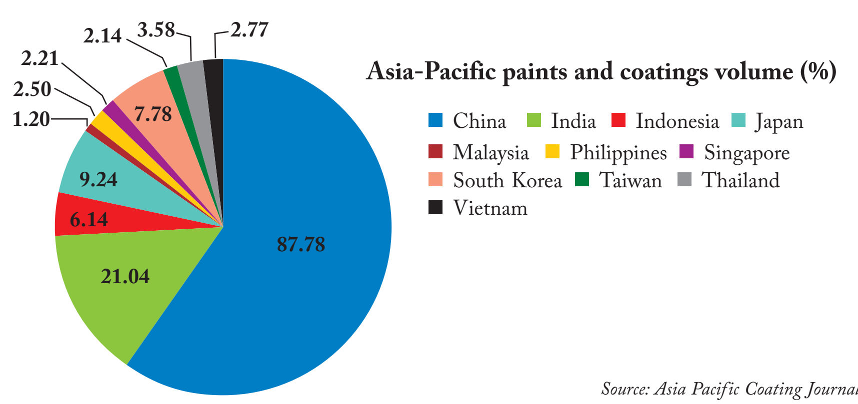
A long-term outlook for a big haul

The rapid growth in Asia represents a good investment opportunity. However, it must be viewed as a long-term investment. Many investors believe that the region is entering a 'golden era' where a long-term view can generate substantial returns despite the likely volatility.

Asia-Pacific paints and coatings volume (tonne) - 2014



Source: Asia Pacific Coating Journal

■ Dr Mosongo Moukwa

Many investors generally view Asia as a high return proxy for global economic growth because Asian equity markets appear to be dominated by macroeconomic developments. However, when one looks at the MSCI index, the story tells a different story. The index, created by Morgan Stanley Capital International (MSCI), considered to be a good measurement of the stock performance of the concerned markets, is often quoted by financial media to describe how a region's stock market is doing. When one looks at each year over the past five years, the MSCI US Index in fact has produced higher returns than the MSCI Emerging Market Asia Index.

The Indian market (as captured by the MSCI India Index) delivered a Return on equity (ROE) of 26 per cent, 9 percentage points higher than its Asian peers, in 2007. However, now, its ROE is just 2 percentage points higher. ROE helps investors gauge the value the company creates. It measures the profit generated by the company on shareholder funds. Among other countries, it appears that India has lost some of its advantages to lure foreign investors. Coupling that with market illiquidity and volatility that periodically seem to beset Asia, the question is: whether it is worthwhile investing in Asia at all?

Capital markets in Asia have grown in size to the point that its aggregate market capitalisation rivals that of the US and Europe. The emergence of global and local champions has created substantial opportunities. For example, a decade ago, Samsung Electronics was a little known brand outside of Korea, but has now grown to many times the size of Sony and Philips combined. Ten years ago, banks and insurance companies did not even exist in China as listed entities, but are now the largest of their kinds in the world. Despite their recent lacklustre stock price performance, early investors made substantial returns. In India, the story is the same. Over the past six years, Asian Paints has quadrupled in size to become the fifth-largest decorative paints company in the world, with annual revenues of ₹ 9,632 crore and a market capitalisation of ₹ 38,081.59 crore.

Diverse Asian markets

Asia is not one single homogenous country. It is diverse in its markets, ranging from developed economies such as Japan and Korea to emerging ones such as China, India and Indonesia, with some linkages and interdependencies. This understanding is important. It helps reveal powerful structural trends that can lead to investment opportunities, despite the short-term macroeconomic volatility. Take India and China, for example. The industrialisation and emergence of these two countries have fuelled demand for some goods and raw materials from other countries in the region, such as from Indonesia.

Asia as part of corporate strategy

The rapid growth in the region has not gone unnoticed by leading coatings manufacturers and raw material suppliers. They are now executing their corporate strategy by tapping into growth in Asia. The vast majority of new construction of coatings end-product and raw material production facilities is occurring in Asia-Pacific. One of the major indicators of growth is the demand from end-user industries such as steel, automotive and furniture manufacturing, and construction. In addition, higher domestic demand in emerging Asian countries has encouraged the growth of domestic or local players.

Paints and coatings industry

The paints and coatings industry in Asia-Pacific depends heavily on the end-user industries it serves – construction, steel, marine, automotive and wooden furniture. The Asia-Pacific paints and coatings market for 2010 was approximately $ 48 billion. Countries such as China, India, Vietnam and Indonesia are identified as high-growth countries where there are more opportunities for the development of paints and coatings market. However,

Table 1: MSCI equity index return

	1 year	3 years	5 years
US Broad Market Index	22.38%	13.63%	2.57%
Emerging Market - Asia*	4.40%	3.35%	-2.05%

* China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand

Source : www.msci.com

the specific high-growth segments vary between countries. For example, China has witnessed high growth in its steel and construction industries, and India has experienced positive growth in its construction and manufacturing industries. In contrast, Asian countries such as Vietnam and Indonesia are witnessing growth in the decorative, furniture, marine and protective coating industries.

Potential for outperformance

The quality of management teams runs the gamut, and the negative as well as positive impacts of structural trends tend to be amplified by scale. This presents the potential for outperformance in Asia. There are challenges, however. Challenges can be broadly categorised as company, personnel, and market.

In China, for example, there are different kinds of Chinese companies – Chinese-native companies; Taiwanese and Hong Kong-based companies; and foreigner-owned Chinese companies. Recognising each and treating them accordingly is important. Companies looking to expand in other parts of Asia-Pacific such as India and Vietnam should expect significant cultural and operating differences in these countries as well. In countries like China and India, there is also a shortage of talented manpower for some positions and roles, which makes not only an effective management difficult but also tends to drive wages up. In addition, for Asian labour-intensive export-oriented manufacturing companies, the rising income is an immense cost challenge.

In comparison to developed countries, the coatings market in Asia typically tends to focus on the low- to mid-end segment, although the growing middle class has begun to drive the demand for high-quality premium products. Because of the greater emphasis on low-cost products, R&D capabilities are generally limited, resulting in a lower overall level of product quality. When it comes to the coatings industry in India, only a handful of companies such as Asian Paints can rival the capabilities of their counterparts in developed countries. High foreign investments from multinationals such as Dutch group Akzo Nobel and Japan's Kansai have led to the expansion of facilities and gave a boost to the industrial sector.

The price situation is further compounded with the ongoing shortages in raw materials and price increase. When confronted with this situation, price is often the first priority, followed by product reliability or quality. Large enterprises that win the price war or resource war will emerge to dominate the Asian coating market. Multinational companies such as the US group DuPont and Germany's BASF have implemented a vertical integration strategy to overcome the margin squeeze caused by the fluctuation of raw material costs for paint products. These leading companies have a higher degree of bargaining power compared to small or local enterprises. Small-scale, lower-level corporations will either close down or be acquired. Opportunities therefore are in the high quality and superior product quality. Corporate governance issues such as lack of profit objectives of state-owned enterprises, dominant entrepreneur owner-operators with misaligned incentives or even outright fraud by company management will haunt the stock price of many companies.

How to effectively address these risks will separate the winners from the losers. It will create greater dispersion, which provides substantial outperformance potential for talented fundamental investors. The spread in total shareholder returns between the first quartile and third quartile Asian stocks in the last three and five years is 30 per cent and 20 per cent respectively. The same spread for the EU stocks is lower at 25 per cent and 16 per cent. For US stocks, it is even lower at 20 per cent and 13 per cent.

A calculated approach

The Asia-Pacific region is an important and growing part of the global coatings marketplace. Unlike other regions of the world, the Asia-Pacific region has continued to grow, even in the face of the global recession. In particular, China and India have shown the greatest levels of growth, with China becoming the world's largest coatings market in terms of volume. Over the next five years, these growth trends are projected to continue with China and India leading the way, although a slowdown in the Chinese and Indian economy seems apparent this year.

On the market front, Asian markets will continue to be a volatile asset class with periods of panic and euphoria over the market cycle. On the surface, it is tempting to take a risk-on-risk-off approach to invest in the Asian markets. However, few investors will be able to consistently navigate short-term directional bets without being wrong footed by the market. A more constructive approach is to take an over-the-cycle multiyear fundamental view towards investing in Asia. Instead of thinking of the long-term as a series of short-term investment decisions, investors should see the short-term as a series of contractions of the long-term horizon. Herein lies the real opportunity for investing in Asia. ■

Dr Mosongo Moukwa is Vice President (Technology), Asian Paints Ltd, Mumbai. He was Vice President (Global Technology), Reichhold, North Carolina. He is a member of the American Chemical Society, the Commercial Development and Management Association and the Licensing Executive Society. Email: mosongo.moukwa@asianpaints.com