Ukraine. Only some of this was sold down before sanctions meaning the trust was forced to write the remainder down to zero. However, the trust remains the legal owner of these positions, and should they become tradable again they could deliver significant returns. The managers have been able to offload three of these positions within the sanctions regime, in both cases delivering significant bumps to NAV (see **Performance**). There is the potential for entirely uncorrelated returns to come from other such opportunities, particularly in the case of any peace deal. On the other hand, as they are valued at zero there is no further downside at all.

Gearing

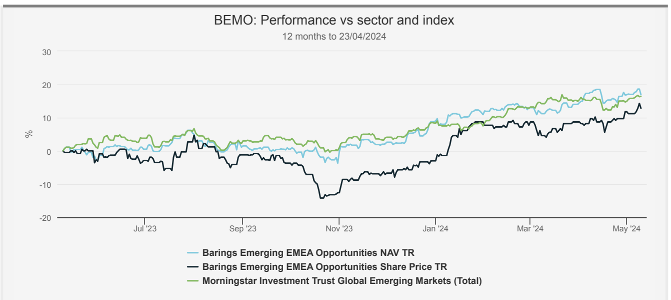
BEMO is currently ungeared, having repaid a loan facility when it was up for renewal in 2020. Since then, the board and managers have been wary of the heightened volatility in markets and therefore not geared up again – this was shown to have been the right decision in 2022. The managers do not currently have any loan facilities in place, but the board has stated that they may consider using gearing again in future, but only when "they have a high degree of confidence that gearing would add significant value to the portfolio." We note that high interest rates have to be taken into consideration as it makes it necessary to earn a higher return to offset the cost of debt.

Performance

BEMO has delivered a strong year of performance, beating the returns of its own benchmark, the MSCI EM EMEA Index, and broader emerging market benchmarks. The trust's NAV total return over 12 months is 16.9% at the time of writing, compared to just 10.1% for the MSCI EM EMEA Index. This followed a very difficult 2022 when the managers were blindsided by the Russian invasion of Ukraine. Key contributing factors to returns have included alpha from the trust's Turkish holdings, which have benefitted in a strong market rally in Turkey. The trust has also been able to realise some of the value in its Russian holdings which had been written down to zero. In December 2023, it took part in a tender offer of Russian retailer Magnit, exiting its position, whilst in January it was able to sell its holdings in Russian retailer X5 and TCS. Both cases provided significant uplifts to NAV.

When we met recently with Matthias and Adnan, they cited good returns from central European financials and their Turkish stock picks as key factors behind driving alpha. Turkish stocks have done particularly well since the start of 2024; in the managers' view, the market is increasingly pricing in a return-to-monetary orthodoxy. To a large extent, this means aiming to get inflation under control, and so the decisive action by the central bank to hike rates to 50% has been rewarded. Recent local election results have been read as a message to President Erdogan to take inflation seriously, and Matthias and Adnan remain positive on the outlook for the country's markets, noting that international investors are raising their allocations from a very low base. Of the other major contributing factors, central European countries saw an improving economic outlook, and there was a strong 2023 tourism season in Greece. Overall, a diverse set of drivers have been behind the trust's strongest performers, a testament to the uncorrelated countries and regions of investment.

Fig.3: One-Year Performance

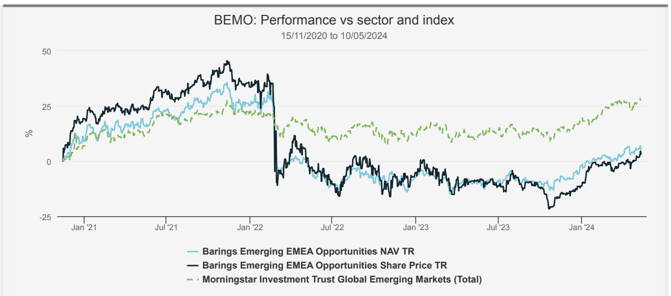


Source: Morningstar

Past performance is not a reliable indicator of future results.

Looking back further, prior to the war in Ukraine, Russia made up 22% of the MSCI Emerging EMEA benchmark and 28% of the trust's portfolio. BEMO generated strong absolute performance before the Russian invasion of Ukraine and outperformed its benchmark. However, the regional benchmark fell considerably when war broke out, and Russian stocks were shortly written down to zero. This impacted BEMO in relative terms too, as it was overweight the country, and so long-term returns have been dominated by this influence. However, it is promising to see that the trust has all but made back the losses in this period with strong recent performance. Under the current strategy, which has been in place since November 2020, NAV total returns to 23/04/2024 have been 5.2% versus 7.1% for the index.

Fig.4: Performance Since Change In Strategy



Source: Morningstar

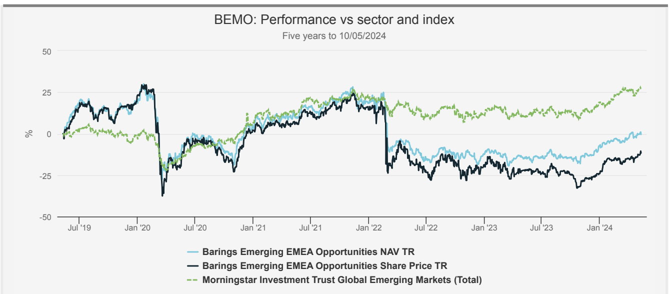
Past performance is not a reliable indicator of future results.

It's worth noting that the remaining Russian holdings are still in the portfolio, valued at zero, with no management fees charged on them. As such, if the manager is able to realise value in them, they are a free option which could drive relative returns from here. The recent sale of the Magnit, X5, and TCS transactions shows how this might be done within the current sanctions regime. The managers remain vigilant to other opportunities and recognise that there remains value to be gained were all the Russian holdings to be successfully realised, although this clearly depends on military, political, and sanctions developments.

As for the current portfolio, in our view, it contains an attractively uncorrelated set of opportunities. The drivers behind emerging Europe, Turkey, the Middle East, and Africa are different in each case, and mostly the regions look to be in recovery mode, suggesting the potential for good near-term returns. South Africa remains the most troubled major county in the portfolio, but Matthias and Adnan view it as likely having troughed out and have only selective exposure, guarding against the risks. With major developed markets having seen strong returns over the past year, we think there is catch-up potential in these markets and the opportunity to improve risk-adjusted returns with low correlation. Over the last three years (so excluding the effect of the removal of Russia from indices), the MSCI EM EMEA Index has a correlation of just 0.48 to the MSCI Emerging Markets Index and 0.45 to the MSCI World Index of developed markets.

For completeness sake, we show below that over the last five years (to 23/04/2024) BEMO's NAV total return was -0.5%, according to Morningstar and the MSCI EM EMEA Index is down 1.5% with the average emerging markets trust up 27.4%. However, BEMO's returns over the period represent the results from two differing strategies.

Fig.5: Five-Year Performance



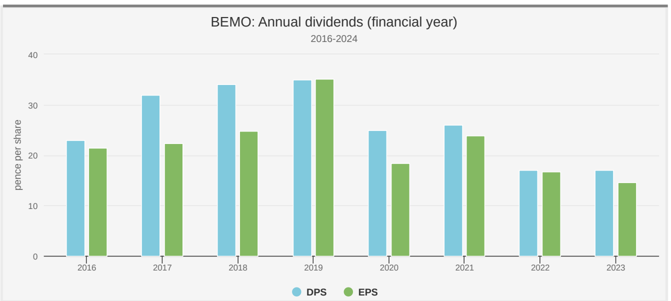
Source: Morningstar

Past performance is not a reliable indicator of future results.

Dividend

Capital growth is the key objective of the trust, but BEMO has paid an attractive dividend for many years. It is currently supported by the ability of the board to pay out up to 1% of NAV from capital reserves each year. Reserves have been used for the last four years to partially offset the decline in portfolio income from the pandemic, and then more significantly from the sanctions placed on Russian assets post-Ukraine invasion. In 2023, the dividend was held at 17p, with portfolio income at 14.59p. This equates to a historical yield of 3.1% at the time of writing. For income investors, diversification is an important risk mitigation, and we think BEMO could play a role in that regard, given that its underlying markets have little representation in global benchmarks. Looking ahead, Matthias and Adnan are confident that their portfolio will be able to deliver sustainable income growth. By looking for quality companies with strong financial positions and regard for minority shareholders, they expect to build a platform for dividend growth. In addition to the ability to pay a limited amount from capital reserves, BEMO also has revenue reserves worth around 0.94 times the 2023 dividends.

Fig.6: Dividends Per Share



Source: BEMO

Management

BEMO is managed by Matthias Siller and Adnan El-Araby. Matthias is head of the EMEA Equities team and has managed the trust since 2008. Adnan joined him officially as a co-manager in March 2018 but has been a member of the EMEA team, working with Matthias, since 2010. Matthias has run EMEA portfolios since 2001, having previously worked as a market maker and prop trader in Central and Eastern European equities in Austria; as such, he has more than two decades of experience in the region. Adnan joined Barings from Legg Mason in 2010 and focusses on resources, healthcare, technology, and automobiles across the EMEA region.

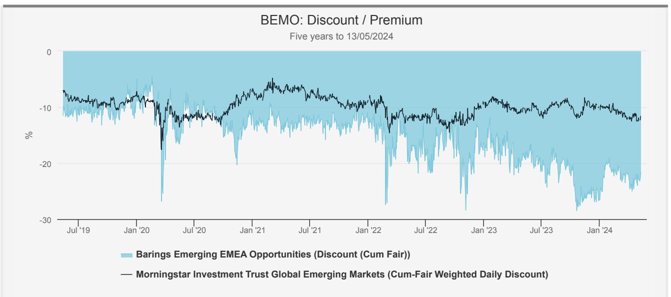
In total, the EMEA team is comprised of five members, three of whom have responsibilities for researching stocks across both emerging and frontier markets. The other team members are involved in investment decision-making and have broader management oversight. These include Ghadir Cooper, global head of equities, and Michael Levy, co-head of the global emerging market team (with responsibility for EMEA and Latin America). The EMEA desk manages approximately $1.6bn of assets across

EMEA and covers over 170 companies that fit the criteria for potential inclusion in the portfolio. The managers can also call on the research of the broader global equities platform, made up of over 450 professionals. This includes sector specialists who can bring a broad perspective to companies in the index, and their work has already been instrumental in seeing companies like Anglo American find their way into the portfolio.

Discount

BEMO is a growth proposition, offering the potential for outsized returns by investing in often-overlooked markets. As such, it is no surprise that the discount drifted out over 2023 when investors were increasingly risk-averse in the light of high interest rates and fears of a potential recession. In Q4 2023, the mood shifted as it became apparent a peak in rates in the US and UK had most likely been hit, and the direction of travel was down. Economic news also seemed better than feared. We think this contributed to BEMO's discount narrowing in the last two months of the year. Then, in December and January, the company announced it had sold three Russian assets, and this led to a sharper narrowing of the discount. Rate cut expectations have moderated since, and BEMO's discount has drifted out slightly again to 22% at the time of writing. However, we think there is clear potential for the discount to narrow when risk appetite increases, and/or there is positive company-specific news.

Fig.7: Discount



Source: Morningstar

Over the longer term, the board has stated it will make a tender for up to 25% of the shares if either of the following two conditions are not met:

1. the average cum-income daily discount to NAV exceeds 12% over the five years to 30 September 2025

2. the NAV total return performance does not exceed the return on the benchmark by 50 basis points per annum over the five years to 30 September 2025.

At the time of writing, the discount has averaged 17% over the period and the trust is c. 2.6% behind the benchmark, so both conditions are in play. The board noted in the 2023 annual report that given what has happened since these conditions were set (notably the Russian invasion of Ukraine which led to Russian assets being written down), it thinks there is a strong likelihood the targets will be missed. As net assets are relatively small, at c. £83m, the take-up of the tender could call the viability of the strategy into question, and so the board states it will consider its options as the target date nears and may offer other strategic options instead of the tender, which we would expect to mean considering a full wind-up or a rollover into an open-ended fund amongst other possibilities. We note though, that relative performance has significantly improved since the end of September 2023, and the trust has been able to realise some value from some of its Russian holdings, so the performance target looks much more in reach. Either way, we think the discount makes the shares look attractive for investors with a time horizon of at least 18 months.

The board has the ability to use buybacks and has stated it will do so with the aim of containing discount volatility and providing liquidity to the market. During each of the 2022 and 2023 financial years, c. 1% of the shares in issue were repurchased. The board observes that whilst it aims to contain discount volatility, the effectiveness of buybacks is reduced in periods of elevated market volatility. We note they also shrink the market capitalisation and therefore increase costs per share.

Charges

BEMO's latest ongoing charges figure (OCF) is 1.59%. This compares to a global emerging markets sector average of 1.04%, according to the AIC. The higher costs reflect BEMO's small size relative to peers which increases the impact of fixed costs as a percentage of NAV. On the other hand, the trust is a specialist product, offering rare, expert access to a region that is varied geographically and thematically, and therefore arguably higher costs should be expected. The management fee is 0.75% of NAV, at the lower end of the range in the sector. The latest KID RIY is 2.04%, compared to a sector average of 1.46%, according to JPMorgan Cazenove.

ESG

ESG analysis is integrated into the stock selection process. All companies under coverage are assessed on a comprehensive set of ESG considerations and assigned a rating on each of them. These form a final company rating which affects the required return for investment. The worse the rating, the higher return hurdle has to be met for an investment to be made. Barings has also introduced a Carbon Cost assessment for relevant companies they anticipate will be impacted by costs associated with reducing greenhouse gas emissions. This can affect the required return in the same way.

ESG issues can also influence the assessment of the quality of a company. Analysis focusses on identifying the direction of travel, with companies rated on improvements or deterioration in three key themes: the sustainability of the business model, the quality of the management, and the hidden risks on the balance sheet. The team feels this approach is highly complementary as ESG analysis unearths risks not apparent from traditional analysis, serving to anticipate capex or litigation risks not captured within standard analysis.

A key pillar of the approach is to be forward-looking. As such, the team is looking for companies that are improving, rather than taking a static snapshot of historical data. Additionally, active engagement is preferred over exclusion, and the team will look to drive improvement through dialogue with companies. All members of Barings' EMEA investment team meet with management teams, visit operational facilities and analyse industry competitors to gain an insight into the company's business model and sustainable competitive advantage. Matthias and Adnan use their own ESG assessments rather than relying on the assessments of third parties, preferring to rely on proprietary analysis. That said, Morningstar has awarded the trust two out of five globes for sustainability.

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