INVESTLOGIC
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Nurturing Undiscovered Companies

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Emerging economies can tend to have higher growth rates and can be more dynamic than more mature, developed markets. As such, they often contain a higher proportion of smaller, faster-growing businesses. We believe there's a potential wealth of untapped opportunities among these small- to medium-sized companies, often at the expansion or pre-initial public offering (IPO) phase, before they make their way onto the listed stage as publicly traded entities. As long-term emerging markets investors, we see this pool of smaller (often private) companies as fishing waters in our hunt for often undiscovered opportunities we think could have potential, with a little nurturing.

Not All Equity is the Same

Private equity has played an important role in emerging markets, particularly during periods of economic crisis. When traditional sources of funding (such as bank loans) dry up, private investors may step in to keep a cash-starved company afloat. In our view, many of these companies are well-run enterprises providing much needed goods and services. They just need a helping hand, which can be an infusion of cash or sometimes, just help getting noticed. A company's potential may not be fully realized simply because it is unknown in the financial community.

The use of private investment in public equity, or "PIPE" investments is more common in emerging markets (particularly India) than in developed countries. Often the free floats (shares readily available for trading to the public) and stock market turnover of smaller listed companies are less significant, making it difficult to accumulate substantial positions through public markets. For example, in India, out of approximately 5,000 listed businesses on the country's two main stock exchanges, as few as 300 achieve monthly stock turnover above US$1 million, and together represent about 85% of the overall market capitalization.[1] In these circumstances, PIPE investments can provide an attractive way for a small- and medium-sized—yet growing—company to obtain exposure to capital.

Opportunities in Small and Growing Companies

In our opinion, one of the positive aspects of investing in small and growing companies and having the opportunity to become a shareholder at the board level is that it can afford us greater possible influence on company decisions and behavior, particularly when things seem to be moving in the wrong direction. Working with management is key. From this close proximity, we are often able to obtain a greater depth of knowledge and understanding about a company, putting us in a better position to potentially effect positive change for future shareholders, too. This is part of our overall investment philosophy at Templeton Emerging Markets Group, no matter where or how we invest. We've always tried to be "activist" managers. We often attend shareholder meetings, we vote on crucial decisions, and when we don't like something we see going on with a company (particularly related to corporate governance issues), we aren't afraid to speak up about it.

In our team's view, some of the most interesting opportunities to invest in small and growing companies that may be off the radar are currently in China, Southeast Asia (particularly Vietnam) and Brazil. Broadly speaking, consumer-related industries and those in healthcare, industrials and light infrastructure can present particularly attractive opportunities at this time. However, as with any investment, we do our due diligence on a company-by-company and country-by-country basis. Individual investment opportunities depend largely on the level of development within countries, and the industries on which economic development is centered. For example, Brazil's current focus is heavy on the construction of new roads and transport links, whereas in India we are seeing rapid expansion of the healthcare and pharmaceuticals industries. Meanwhile, in Indonesia, there is a fast-growing consumer population.

Risky Business

Small- and mid-sized company stocks can be volatile, especially over the short term. Smaller or relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. When it comes to smaller and growing emerging market companies, the main risks we think are important to watch out for are exit liquidity risk, corporate governance issues, and political and foreign exchange risks, as well as economic and political risks that generally apply to all types of investments.

Some of these risks can be mitigated. For example, in the capital market arena, improving shareholder protection has helped soften the risks relative to developed markets, but there is still work to be done. In order to reduce corporate governance risk, it's crucial to conduct thorough due diligence on the company and management team prior to investment, which is true no matter which stage of development a company is in. We have found that foreign exchange risk can potentially be mitigated by targeting either export- or import-focused companies to help counter depreciation or appreciation of local currency.

By investing in small and developing companies, we believe we gain valuable insights into the industries, sectors, and business climate at large that can apply to other companies operating in a particular country or market as well. And, though it's not the kind of return you'll see in an annual report, watching some of these companies we've worked with make their way to the stock tickers is certainly its own reward.

1. Source: Bloomberg LLC, December 2012.