# Hello 2015: the EM “catch up” themes to watch

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Over the past 20 years, 700m people have been lifted out of poverty in developing economies. This new middle class should grow another 60 per cent by 2020, increasing total consumption from $8tn to $13.5tn a year.

As the income gap with developed world peers narrows and aspirational consumer values converge, the emerging market middle class will be able and willing to pay for better education, health, housing, and infrastructure. These ‘public’ industries represent the most dynamic areas of the developing world – the new emerging markets to watch in 2015 and beyond.

Mass transit in Asia is an excellent example. The number of Asians living in megacities with more than 10m residents will double by 2025, the UN predicts. Meanwhile, vehicle ownership is doubling every five years amid rising incomes, while sharply rising carbon emissions are reducing air quality.

Asian countries are expected to spend over $200bn on mass transit rail systems in the next decade to combat rising urban congestion. In addition to spending billions on private contractors, Asian countries are also making mass transit rail an attractive for-profit enterprise. In Taiwan, fare revenue is 19 per cent greater than operating expenses, with Hong Kong and Singapore boasting even higher margins. In London, Berlin, Madrid, and Milan, mass transit rail systems’ fare revenue is lower on average than their operating costs.

Latin American education is another example. In Brazil, a government program called FIES, which finances students at private higher education institutions, has become a key driver of higher education in the country as a whole. Under FIES, interest rates charged on student loans have fallen to 3.4 per cent a year, with grace periods of 18 months after the end of the financing period and repayment terms of up to three times the length of the program plus an additional 12 months. For private education providers, the financial environment is therefore supportive. Distance learning has also provided another big opportunity for the private sector, partly due to lower tuition costs. Between 2003 and 2013, the number of distance learning students in Brazil grew at a compound rate of 42 per cent.

To be clear, private companies’ grip on the market is not growing in all these areas. Private healthcare spend within the so-called ‘fragile five’ nations of Brazil, India, Indonesia, South Africa, and Turkey actually fell as a proportion of total healthcare spend from 2002 to 2012, according to the World Health Organization. However, in most cases, healthcare spending in these countries grew as a proportion of GDP, and GDP overall grew substantially, mitigating the private sector’s dwindling market share. Furthermore, in the ‘fragile five’ and other emerging markets, growth is slowing, external financing is dwindling, and governments are under pressure to moderate spending. The private sector has an opportunity to fill the gap.

World Bank data illustrates how far standards in such areas must rise to catch up with developed middle class norms. Some 42 per cent of the population used the internet in emerging markets in 2013, compared with 87 per cent in developed markets. Electric power consumption was 2.7 times higher in the developed world. While school enrollment and teacher-pupil ratios do not differ as wildly between emerging and developed markets, there is still significant scope to improve the quality of education in the emerging world.

Finally, emerging market healthcare expenditure per capita totaled $986 a year in purchasing power parity terms in 2012, only 21 per cent of developed market spend.

China and India are potentially at the forefront of this trend towards improving 'public' goods and services. Both countries are expected to grow their middle class as a proportion of the population at an above-average rate over the next six years, according to our analysis of data from the Brookings Institution. Following these countries, we find Brazil, Indonesia, the Philippines and Thailand, where the middle class is expected to expand rapidly during the same period.

When trying to benefit from the growth of the middle class in emerging markets, most investors focus on traditional consumer goods and services. However, this story has already been largely played out in the stock market. Many emerging market consumer companies already trade at high valuations and offer limited potential for gains. By contrast, the consequences of a growing middle class on the provision of 'public' goods and services have not been fully realised. A plethora of small and medium-size companies are increasingly filling the gap.

This new emerging market story is better played through companies in the developing world rather than developed market firms with emerging market businesses. There are two reasons for this. First, emerging market firms have a better grip on their local markets and are therefore more ready to exploit opportunities in infrastructure and education, among others. In China, for instance, many of the listed public toll roads are owned by provincial governments. Second, it is hard to find relevant developed market firms that derive a significant portion of their revenues from these industries in emerging markets, capping potential gains.

As we enter 2015, investors are justifiably disillusioned with poor growth in the commodity laden 'old emerging markets' over the past three years. Yet, there is much to be excited about if we look at the new emerging industries flourishing beneath. Investors who are cautious on the old emerging markets will still find much to celebrate in the new.

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