

The future of emerging markets: Domestic Consumption

The RBC Emerging Markets Equity team

Domestic Consumption has been an important theme over the past decade in emerging markets (EM). With the onset of COVID-19, we have seen a meaningful shift in consumer behaviour as demand for groceries, pharmaceutical products and online shopping has increased, while spending on travel, live entertainment and clothing has declined significantly. While it is likely that consumption patterns will revert to long-term trends in some areas, we believe that in others there could be permanent structural shifts.

History has taught us that crises can lead to lasting changes and can fundamentally reshape consumer behaviour. During World War II, for instance, women were encouraged to fill jobs on the domestic front. After the war, the effects of those shifts persisted and led to a permanent increase in female workforce participation. The 9/11 terrorist attacks in the U.S. resulted in heightened surveillance and a reduction of privacy. Finally, and more relevant to consumption trends, the 2003 SARS outbreak in China changed attitudes towards shopping. As people became afraid of human contact, consumers turned to online retail. Although the SARS outbreak was short-lived, it resulted in a continued use of e-commerce channels. (Exhibit 1).

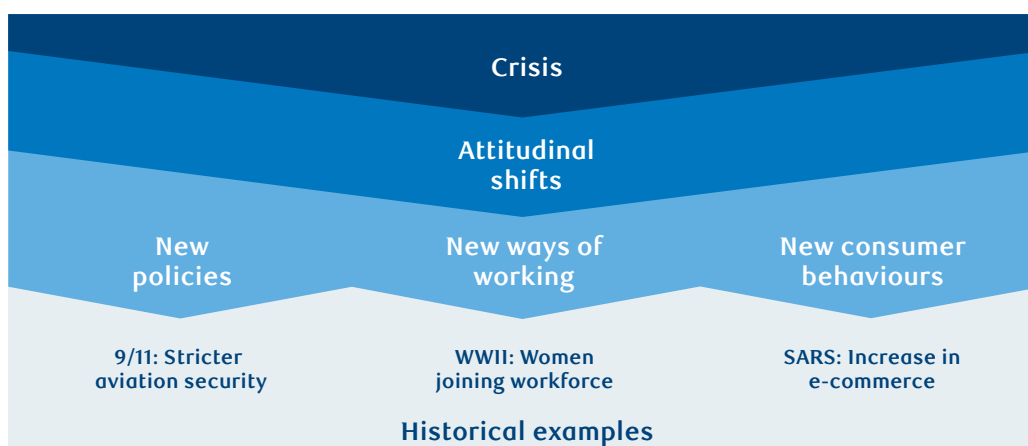
The case for domestic consumption: Is the theme still intact?

Historically, the main drivers behind the Domestic Consumption theme in EM have been: the EM middle class and rising incomes, positive reform momentum, population growth, urbanization, employment trends, an under-leveraged consumer and increased digital services. In a post COVID-19 world, the key question we must ask ourselves is whether the theme is still intact and which of these factors are still supportive?

In the near term, it is likely that the EM middle class consumption story will stall as a result of the pandemic due to a weaker macro backdrop, job losses and subsequent declines in real disposable income. Despite this, we continue to believe in the long-term structural case for domestic consumption in EM. In this paper we identify several important factors which reinforce our long-term view:

Rising incomes and employment: In recent decades rapid economic expansion has been instrumental in lifting people out of poverty and into the middle class, however as a result of the pandemic EM GDP, and subsequently GDP per capita, has suffered an unprecedented shock (Exhibit 2). We expect the younger generations - Millennials and Generation Z - to be amongst the hardest hit in terms of their earning potential, and because they account for nearly 50% of the overall EM population, this is likely to hamper EM consumption in the near term (Exhibit 3). If we look at

Exhibit 1: Crises often lead to lasting changes



Source: BCG Henderson Institute. Data as at March, 2020.

Exhibit 2: Per capita GDP growth in EM



Source; IMF, Citigroup Research. Data as at April, 2020.

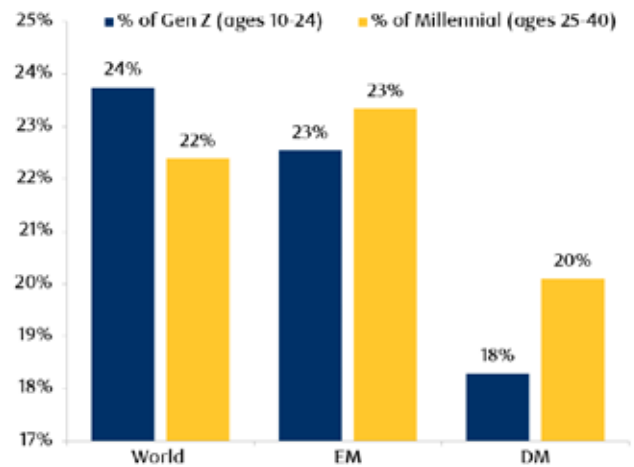
historical trends from the U.S., however, we can see that, in general, it has taken around three years for real incomes to recover following a recession. We think the trend could be similar in EM.¹

Structural reforms and government stimulus: Before the pandemic, our thesis was that reform momentum would be a key driver of domestic consumption in EM. Although some reforms will naturally be put on the back burner as a result of the pandemic, we expect to see more focus on other much-needed reforms, specifically within the healthcare and transport segments. While the pace of reforms may not be as fast as we would like, we do expect there to be stimulus that will boost the consumption story in EM.

Population and demographics: Population growth has always been an important driver of EM consumption. The United Nations (UN) estimates that by 2030 the global population will reach 8.5bn, up from 7.7bn in mid-2019, with 97% of that growth coming from countries classified as 'emerging' or 'developing'.² While the pandemic has raised concerns regarding population growth, a substantially younger EM demographic could potentially mean lower mortality rates. To put this into context, the average age in Africa is 19.7 years, in India it is 26.8 years, and in Latin America it is 31 years; this contrasts with 43.1 years in Europe.³

Urbanization: Economic activity, which in general is stronger in urban areas, tends to lead to higher GDP and incomes levels and, in turn, higher consumption. Although the recent work-from-home transition could be an argument for a reversal in urbanization trends, we believe this is more likely to impact the developed world. Over the longer term,

Exhibit 3: Millennials and generation Z in EM



Source: United Nations, Population Studies. Data as at December, 2019.

we expect urbanization in EM to increase from the current low levels, and for this to drive the growth of megacities and concentrate wealth and income in those areas.

Household leverage: A key driver of EM consumption growth has been consumer lending, driven by financial reform. Despite an increase in consumer credit, however, household leverage remains low. In EM excluding China, household debt as a portion of GDP has remained relatively stable at around 20% over the past 20 years.⁴ This could be supportive for EM consumption trends.

The impact of digital and technology: The evolution of online retail has been a key theme in recent years. Increasing e-commerce has brought greater convenience, transparency and choice for consumers, and this is accelerating the pace of consumption growth. We expect this trend to benefit from COVID-19 as global lockdown measures have created a host of new e-consumers; we believe the switch to e-commerce could become permanent.

Lessons learned from China

China is several weeks ahead of the West and other EM countries in terms of its experience of the COVID-19 outbreak. Therefore, analysing the behaviour of Chinese consumers could help us to ascertain which structural changes could occur elsewhere. Below are some of our key findings:

- **The impact on eating habits:** Initial research suggests that eating habits could change beyond the pandemic, with recent studies pointing to an increased emphasis on the importance of fresh food, healthy eating and dining at home.⁵ This could create an opportunity for manufacturers, retailers, restaurants and food delivery

¹ BAML Research, April 2020. ² UN World Population Prospects 2019. ³ JP Morgan Research, April 2020. ⁴ Refinitiv, Credit Suisse Research, April 2020.

companies to rethink their offerings to ensure they satisfy the increasing demand for healthy, fresh food, while maintaining high quality and hygiene standards.

- **The importance of health:** COVID-19 has increased people's desire to be fit and healthy, and the health-conscious movement is here to stay. A recent consumer survey in China shows that 70% of respondents are keen to exercise more and eat healthier food in order to boost their immunity after the pandemic.⁶ This is also expected to impact shopping habits with research suggesting an increased willingness amongst Chinese consumers to spend more on things such as exercise, organic foods, vitamins and health supplements.⁷
- **The permanent switch to online shopping:** Due to lockdowns, social distancing measures and store closures, consumers have gravitated towards online shopping and this is likely to become their primary shopping channel in future. Research suggests that a significant portion of first-time online users in China are willing to continue using online channels across different areas such as social e-commerce and online groceries.⁸
- **The increased use of online learning and education:** In China, COVID-19 has also augmented the use of digital solutions in the education space. Interestingly, the surge in demand has come not just from students, but also from the general public who have begun to regard online learning as a routine source of wellbeing. As online learning becomes more integrated into people's working lives, this could provide an attractive opportunity for education companies.
- **The increased use of gaming:** Lockdown measures have forced people to seek alternative forms of entertainment such as eSports and live streaming. There are 600 million eSports gamers globally and the number is expected to reach 781 million by 2023.⁹ It is possible that social distancing measures could last for some time and therefore consumers are likely to continue using digital entertainment, not only for convenience but also due to cost effectiveness.
- **The effect of demographics:** The pandemic appears to have changed spending habits across different demographic groups within China. Recent surveys suggest that older generations are now willing to spend more in the near term, while some younger consumers have become more cautious on future spending. This signals a shift in trends observed previously.¹⁰

- **The potential to upgrade:** Although some consumers have become more cautious about future spending, we expect premiumization to remain a relevant theme in certain categories. In China, we have only seen down-trading in select large ticket items such as home appliances and autos. Conversely, we have seen a fast and robust recovery in categories such as premium spirits and cosmetics.

Implications on ways to play the Domestic Consumption theme

The changing consumption habits and structural shifts that we expect as a result of the pandemic are likely to have far-reaching consequences for countries and industries across the Domestic Consumption theme. While there will be many complexities and nuances, we highlight below two key trends that we expect will impact EM more broadly:

1. The role of omni-channel retail¹¹

The onset of COVID-19 and the subsequent increase in digitalization may have long-lasting implications on distribution channels in EM. While there will be differences between countries, depending on their stage of retail development, one key trend that we expect to see across EM is within the food retailing space.

Currently, consumers make decisions about what to purchase based on their needs rather than the channel type. They do not mind using multiple channels in order to find the best deals, and they are willing to switch between online shopping and physical stores. Therefore, while we expect online food retail to increase as a result of the pandemic, we do not believe it will be at the expense of 'bricks and mortar' businesses. We believe that physical stores will continue to be relevant within EM and that online delivery will complement physical retailers. What will be key for EM in the future is the omni-channel strategy.

We believe EM will go down a different path to developed markets, where we have seen the emergence of pure online food retail players, for the following reasons:

- **Smaller basket sizes:** Disposable income in EM is lower than in the developed world and this would mean that the average 'basket size' would be significantly smaller than the level required to break even for a pure online food retail business model.
- **Stage of retail development:** Traditional retail is still very relevant in EM. For instance, in China, which is relatively more developed than other EMs, traditional retail still represents approximately 60% of the total.¹²

⁵ Nielsen, April 2020. ⁶ McKinsey, March 2020. ⁷ Nielsen, April 2020. ⁸ CTR Market Research and B of A Global Research, May 2020. ⁹ Morgan Stanley Research, April 2020. ¹⁰ McKinsey and BCG Research, March 2020. ¹¹ Omni-channel Retail is a shift from single-channel retail (for example shops) to a multi-channel retailing approach (for example shops and online through multiple devices and platforms). ¹² Euromonitor, UBS Research, September 2018.

- **Delivery times:** Traffic congestion in most major cities in EM makes it hard to set up one large central order fulfilment centre and to deliver orders to customers on time. A decentralised model would be more practical in EM where the physical stores would be used as distribution centres.

2. The rise of local and sustainable brands

Historically in EM there has been a tendency for consumers to move away from local brands as their incomes increase. Interestingly, over the past few years, we have seen this trend reverse, with local brands faring well despite increasing levels of GDP per capita across EM. There have been several key reasons behind this:

- Local brands understand local preferences,
- There have been improvements in the quality of the products available,
- Local brands have positioned themselves as value plays for the price-conscious consumer.

The personal care market in India is a good example of a segment where local brands have increased their market share at the expense of multinational companies. We believe that with the onset of COVID-19 the preference for local brands is likely to accelerate further due to three key factors:

1. **Shortening supply chains:** Supply chain disruptions over the past few months could lead to increased localization of suppliers and this shift could be permanent as retailers are increasingly forced to depend on local brands.
2. **Value proposition:** In a world where we are likely to see limited wage increases in the near term, the value proposition will be a significant factor when it comes to consumer choice.
3. **Nationalism:** Many consumers in EM want to support local brands that have suffered as a result of the crisis. This has been particularly true in China where a recent survey found that 85% of participants would choose local over foreign brands in a post COVID-19 world for nationalistic reasons.¹³

The other long-lasting effect that we expect from COVID-19 is an increased focus on sustainable brands. We have found that consumers in China are increasingly choosing brands that recognise environmental issues and impact on society alongside the pursuit of profit. This is a trend we have seen over the past few years, particularly in areas such as personal care and household items, and we expect the pandemic to accelerate it further.

¹³ China Market Research, April 2020.

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