

Resilient Companies Build Resilient Supply Chains

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | MACRO INSIGHT | 2020

The coronavirus pandemic appears to be accelerating the supply chain localization/diversification theme that we in the Emerging Markets Leaders team have been debating for some time. As we focus on structural forward-looking ideas, we seek to identify those firms acting to increase the resilience of their business model to inventory disruptions by diversifying their supply chain.

The companies invested in this theme are not only reducing their environmental footprint; they are also building competitive advantages. By diversifying and going local, they are reducing transport costs and hedging against future supply disruptions that might arise.

De-globalization has been part of the investment zeitgeist since the global financial crisis of 2008, with slowing trade flows and rising nationalism. As the supply chains come under pressure from the transportation and demand disruptions caused by the corona pandemic, we expect the diversification and localization to increase. In fact, we believe that this trend will likely gather momentum in future, along with a rising awareness of the threat of production disruptions and their potential for negative impacts on business.

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¹ Bank of America Research as of 2 February 2020



Supply Chain Diversification Gathers Momentum

A recent Bank of America survey of 3,000 firms reported that companies in 10 out of 12 global industries have shifted, or plan to shift, at least part of their supply chains¹. Similar intentions have been expressed by the companies invested by the Emerging Leaders Strategy. Against this backdrop, we believe that the chemical and technology sectors in particular will benefit as more firms shift away from China with India and Southeast Asian countries potentially becoming the beneficiaries. The reliance on China across pharmaceutical, technology and chemical sectors will likely lessen in the period ahead, and indeed, we see potential for massive change as supply chains are diversified.

“this trend toward localization is only likely to gather momentum in future”

In our view, the main question now is: How quickly will these supply chain changes take place? When the U.S.-China trade war started in 2017, some firms moved to Vietnam by setting up small ancillary capacities there. Many of the companies that had relocated had intended this to be a temporary solution to the ongoing trade tension between the U.S. and China, but these temporary moves have now become much larger permanent solutions. We have been monitoring the rate of change in the

relocation process and find increasing anecdotal evidence of more firms, and not just American ones, announcing joint ventures with Southeast Asia- and India-based companies in the chemical and pharmaceutical sectors.

Case Study: A Global Leader in Benzene Chemical Based Products

One of our investment holdings is a play on the structural increase of India's market share in the global chemical supply chain and the ongoing import substitution within the domestic market. It is a mid-teens topline and profit growth story, helped both by volume and mix improvement. The holding has compounded EBITDA growth of 16% CAGR over last 20 years and has maintained 16%+ ROIC. It has built a sustainable business by building “depth” in chemistry (continuous downstream integration) and “breadth” in customer base over the last 20 years.

Our investment in the holding is also a call on the execution skills of the promoter family along with the described global reallocation trend. There has been a successful transfer of management control to the second generation whom have demonstrated their capabilities by significantly expanding the firm's products and diversifying clients over the last five years. We expect earnings will accelerate to the high teens in the second half of this year as the first half will see disruptions from the COVID-19 virus.

We believe that the company should deliver strong upside potential given its growth trajectory. Over the long term, we expect specialty chemicals to show double-digit growth for the next decade, driven by:

- I. Increasing share of exports from India due to supplier diversification by global majors and environment-related shutdowns in China. India's share of the global chemicals trade has increased from 3.5% to 4.6% over the period 2015-2018².
- II. Increase in per capita consumption in India (20% of world average as the per capita consumption in India is US\$23 versus global average of US\$100²).
- III. Import substitution (45% share of imports)².

This stock had initially sold off as the global chemical supply chains became disrupted due to the shutdown in Europe and India, which offered us an opportunity to increase the position size given our conviction on the theme and the company. Its structural story remains intact and the short-term disruption remains a function of how soon it, and its customers, can restart their plants. Moreover, the recent decline in oil prices should provide additional tailwind for the holding as it releases working capital previously tied up within the business.

Resilient Supply Chains Are the Key to Success

The chemical industry's supply chain inefficiencies have been exposed by the COVID-19 crisis, and we believe that in the medium-term, the process of diversifying the supplier base away from China will accelerate, and Indian companies stand to become the biggest beneficiaries as their resilience to future supply chain shocks increases.

² Credit Suisse as of 15 May 2019.

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