MONEY MANAGER INTERVIEW

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Identifying High-Quality Growth Companies in Emerging Markets

ERIC CHENOWETH is Co-Portfolio Manager of the Scout Emerging Markets Equity strategy, including the Scout Emerging Markets Fund, at Scout Investments, Inc. Prior to joining the firm in 2011, he was the Director of Global Energy Equity Research for Morningstar, Inc., in Chicago. He has 16 years of financial industry experience. Mr. Chenoweth earned his MBA with a concentration in accounting and finance from the Booth School of Business at the University of Chicago and Bachelor of Arts degrees in mathematics and economics from the University of Chicago. He is a CFA charterholder and a member of the CFA Society Kansas City, as well as the CFA Institute.

SECTOR — GENERAL INVESTING

TWST: Could you tell me your name, your role at the firm and the firm’s name?

Mr. Chenoweth: My name is Eric Chenoweth. I am a Co-Portfolio Manager on the Scout Emerging Markets Fund. Scout Investments is a $27 billion investment management company that runs both equity and fixed income strategies.

TWST: Does the strategy you work on have a unique philosophy?

Mr. Chenoweth: Yes. My partner, Mark Weber, and I designed the strategy to be focused on investing in high-quality growth companies in the emerging markets. It’s an investment philosophy we thought was underrepresented in emerging markets, although it might be a more prevalent strategy in the developed markets. And when we say quality, it means something very specific to both Mark and I. We think a quality business can reinvest in itself, in its own operations at high incremental returns on capital for a long period of time.

We both took economics courses, and we know that when companies generate high returns on capital, it tends to generate competition for that business. That’s why identifying a competitive advantage is so important. It allows the company to continue to invest at high returns for a very long period of time. We believe long-term, high-return growth protected by a wide moat is a very rare combination of attributes for a company to possess. We identify, out of 32,000-plus emerging and frontier companies that we consider, the 100 or fewer companies that best represent these qualities. We use that list as our investable universe.

TWST: So how would you define an emerging-market company?

Mr. Chenoweth: We would define an emerging-market company as either one domiciled in an emerging-markets country or one domiciled in a developed-market country that gets more than half of its revenue from the emerging markets. And even within the emerging markets, we focus our attention on the companies doing business in emerging markets as opposed to those exporting to the developed world. I think that’s another important distinction between our strategy and many of our peers.

TWST: Your definition of emerging markets wouldn’t be limited to companies that are located in emerging economies, in other words?

Mr. Chenoweth: Precisely.

TWST: Could you maybe give me an example of a company you find interesting?

Mr. Chenoweth: One company that meets our strict criteria is a Russian retailer called Magnit (MCX:MGNT). It’s a company that will have over 14,000 stores by the end of this year. That’s about 2,000 stores from last year. So they’ve been building out stores at a very rapid pace. They’ve been expanding rapidly for over a decade. Since the fall of the Soviet Union, they’ve been one of the fastest growers in the retail space in Russia, started by an entrepreneur in a town in southern Russia who realized there was a great need for good retail distribution within the country.
Magnit’s convenience-store format is very powerful because it works for smaller population centers. This allowed Magnit to avoid having to compete for the very large metropolitan areas that a lot of the other retailers who entered Russia at the same time fought to capture, namely Saint Petersburg and Moscow. Magnit focused instead on smaller cities. They built distribution centers that covered parts of the country the competition didn’t reach. They’ve built their own trucking fleet as well.

But Magnit is still gaining share, still growing its business very rapidly and taking this time to reinvest some of that wide margin into prices to fuel that further expansion. We are very confident that they can continue to grow the business and also see that margin come back. And at 6.8 times our estimate of cash flow in 2017, that looks very cheap within our investable universe of 100 very high-quality emerging-market franchises, especially when you consider we still think it has 15% to 20% cash flow growth per year over our five-year cash flow forecast.

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That early expansion and reach to underserved regions helped build the competitive advantages they enjoy today. Their scale and reach gives them bargaining power with their suppliers, which is one of the keys to their great profit margins. Zooming out globally, Magnit has had some of the highest EBITDA margins within their category of retail globally, which is quite impressive.

So how do they do it? They offer convenience and location and a product assortment that’s very hard to find in some of these regions, which gives them that great margin potential. Over time, Magnit added new formats like hypermarkets and, most recently, cosmetic stores. Expanding these new formats and increasing the density of its smaller stores provides Magnit with a path to sustained long-term growth.

The Founder still owns about 40% of the company. The stock price recently fell, we believe because of a temporary compression in profit margin. We think it’s temporary because times have been especially tough for the Russian consumer recently. As times become tough or during harvest season, shoppers sometimes move away from modern retail toward more of the local open-air markets, which often provide the biggest discounts.

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for the next five years at least. It’s a much more expensive company than Magnit but still ranks high enough within our universe to get placed into our portfolio.

The company was started by a couple of ex-HP engineers in the early 1980s. They built a business around embedded computer systems and industrial computer systems targeting various manufacturing businesses across Asia. Its leading market share was solidified during 2008 and 2009, during an industrial downturn. Like other companies we own, it made the most of a downturn while its peers were in retreat. It now is reaching a stage where it’s moving more into software. So we think that its margin profile could improve considerably.

The cloud allows its embedded computer systems and hardware to link up better with cloud-based data analytics systems like Microsoft Azure or IBM. And Advantech can provide the middleware that will gather that data from its hardware and allow it to be analyzed by these larger enterprise software systems. And this is something that I don’t think is that well-appreciated yet. As they do this, that will allow them to differentiate themselves even further from other hardware providers in the marketplace who don’t have this software solution.

The other thing about Advantech that just makes it so much more stable than its competitors is that it managed to build up a lot of very small customers over decades. Advantech’s competitors tend to focus more on big projects and customers that lead you to have more of a feast-or-famine profile to your business. It also makes it harder for you to run your factories at consistently high utilization rates, which is something that Advantech does well. It also allows Advantech to have a much better and more stable sales force. It’s a higher-touch client base. So the aftermarket business there is better. You are able to keep your sales force more productive. So over time, Advantech has continued to build on this better business model, and it’s something that can’t easily be replicated.

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Advantech is a company that can generate very high returns that are likely getting higher based on where they are investing going forward, more toward the software side. It’s also a business that has seen growing demand for its products beyond its traditional industrial base, in smart city projects and healthcare, for example. So there is the potential for them to expand their addressable market. So it’s an exciting company with high growth. We think it’s trading for about 16 times our estimate of 2017 cash flow, which makes it quite a bit more expensive than Magnit. It would mean that typically we would probably invest a bit less in a company like this, given it would rank lower in our universe based on its relative risk-adjusted return profile.

**TWST:** Did you want to mention a third company?

**Mr. Chenoweth:** Sure. Let me step back and talk a bit about how we think about selecting companies within our framework. We mentioned earlier that we identified the 100 best franchises in emerging markets, as we see it, based on their ability to reinvest in the business and achieve high incremental returns. That list has 100 or fewer companies. We rank order that list based on our qualitative views and five-year cash flow forecasts. We try to weight positions in the portfolio according to how compelling they are relative to each other. So 35 to 50 companies typically qualify for our portfolio. There are 40 presently, and the ones we’ve talked about have all met the conditions to be in the portfolio.

So with that I will jump over to India and the leading wireless telecommunications company there. Bharti Airtel (BOM:532454) is another company we find incredibly compelling. It has leading market share by a fairly wide margin. More than a third of the wireless market is served by Bharti. It can scale its distribution better; it can scale its fixed investment better. The wireless business is a tough business globally. It’s hard to find a wireless business that meets our strict quality criteria. But India is an interesting market. It has very, very low smartphone penetration. In a lot of emerging-market countries, you don’t see smartphone adoption until the price of the smartphone reaches about a week’s wage. That’s a price point that is finally starting to get hit with greater frequency in India. We think smartphone penetration should climb from around 10%
today toward 50% to 60% over the next five to 10 years. That leads to a very considerable growth trajectory for Bharti, the leading provider.

Also, the market is improving as the networks migrate upward. The 2G marketplace in India was very ugly. Even though Bharti led in that environment, there were about a dozen players, and it was a very competitive pricing environment. What’s happened since then, as customers move to 3G and 4G services, is that the number of companies who can compete is shrinking. Fewer have the ability to invest in the spectrum, and all that comes with providing a higher-speed wireless data network. So that’s led to some pricing power again. This relative pricing stability also helped Bharti improve its margins and profitability, even as it sees its growth start to improve. So that’s a big driver for Bharti.

And I think the other thing that helped is, back in 2010, they messed up jumping into Africa, and they have been slowly walking that back and selling off some pieces of that business. Importantly, I think it’s a lesson learned. And I think it is good to know that they won’t jump outside of India so easily in the future because we think that’s a risk for a lot of wireless companies: the desire to build empires, which can destroy a lot of shareholder capital. So Bharti is more and more focusing on its crown jewel. So it’s reinvesting there quite heavily in spectrum that allows it to become a leader in 4G.

It is trading for just 5.5 times our forecast for 2017 cash flow, and even though it is a large company and even though it is a wireless telco, we think it can have 10% per year cash flow growth over the next five years. That growth trajectory, although more modest than a Magnit or an Advantech, looks quite compelling given the very low cash flow multiple. It has been one of our top-10 holdings over the past year.

TWST: What would be the risk for a telecom company to try and get into a region like Africa?

Mr. Chenoweth: The challenge that Bharti faced — and this would be the same for any new entrant — the challenge is the ARPU is very low, the average revenue per user is very low, so you have to be able to gain a lot of market share to cover that fixed investment. The telecom space is a very capital-intensive industry. So if you’re going to be able to reach a lot of customers and build a nationwide network, you have to have a lot of revenue to cover that. In order to have a lot of revenue, you have to get a lot of users or pick off the few high-value users. So you will face a tough competitive dynamic.

And I think Bharti thought, because they had been so successful in India, a country that’s got an even lower voice price and revenue price per user than much of Africa, they thought they could use what they had learned in India. They thought they would be a natural owner of assets in Africa. So I think it’s a lesson for anyone, any telecom company that thinks it can compete in Africa; you should consider Bharti’s case.

TWST: Did you want to mention a fourth company?

Mr. Chenoweth: Sure. Let’s go back to talking about convenience stores. Grupo FEMSA (NYSE:FMX) in Mexico has been in and out of our top 10 over the last year. It plays well into what we talk about as far as having high-return growth. It’s a company that is known for its position in Coke FEMSA (NYSE:KOF), which is a Coke distributor throughout Mexico and a lot of Latin America, and also the Philippines. And they own about half of that company, about 48% of Coke FEMSA.

They also own about 20% of Heineken (OTCMKTS:HINKY), which is a legacy position that they’ve mentioned that, at some point, they’d like to exit. So the company has some legacy businesses you don’t think of as fast growth. Heineken is probably growing low to mid single digits. Coke FEMSA is still growing mid to high single digits. However, FEMSA has been investing heavily in some high-return growth businesses that make up over a third of the overall group value in our estimate.

OXXO is a business that has been growing very rapidly. They continue to build out about 1,200 convenience stores every year, which gives them a high-single-digit growth rate on just store buildout, to give you some perspective there. Same-store sales have been growing between 3% and 9% as stores mature, and OXXO’s value proposition improves. OXXO has added more SKUs that get replenished more frequently. They’ve also added prepared foods.

As OXXO continually improves its store offering, unorganized players will find it harder to keep up. Other new enhancements include a deal with Amazon (NASDAQ:AMZN) to do in-store delivery for Amazon products. So the OXXO store has become a very important part of a lot of average people’s daily lives in Mexico. It’s often visited on the way to work in the morning and then on the way home. And with the scale they have achieved, they have a lot of bargaining power with suppliers.

Steady topline growth and margin improvement should boost cash flow 15% to 20% a year. FEMSA has learned from OXXO that there are a lot of retail formats that are underrepresented in Mexico and Latin America. Drug stores and gas stations are formats that offer FEMSA considerable growth potential in coming years. And drug stores are off to a good start. FEMSA is at the point where it should start to gain bargaining power with large drug companies.

So that will do a couple of things. It will allow them to take down prices and improve store margins. We think,
whenever the Heineken stake gets liquidated someday, that will provide a lot of cash for the company to reinvest in much higher growth, higher margin businesses. Heineken’s shares are currently about a third of the value of FEMSA. So we’re excited about FEMSA. It’s a tough one to give you simple multiples on because of the many moving parts, but we think right now the OXXO convenience-store-chain part of the business plus the drug stores is trading for just under 11 times our forecast for 2017 cash flow, which is again very compelling considering we think that part of the business will probably grow 15%-plus per year over the next five years.

You’re not going to have cheap money there to fund you on demand, as it might be in the developed world. That leads to some different risks, funding risks that can crop up more frequently than they would in the developed markets and would suggest you should craft a careful investment strategy. We think, all in all, these risks of greater volatility in the emerging markets play to the strengths of our strategy.

We noticed when we launched the fund in 2012 that a lot of our peers, because they’ve had to deal with this considerable country market volatility, tend to be more macro-focused. As other investors shift funds between countries

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TWST: We’ve been talking about emerging markets. Is there any general advice you can give to investors given the risks out there about investing in emerging markets?

Mr. Chenoweth: Looking at the past three years, I think it’s been a helpful gut check for investors. The decade before the past few years was much easier, in hindsight. Over that decade, a weaker dollar meant a pretty incredible tailwind for many of these companies and economies. A lot of people got excited about emerging markets and money flowed in. And that led to, in our view, a lot of competitive destruction in the emerging markets.

In our view, this destructive competition finally slowed over the past one year to 18 months. Times got tougher in the emerging markets as the U.S. dollar strengthened and capital became scarcer. A lot of emerging-markets companies borrow in U.S. dollars because their local currency debt markets aren’t developed. So as that hit them, they have been forced to tighten their belts and really look to become more efficient, exit a lot of the businesses they entered when growth capital was easier to come by.

And now, the few companies we see expanding into new markets are the companies we tend to prefer, like FEMSA, companies that have very strong franchises, that are largely self-funded. A lot of the reckless competition is going away, which I think it’s helped. I think this is something that will be healthy for the long term. And even though it’s been a struggle recently, it is ultimately very healthy.

So what do we do to address these big changes that can happen just by the simple change in U.S. dollar? We try to create a portfolio of companies that all have very strong balance sheets that can reinvest in their business using their own cash flow and not have to rely on capital markets. It is quite a bit different than the developed world. I think this week, I read about a very large European company that issued a 0% coupon bond. So it’s different in the emerging markets.

largely based on macroeconomic themes, we think that leads to some pretty good opportunities for a fundamentally focused investment manager like ourselves. Indonesia might not be appealing right now, let’s say; so if Indonesia is not appealing, it doesn’t mean that every company in the country should be sold or trimmed. There will be some companies there, like the companies we’ve owned there, that have good balance sheets and very visible growth prospects that can weather the downturn and even emerge stronger. If we can find these companies, when the macro tides go out, we want to invest in them.

And we found that because emerging markets are so volatile, we get these opportunities a few times a year. We can hopefully purchase great companies at discounted prices and generate stronger returns because of that. And it’s a marketplace we don’t think is going to change. Investors are still very macro-focused, and the capital markets are less developed, so these swings are going to happen more frequently. That’s something that investors in the space need to understand. With that understanding, we developed a strategy that we thought would give us the best chance and the confidence to invest in businesses with good finances, good growth with high returns and competitive advantages.

TWST: Thank you. (ES)
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The Fund may, at times, experience higher-than-average portfolio turnover, which may generate significant taxable gains and increased trading expenses, which, in turn, may lower the Fund’s return.

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**View Scout Emerging Markets Fund holdings.**

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