January 2024

Emerging Markets Sustainable Equity

How to measure the value created by emerging markets companies

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Introducing EVA

When a company's operations generate a return that exceeds its cost of capital, value is created. Economic value added (EVA), also referred to as economic profit, is a measure of this value. It is the difference between the return on invested capital (ROIC) and the cost of capital, multiplied by the amount of invested capital[2].

EVA = (Return on invested capital - Cost of capital) x Invested capital

Three inputs are needed to calculate EVA:

1. **ROIC** is the net operating profit after tax divided by the invested capital.
2. **Cost of capital** is an opportunity cost for a company's investors. It is also referred to as the investors' required return or expected return. In practice, we use the weighted-average cost of capital (WACC).
3. **Invested capital** represents the cumulative amount the company has invested in its core operations – primarily property, plant and equipment (PP&E), intangible assets and working capital.

Only when a company's ROIC exceeds its cost of capital will growth increase a company's value. Growth at lower returns reduces a company's value and, instead of investing in growth, it should instead return excess cash to shareholders through dividends or share buybacks.

Using the EVA approach, a firm's value is calculated by discounting its projected economic profit at the cost of capital and adding the starting invested capital.

$$\text{Firm value} = \text{Capital invested}_{\text{Assets in place}} + \sum_{t=1}^{t=\infty} \frac{EVA_{t,\text{ Assets in place}}}{(1+k_c)^t} + \sum_{t=1}^{t=\infty} \frac{EVA_{t,\text{ Future projects}}}{(1+k_c)^t}$$

[1] For further information on the investment team, please see the Important information section.

[2] New York University Stern School of Business – Investment Valuation 3rd Edition – Chapter 32.

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Why EVA matters for investors in emerging markets equities

There are several reasons EVA is a useful metric for assessing the value of emerging markets companies.

First, different markets require different levels of returns. This is particularly the case in emerging markets, where the cost of capital varies significantly. For example, the long-term risk-free rate in Brazil is 11.2%[3] vs. 2.4% in Taiwan, resulting in considerably different costs of capital. Therefore, companies operating in Brazil need to generate a higher ROIC to create value for shareholders than companies operating in Taiwan. The way EVA is calculated takes this into account (as shown above).

In addition, EVA better assesses the quality of management teams' decision-making, via the concept that a business can only grow its value if its incremental investments generate a positive EVA. The EVA approach therefore promotes longer-term thinking, as it does not punish companies for investing (creating near-term cash outflows) as long as the incremental ROIC is above the company's cost of capital.

For these reasons, an EVA assessment is core to the philosophy and process of the Ninety One Emerging Markets Sustainable Equity strategy[4]. Simply put, we look for long-term value creation in the companies we hold as measured by EVA. To seek to avoid overpaying for a company and to capture valuation upside, we require that a company is creating greater value than is priced by the market.

Below, we present EVA case studies for two industrial companies in our 'Sustainable Growth' universe: SF Holdings and Delta Electronics[5]. The latter was held in the Emerging Markets Sustainable Equity portfolio as at end-December 2023.

Case Study 1 – SF Holding

Company description

Founded in 1993, SF Holding is the largest integrated logistics service provider in China. Its core businesses include express services, freight, cold chain, pharmaceutical, intra-city on-demand, supply chain and international. SF Holding generated RMB 267 billion (c.US$40 billion) of sales in 2022, 77% of which came from mainland China. Headquartered in Shenzhen, the company has a presence in c.100 countries, operates more than 2,000 warehouses and has over 162,000 employees.

Value creation assessment

SF Holding's value creation, as measured by EVA, peaked in 2020. Then followed a sharp decline and two years of negative EVA (see table) – despite the company increasing sales at a compound annual growth rate (CAGR) of >30% during this period.

We believe SF Holding is unlikely to create value consistently for shareholders as it lacks strong competitive advantages, and is therefore not a candidate for the Emerging Markets Sustainable Equity portfolio. There are three reasons for this:

- Logistics is a commoditised industry. It is difficult for companies to provide differentiated services over the long term, which gives them limited pricing power. This is reflected in the industry's low gross margins (mid-to-high 'teens' percentage).
- SF Holding's mid-teens ROIC during 2018-2020 was more than sufficient to cover its cost of capital. However, as the industry grew it attracted new players, given the low barriers to entry. That made it difficult for logistics providers to avoid competing on price, particularly in periods of slower demand when companies tend to fight for volume to improve capacity utilisation. Logistics companies' weak competitive advantages and the cyclical nature of the industry leave little room for operating-profit generation. SF Holding's past five years' average operating profit margin has been only c.5% as at 31 December 2022.
- In the logistics industry, every competitor seeks the advantage of scale. This leads to heavy investment in warehouses, logistics networks and courier drivers. Consequently, SF Holding's capital intensity has increased over time. We note the following:
  - The company's 5-year CAGR growth of PP&E was 33%, vs. a 12% 5-year CAGR of net operating profit after tax (NOPAT).
  - PP&E accounts for c.70% of invested capital. Given SF Holding's structurally low margins and increasing capital intensity, we see little scope for return improvement to cover the cost of capital.

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[3] As at November 2023.

[4] For further information on the investment process, please see the Important information section.

[5] No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.

This is not a buy, sell or hold recommendation for any particular security. Securities selected to illustrate how the Ninety One Emerging Markets Sustainable Equity investment team may apply EVA analysis, using two companies with dissimilar EVA profiles. For further information on specific portfolio names, please see the Important information.

SF Holding EVA analysis

RMBm	2018	2019	2020	2021	2022
NOPAT	3,862	5,040	6,617	3,085	6,920
Invested capital	32,446	41,588	49,784	104,132	108,979
ROIC	16.6%	15.5%	15.9%	6.2%	6.6%
WACC	6.8%	6.8%	6.8%	6.8%	6.8%
EVA	**2,290**	**2,843**	**3,801**	**-286**	**-131**

Source: Ninety One, December 2023.

Case study 2 – Delta Electronics

Company description

Delta Electronics is a leading global provider of power and thermal management solutions, headquartered in Taiwan. It generated NT$384 billion (US$12 billion) of sales in 2022. The company's products are used in a wide range of applications across industries, including in electric vehicles (EVs), datacentres, industrial automation, consumer electronics and telecoms infrastructure. Delta has 9,000 R&D (research & development) engineers worldwide and production capabilities across China, Thailand, India, the US and Europe.

Value-creation assessment

Delta Electronics has been value accretive over more than a decade and has generated positive EVA consistently through the economic cycle (see table). The main drivers of this are as follows:

- Delta's professional enterprise customers are demanding (examples include Apple and global automotive original equipment manufacturers (OEMs)). The mission-critical nature of Delta's products and solutions means these customers value performance, quality and manufacturing capabilities, among other characteristics. The process to become a supplier to these customers is consequently lengthy, complex and demanding, which creates a high entry barrier. However, once a supplier is approved, its profitability is supported by either pricing or volume. As a result of these dynamics, Delta has tended to earn a ROIC (5-year average of 16%; see table) above its cost of capital (c.5%).
- Delta started by producing switching supplies for consumer electronics companies in the 1970s. Since then, its management team has been actively reinvesting to broaden the application of its products to cover more end-markets (PC/laptop, mobile, automation and telecom etc.). The latest example of this is the electric-vehicle (EV) market, where Delta has emerged as a supplier of various products, seeking to ride the global structural growth trend of decarbonisation.
- Delta spends 9% of sales on R&D, materially more than its Taiwanese ODM (original design manufacturer) peers. Its gross margin has improved by c.10 percentage points over the last decade, which is the result of value-accretive investments as Delta moved into higher value-add products. This is an example of management decision-making contributing to positive EVA generation.

Data Electronics EVA analysis

NT$m	2018	2019	2020	2021	2022
NOPAT	14,858	15,929	25,108	25,089	33,276
Invested capital	100,742	171,320	168,405	192,499	220,928
ROIC	16.0%	15.8%	14.7%	14.9%	17.3%
WACC	5.3%	5.3%	5.3%	5.3%	5.3%
EVA	**9,950**	**10,619**	**16,077**	**16,212**	**23,129**

Source: Ninety One, December 2023.

Summary

We believe EVA is a valuable metric for evaluating a company's financial performance, as it considers both the cost of capital and a company's operating profitability. In emerging markets, where the cost of capital varies significantly, it is a useful input for helping to identify companies that create value for shareholders.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Costs and charges will reduce the current and future value of investments. Past performance does not predict future returns. Investment objectives may not necessarily be achieved; losses may be made. Target returns are hypothetical returns and do not represent actual performance. Actual returns may differ significantly. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

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