Barings Emerging EMEA Opportunities

BEMO offers exposure to both sides of the energy transition...

Update
29 July 2022

Overview

Barings Emerging EMEA Opportunities (BEMO) is the only investment trust dedicated to the emerging markets of Europe, Middle East and Africa; a universe of countries with big potential which have little representation in mainstream emerging market indices or funds. There are also only two open-ended funds, out of the over 5000 in the Investment Association, which focus on this region, making BEMO a rare beast indeed. Yet, as we discuss in the **Portfolio section** below, the region has the potential to benefit from one of the major economic themes of the coming years – the energy transition – in a number of ways. The countries of the middle east offer an alternative source of fossil fuels to Russia during the transition, and high energy prices should have positive effects throughout their economies. Meanwhile, South Africa is home to companies in the mining sector which generate the raw materials needed for electric vehicles, solar panels and the like.

BEMO was known as Barings Emerging Europe until November 2020 when its universe broadened to encompass the Middle East and Africa, as well as Eastern Europe. BEMO had a material position in Russia prior to the invasion of Ukraine, which led to significant losses when it was written down in the aftermath of the invasion. The trust has traded on a wider than average **Discount** since the war broke out, and that is currently 18%.

The board has placed importance on the dividends paid to shareholders in the past and can make a contribution of up to 1% of NAV from capital to the annual payout. Due to the loss of income from the Russian holdings, the level of income which the portfolio can generate has been reduced. This was reflected recently in a reduction in the interim dividend.

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

BEMO has been through a difficult patch recently, with the NAV taking a hit from the Russian invasion of Ukraine and the benchmark changing materially following the exclusion of Russian stocks from the MSCI universe. However, we believe it is time to look to the future. There is a case for investing in this collection of markets which could appeal to many. In particular we note the Gulf states are receiving renewed attention from international, professional investors. This has been boosted by the prospect of structurally higher energy prices thanks to the exclusion of Russian products from Western markets and a slowdown of investment in production by Western companies. Saudi Arabia, in particular, looks an even more critical source of hydrocarbons in the short to medium term. Meanwhile South Africa is rich in the minerals which are critical to the green energy revolution, be it for electric cars or solar panels. As a result, EMEA offers a way to play both sides of the energy transition. Additionally, we note the Gulf states were making efforts to encourage foreign investment prior to the invasion of Ukraine, impelled by their recognition that the era of fossil fuels is coming to an end.

At the time of writing, BEMO is available on a wide discount of 17.8%, the widest in the global emerging market sector. This could prove to be a good long-term entry point, although we note that the growing risks of a recession in key countries like the US may mean the immediate future is volatile.

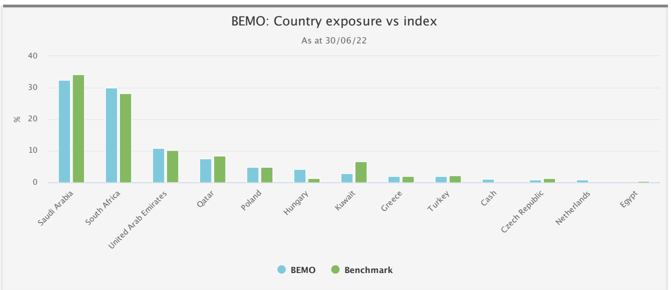
BULL
Offers attractive diversification to the typical exposure of a global or global emerging markets trust
Managers have a strong track record of generating alpha and Barings is a major investor in the trust's under-researched markets
Gulf states benefit from structurally higher energy prices

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 will exclude many professional investors and may call into question the viability of the vehicle if there are further market falls

Portfolio

It has been a tumultuous period for the shareholders and managers of Barings Emerging EMEA Opportunities (BEMO), but the shape of the future portfolio and opportunity is now coming into view. Following the removal of Russian equities from the MSCI universe, the trust's benchmark (since November 2021 the MSCI Emerging Markets EMEA Index) is roughly 34% invested in Saudi Arabia and 28% in South Africa, with the majority of the remainder invested in the Gulf and a small allocation to Eastern Europe. This forms a universe packed with potential, in particular with regards to the energy transition. Saudi Arabia's importance as a source of hydrocarbons during the transition has been increased by the cutting out of Russia from the global market, while South Africa offers exposure to companies generating the metals needed to facilitate new energy sources and electric vehicles.

Fig.1: Country Allocation



Source: MSCI, BEMO

The mandate was broadened to cover the whole EMEA region in November 2020. Prior to the war in Ukraine, Russia made up 22% of the MSCI Emerging EMEA benchmark, and 28% of the trust's portfolio. While there has been a serious impact on the portfolio's valuation due to the outbreak of war, with the Russian exposure written down to zero, the decision to diversify the opportunity set has been vindicated owing to the significant reduction in exposure to Russian equities on the change in mandate.

As noted above, the two key markets are Saudi Arabia and South Africa. South Africa's key competitive advantage is access to a broad range of metals. The country is the leading global supplier of platinum group metals – these have a key role to play in the energy transition (being used in catalytic converters in cars but also inside fuel cells and for green hydrogen electrolysis). BEMO has a significant position in diversified miner Anglo American, a key producer of nickel and platinum group metals.

Meanwhile, high commodity prices have helped push South Africa's current account into surplus, whilst corporate investment has rebounded significantly. Real earnings growth excluding resources is still below pre-COVID levels, which suggests there is catch up potential. Social unrest remains a danger, but the government is engaging in a structural reform program to encourage private investment and employment, including by cutting business rates.

Saudi Arabia and other Middle Eastern markets have been increasingly opening up to the world and this, along with strong growth, is seeing their representation in benchmarks rise. A burgeoning IPO market is broadening the investment opportunity set across the region, whilst a strong fiscal outlook, low single digit inflation, and a reform agenda which should further boost consumer confidence supports the investment case.

Most importantly, increased revenues from oil and gas should lead to a broader wealth effect in Middle Eastern economies. The vast sums of money generated across the region from oil and gas revenues will be reinvested to create a number of opportunities across sectors, as the country looks to diversify their economy via initiatives such as Vision 2030 and invest further into renewable energy.

Readers of the FT may have noticed the paper **report** an increasing amount of hedge fund managers and other investors looking to base themselves in the Gulf to take advantage of the secondary effects of high energy prices on the region. Matthias Siller, BEMO's lead manager, highlights that the Saudis will have a budget surplus of 20-25% this year, at least some of which will go into the local economy rather than being saved.

The portfolio also has a smaller amount of exposure to countries across central Europe. In the short term, these markets are most exposed to the conflict due to their geographic proximity and close energy links between Europe and Russia.

Over the medium term, Matthias believes opportunities exist as the region pivots away from Russian gas. This is supported by large EU infrastructure projects, such as the European Green Deal and NextGen EU funds that are set to bring billions of euros to EU member states to help transform their energy systems. This in turn should allow local banks to spend up loan growth and facilitate surplus liquidity. There is also an opportunity for the region to take advantage of nearshoring trends, where companies are bringing manufacturing closer to customers. Certain eastern EU member states are well placed to provide lower cost skilled labour, strong regulatory protection and, crucially, a lower delivery time for the end consumer due to their closer geographical proximity.

Currently just over half BEMO's portfolio is in the financials sector. This sector, the banks in particular, offers geared exposure to an expanding economy. The fund's largest single positions are in Middle Eastern banks which should benefit from the credit boom Matthias thinks will follow this period of high energy prices. Saudi National Bank and

Al Rajhi Bank, both of Saudi Arabia, are the two largest positions, followed by Qatar National Bank. Saudi Basic Industries is a chemicals giant majority owned by Saudi Aramco which manufactures petrochemicals and fertilizers amongst other products. Financial services operator FirstRand is the largest South African holding, while South African telecoms operator MTN Group is the largest mobile network operator in Africa. Matthias thinks the company is in a strong position to be able to raise prices in an inflationary environment, while trading on attractive valuations.

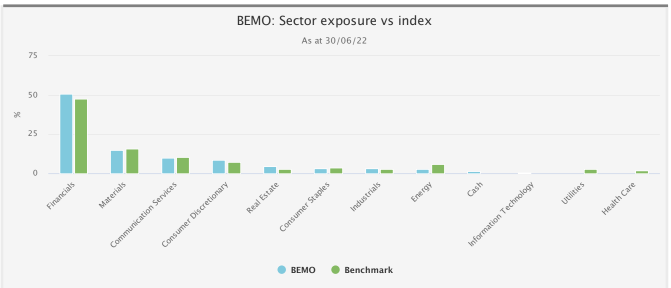
Top Ten Holdings

HOLDING	% OF NAV
Saudi National Bank	7.9
Al Rajhi Bank	7.4
Qatar National Bank	6.3
Saudi Basic Industries	5.2
FirstRand	4.5
Saudi Telecom	4.3
MTN Group	4.0
Emaar Properties	3.5
First Abu Dhabi Bank	3.4
Prosus	3.2
TOTAL	**49.7**

Source: BEMO, as at 30/06/2022

After financials the materials sector is the largest exposure, with just over 15% of the portfolio. It is worth noting that the portfolio is moderately underweight the materials sector, whilst financials were overweight the benchmark's allocation of 47.7% (as of 30 June 2022).

Fig.2: Sector Allocation



Source: BEMO

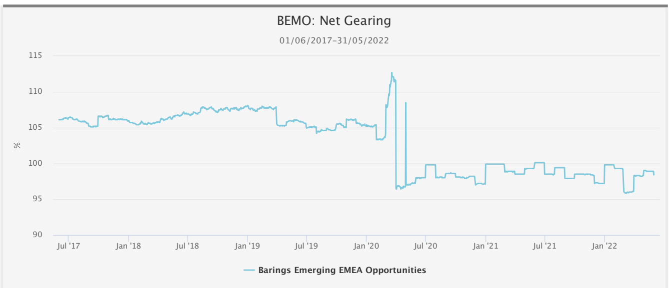
Alongside Saudi Arabia and South Africa, the universe also offers exposure to smaller countries across the Middle East, Africa and Eastern Europe. There is the potential to invest off-benchmark in the frontier EMEA markets too, such as Romania. The team expect the pending listing of the hydroelectric natural monopoly, Hidroelectrica, to contribute to the ongoing improvement in liquidity and increasing involvement of local pension funds and international investors in that market. They also believe the country could be upgraded to Emerging Market status by MSCI, which would lead to greater liquidity and overseas investment. The exposure to Emerging Europe is approximately 10%, with Matthias finding opportunities in insurers which are less exposed to the credit cycle and are beneficiaries of rising interest rates. He argues the low starting valuations mean the margin of safety for an investment in Emerging Europe is arguably higher than developed Europe. Additionally, there are still positive real interest rates in Poland, Hungary and Romania, making business investment attractive.

The approach of the investment team places emphasis on proprietary research, aiming for the majority of alpha to be derived from stock selection. Matthias and co-manager Adnan El-Araby look for companies with above-average growth and quality, which they think are attractively-priced – a 'GARP' approach. 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.

Gearing

BEMO is currently ungeared, having repaid its loan facility when it was up for renewal on 7 April 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.

Fig.3: Net Gearing



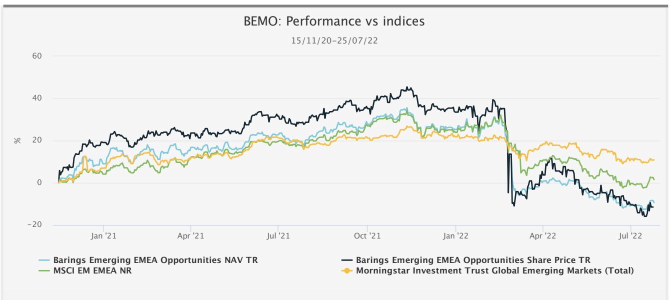
Source: Morningstar

Performance

In November 2020 BEMO's strategy and benchmark changed, following which the Company delivered a strong NAV total return of +36.6% to 30 September 2021, outperforming the benchmark. The managers then had to deal with the fallout from the Russian invasion of

Ukraine, leading to their Russian equity investments being written off and removed from the benchmark. This has created a bumpy ride in 2022, and near-term returns have been poor. However, we would note that looking back to calmer times, the management team led by Matthias demonstrated an ability to add alpha. In the five years to the end of 2020, they generated 2.3% of alpha per year versus the emerging Europe benchmark. The initial results under the new strategy were encouraging, with the trust outperforming the new benchmark, the MSCI EM EMEA over 2021. However, Russian companies were an area of high conviction before the tensions with Ukraine ramped up, and this led to underperformance of the MSCI EM EMEA benchmark when the invasion occurred. Since the change of strategy, BEMO's NAV total return is -9.4% compared to +1.5% for the benchmark (to 25/07/2022).

Fig.4: Performance Since Change In Strategy

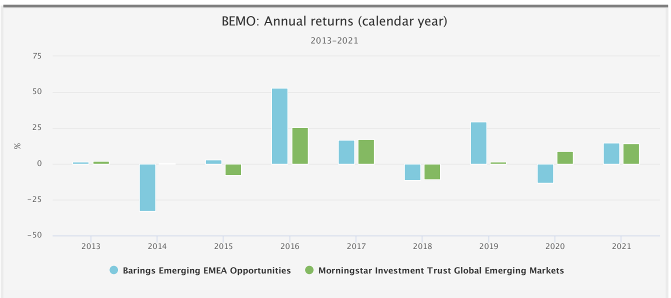


Source: Morningstar

Past performance is not a reliable indicator of future results.

It is critical to note that after the decision to write down the Russian stocks to zero, any direct negative impact from the war has taken effect. As such there is no potential downside from the Russian exposure at this point. When it comes to considering future return potential, focussing on South Africa, Saudi Arabia and the diverse other countries in the index is critical, as we have done in the **Portfolio section**.

Fig.5: Returns

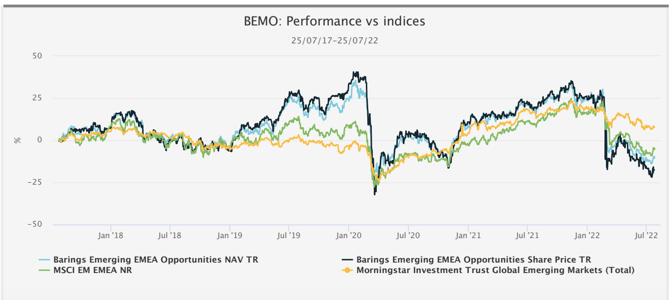


Source: Morningstar

Past performance is not a reliable indicator of future results.

For the record, over the last five years (to 25/07/2022) BEMO's NAV total return was -10.6%, according to Morningstar and the MSCI EM EMEA Index is down 5.5% with the average emerging markets trust up 7.9%. However, BEMO's returns represent the results from two differing strategies, and is dominated by the crash seen in February 2022 in Russia, while the benchmark has changed during the period.

Fig.6: 5-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

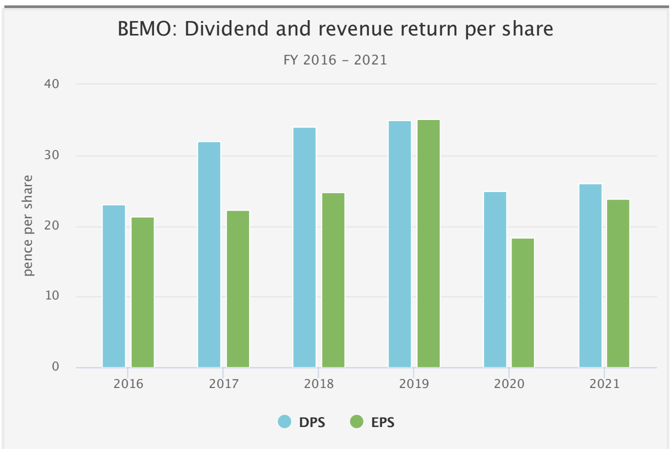
Dividend

BEMO aims to provide an attractive level of income to shareholders, and to that end the board has been able to contribute up to 1% of NAV a year to dividend payments since 2017.

The Russian companies in the portfolio were a major source of income, and so their departure creates a hole that will be hard to fill in the future. This follows the pandemic, which saw dividends on underlying companies fall. The board's ability to pay from capital gives it some flexibility to replace any lost dividends. However, it will have to balance the need for the payout to be sustainable in future years.

The interim dividend for the first half of the 2022 financial year was 6p, down from 15p in 2021 and fully covered by earnings of 8.9p. If the final dividend is maintained at last year's level of 11p, the current yield on the company's shares would be 3.6% at (17/07/2022).

Fig.7: Dividends Per Share



Source: BEMO

Management

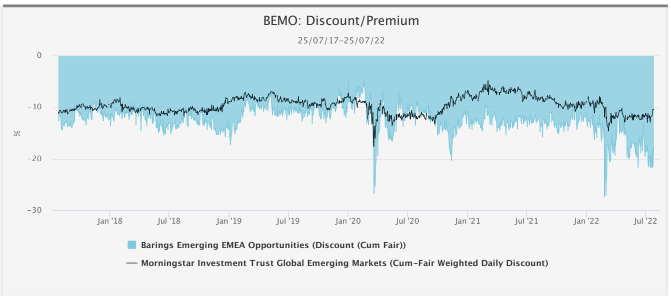
BEMO is managed by Matthias Siller and Adnan El-Araby. Matthias is head of the EMEA Equities team and has managed the trust since 2008. Adnan joined him officially as a co-manager in March 2018 but has been a member of the EMEA team, working with Matthias, since 2010. Matthias has run EMEA portfolios since 2001, having previously worked as a market maker and prop trader in Central and Eastern European equities in Austria; as such, he has 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 six members, four of which 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 £1.2bn 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 emerging market team, made up of over 45 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's discount has widened following the Russian invasion of Ukraine. While there is no Russian exposure left, the trust now trades on a 17.8% discount to NAV. This is the widest discount in the AIC Global Emerging Markets sector. Risk aversion is high in markets at the time of writing. However, we note that Gulf Investment trades almost at par, and c. 50% of BEMO's portfolio is in that region. The positive sensitivity to high commodity prices, particularly oil, makes BEMO's discount look interesting to us on a forward-looking basis.

Fig.8: Discount



Source: Morningstar

The board has the ability to buy back shares and regularly uses the facility to provide liquidity and contain discount volatility. There is also a tender offer provision which will be implemented 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.

In the event of the tender being triggered, investors will have the option to redeem 25% of their shares close to NAV. In our view this only adds to the attractions of the current discount, although there is still some way to go before this date. We note BEMO has net assets of £74m, so if a high proportion of the shares are tendered at this time the viability of the vehicle may be called into question, as it could be if there are significant market falls in the meantime.

Charges

BEMO's latest ongoing charges figure (OCF) is 1.51%. This compares to a Global Emerging Markets sector average of 1.04%, according to JPM Cazenove. The higher costs reflect BEMO's small size relative to peers which increases the impact of fixed costs as a percentage of NAV. The management fee is 0.75% of NAV, at the lower end of the range in the sector. The latest KID RIY is 2.13%, compared to a sector average of 1.24%, according to JPM Cazenove.

ESG

For some ESG investors, fossil fuel investments are simply undesirable. However, we would argue the current crisis underlines the importance of them in the transition toward renewables, which cannot happen overnight. BEMO invests in fossil fuels and in the alternatives to fossil fuels, in other words the managers can make relative valuation calls on the different industries involved in the energy transition. We think that those investors who value ESG highly, but believe the challenge is to reduce carbon emissions over time rather than divest immediately, could find this approach appealing.

Taking a broader view of ESG, Matthias and Adnan use ESG analysis to uncover risks and highlight the likelihood of investee companies adopting more sustainable business practices and opportunities in the future. As such, ESG analysis is embedded into the evaluation and valuation of each company they analyse. A company's performance on ESG metrics is included in the scorecard built up during the research process and influences the risk premium (or discount rate) used to value stocks – i.e. a company's valuation is directly influenced by their approaches to ESG, either by penalising or rewarding a company based on their scoring. While there is no rule saying the managers cannot invest in the lowest ESG-rated stocks, in practice their aim to buy high quality businesses means they would generally not be considered. As much as the current state of affairs permits, the ranking looks at whether companies are improving, and so the lowest rating indicates there is no interest in improvement on the part of company management, generally indicative of a poor-quality team in the view of the managers.

Matthias and Adnan use Barings' in-house ESG analysis in all their work rather than relying on the assessments of third parties, preferring to rely on proprietary analysis. 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. 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.

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