

Global Emerging Markets

The Importance of Quality and Sovereign Strength in EM...

As we look towards 2026, this report explores three interconnected themes shaping our EM portfolio positioning: 1) long-term outperformance of quality companies, 2) acceleration of industry consolidation in a higher-cost-of-capital world, and 3) growing divergence between the strongest and weakest EM sovereigns.

Emerging markets are undergoing a profound shift as the global cost of capital normalises after a decade of excess liquidity. The easy-growth, debt-fuelled era has given way to one that rewards discipline, balance sheet strength, and governance integrity. In this environment, capital is becoming more discriminatory – flowing toward quality companies and sovereigns with proven resilience and sustainable business models.

In this write-up we explore three interconnected themes shaping our portfolio positioning for the year ahead: the long-term outperformance of quality, the acceleration of industry consolidation in a higher-cost-of-capital world, and the growing divergence between the strongest and weakest sovereigns.

1) Investing in Quality for the Long Run

The Northcape EM Strategy remains steadfastly focused on investing in high-quality companies. Empirically, we have observed that the systemic undervaluation of quality has resulted in sustained long-term outperformance versus lower-quality peers. As illustrated in Exhibit 1, while comprehensive data is not available for the full Global EM benchmark, EM Asia shows a clear pattern: companies with high returns on capital and strong balance sheets have significantly outperformed other investment styles, as evidenced by research from Jefferies.

Over the years we have observed that the marginal investor in emerging markets typically operates with a short time horizon – focusing excessively on near-term earnings and underappreciating long-term value creation. This behavioural bias leads to persistent mispricing of high-quality companies with durable competitive advantages, as the market fails to distinguish between temporary earnings ‘flares’, and businesses capable of generating sustained returns above their cost of capital.

The proliferation of data and the growing influence of passive ETF flows have made markets more reactive and short-term in nature, often distracting investors from the fundamental, long-term value creation that quality EM businesses deliver. Against this backdrop, Northcape’s disciplined, long-term investment horizon allows us to exploit these inefficiencies – a form of ‘time arbitrage’ – by identifying and holding high-quality businesses that are mispriced in markets dominated by short-term thinking.

Exhibit 1: Quality outperforms in EM

(Source: Jefferies Research, MSCI)

**2) Industry Consolidation: Driving Pricing Power and Higher Returns for Market Leaders**

The era of near-zero interest rates, effectively free capital, is now firmly in the rearview mirror. We believe the period from 2011 to 2022 will likely be remembered as an anomaly rather than a sustainable equilibrium. Today, a combination of structurally higher debt levels, persistent budget deficits, geopolitical fragmentation, and rising production costs driven by tariffs and reshoring efforts, point to an environment of 'higher-for-longer' interest rates. This backdrop raises the cost of capital globally, but its effects are particularly acute in emerging markets, where funding costs are already materially higher than in developed economies.

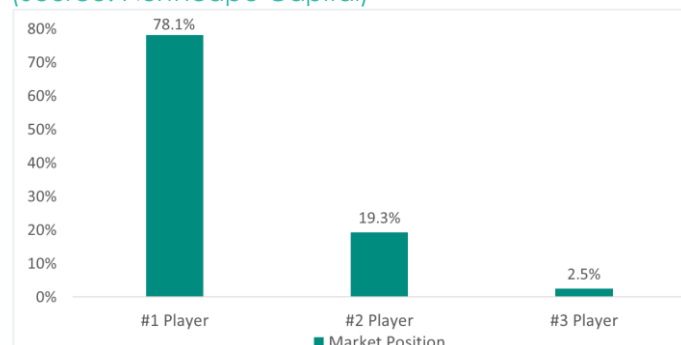
In this environment, access to capital becomes a key competitive differentiator. Many start-ups and weaker companies with negative free cashflows will find it increasingly difficult, or prohibitively expensive, to raise funds. By contrast, leading emerging market companies with strong balance sheets, robust free cashflows, and self-funded growth models are well positioned to consolidate market share.

This consolidation trend strengthens the pricing power and returns on capital of the market leaders – creating a powerful tailwind for quality-focused investors. For Northcape's Emerging Markets Strategy, this theme is particularly evident: as of 30 June 2025, 78% of the portfolio (27 of 34 holdings) comprises companies that are the #1 operators by market share in their respective industries (see Exhibit 2). These

businesses are not only dominant today but are positioned to extend that leadership going forward.

Exhibit 2: Nearly 80% of the Northcape EM Strategy is invested in #1 Players

(Source: Northcape Capital)

**3) Invest in the Best Sovereigns; Avoid the Riskier Ones**

The EM universe comprises 24 distinct economies with vastly different governance systems, regulatory environments, and growth drivers – far from a homogeneous asset class. Our approach is to identify and invest in the best sovereigns, those with sound institutions, credible policy frameworks, strong demographics, and transparent capital markets, as these provide the foundation for consistent long-term compounding of capital.

At Northcape, the best emerging market sovereigns, our "Most Preferred", are defined by three key traits:

1. Institutional integrity
2. Macroeconomic stability, and
3. Demographic momentum.

Institutional strength stems from democratic systems with independent judiciaries, credible central banks, freedom of press and assembly, and accountable fiscal governance. These checks and balances underpin the rule of law and protect minority shareholder rights, enabling capital markets to function with integrity. Macroeconomic stability – anchored by disciplined fiscal policy, manageable debt profiles, and credible monetary authorities – helps foster resilience to global shocks.

Meanwhile, favourable demographics and rising household formation are driving sustained growth in consumption, productivity, and investment – expanding the long-term addressable markets for listed EM companies.

Failure to integrate sovereign risk into the investment process is one of the most significant causes of capital loss in emerging markets. A purely bottom-up approach that ignores exogenous political or macroeconomic shocks leaves investors vulnerable to permanent capital loss when sovereign conditions deteriorate. Events such as Russia's invasion of Ukraine in 2022 demonstrate how quickly investors can be locked out of capital markets through index expulsion, currency inconvertibility, or capital account restrictions. These are not abstract risks – they can result in total loss of capital, particularly for passive strategies that allocate mechanically according to benchmark country weightings, and neglect forward-looking sovereign risk assessment.

Many EM markets that appear 'cheap' on traditional valuation metrics in fact reflect deeply embedded sovereign risks that are not captured in simple P/E multiples. Russia, once hailed as undervalued, proved to be a value trap when geopolitical aggression essentially rendered its market worthless overnight. Similarly, China's equities, long considered 'inexpensive', have delivered chronically poor returns despite strong 'official' GDP growth, as political intervention, weak governance, and systemic capital misallocation have suppressed corporate profitability and shareholder value.

We refer you to Exhibits 3 and 4 which show China's EPS has been flatlining for the past 13 years, and while the stock market has rallied in the past 12 months, China's equity market hasn't yet exceeded its peak of 2007.

Exhibit 3: MSCI China Index Long Term EPS
(Source: Bloomberg Finance LP)

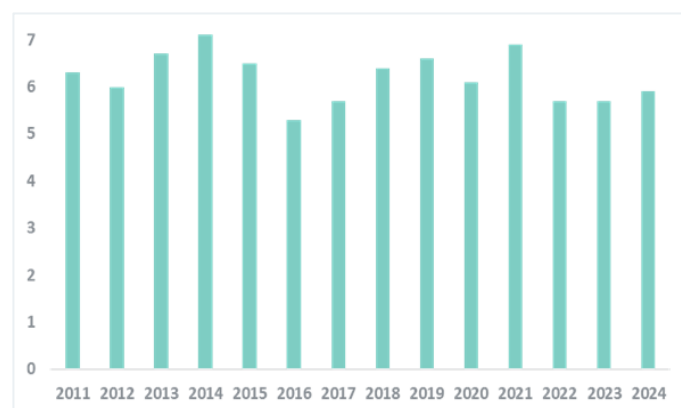


Exhibit 4: MSCI China Index Long Term Returns
(Source: Bloomberg Finance LP)



By actively avoiding weaker sovereigns and allocating disproportionate capital to emerging markets with credible institutions, disciplined economic management, and respect for shareholder rights, the Northcape EM Strategy aims to preserve capital and capture sustainable long-term growth. Exhibit 5 details Northcape's assessment of political and governance risk across the EM sovereigns.

Exhibit 5: Northcape's Political and Governance Risk Assessment
(Source: Northcape analysis)

2Q25	Overall Political Risk Assessment
China	High
Saudi Arabia	High
Thailand	High
Turkey	High
Hungary	High
Egypt	High
Indonesia (new)	High
Peru	High
Colombia	High
South Africa	High
Indonesia (old)	Medium
Brazil	Medium
Malaysia	Medium
Mexico	Medium
Poland	Medium
Greece	Medium
Chile	Low
India	Low
Czech Republic	Low
Taiwan	Low
Korea	Low

Countries in green indicate Northcape's current preferred countries. Note there was an interim change to Indonesia's rating due to recent political turmoil.

America Móvil: A Case Study in Industry Leadership and Consolidation

América Móvil exemplifies the industry consolidation trend currently reshaping emerging markets. As the leading telecommunications company in Latin America, with over 400 million fixed and wireless subscribers, América Móvil is invariably the #1 or #2 operator in all its core markets. This dominant position delivers significant advantages in network scale, reach, and capacity – all vital in providing LatAm consumers with ubiquitous and fast internet access at home, at work, and on the move.

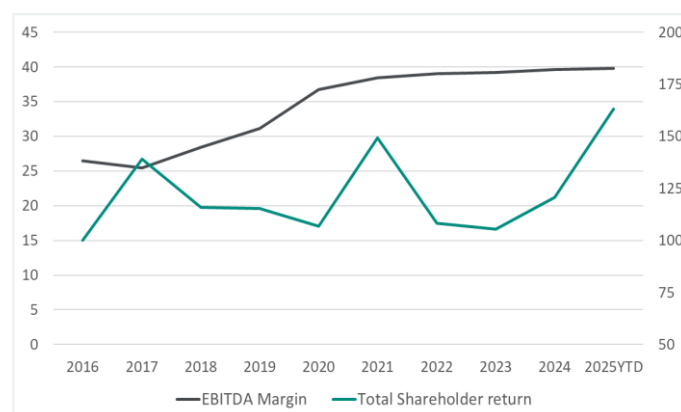
The shift to a higher cost of capital globally has accelerated consolidation across the telecommunications industry. Many smaller or highly leveraged operators have found it increasingly difficult to sustain network investment, as rising interest rates and constrained funding conditions erode their financial flexibility.

In contrast, América Móvil's strong balance sheet, robust free cashflows, and disciplined capital allocation have allowed it to maintain a steady pace of investment in building superior network quality, capacity, and coverage.

Since 2019, the company's returns on capital have steadily improved as it has leveraged these competitive advantages, while industry rivalry has moderated. Several of América Móvil's key competitors are underinvesting in their network capabilities, in part due to higher funding costs, leading to a migration of industry returns toward the leaders. This dynamic reinforces the broader consolidation trend, where scale and financial resilience translate directly into pricing power, higher returns, and durable market leadership. Exhibit 6 highlights the steady improvements in América Móvil's EBITDA margins from 25% to 40% over the past ten years, and how this has eventually driven better returns to shareholders.

América Móvil's experience underscores how tighter financial conditions are reshaping competitive landscapes in emerging markets: strong incumbents are not merely surviving but extending their lead as weaker peers retreat.

Exhibit 6: Industry Consolidation Strengthens América Móvil's Profitability and Shareholder Returns
(Source: Bloomberg Finance LP)



India: A Case Study of a Most-Preferred Sovereign

India exemplifies Northcape's definition of a Most Preferred emerging-market sovereign – combining institutional integrity, macroeconomic stability, and demographic momentum. With over 60% of GDP driven by domestic consumption and a deep, well-regulated financial system, India's growth model is largely self-funded, and resilient to external shocks. The Reserve Bank of India's policy credibility and the government's disciplined fiscal approach have anchored inflation and sustained real GDP growth of around 7% – the fastest among major economies – positioning India as a standout in a higher-for-longer cost of capital world.

This sovereign strength is translating into broad-based industry consolidation and superior corporate performance in India. In sectors such as banking, telecoms, autos, aviation, and IT services, financially robust market leaders are extending their dominance as weaker competitors retrench. Scale, balance sheet discipline, and prudent capital allocation are proving decisive advantages for India's sector leaders.

India's policy coherence and private sector vitality reflect institutional strength not commonly seen in emerging markets. Promoter-owned corporates maintain a sharp focus on returns on capital, while ongoing structural reforms, and sustained infrastructure investment have underpinned long-term productivity gains for the Indian economy.

These reforms have created a corporate environment in India where a significantly larger proportion of companies consistently deliver strong, sustainable outperformance compared with most other emerging markets. In sharp contrast, China's market, despite its breadth, has seen persistently weak long-term shareholder outcomes, with only a small fraction of firms beating the market, or generating returns above their cost of capital, as can be seen in Exhibit 7.

2026 is set to deliver a higher-cost-of-capital and more uncertain world, and we believe the Northcape Emerging Markets Strategy is positioned on the right side of structural change – investing in quality companies and sovereigns with the balance sheet strength, discipline, and integrity to endure while weaker peers retrench. Nearly 80% of our total EM portfolio comprises companies which are the #1 operator by market share in their respective industries. More than 60% of our portfolio is in our Most Preferred sovereigns.

This long-term, fundamentals-based approach stands apart from the short-termism and passive flows that increasingly dominate financial markets. By allocating capital to the best businesses within the best sovereigns, we aim to capture durable value creation while mitigating the risks that too often erode returns in the asset class.

Exhibit 7: Indian corporates disproportionately outperform within EM (Source: Bloomberg Finance LP)

Market	Average Return Past 3 Years	Median Return Past 3 Years	Number stocks in EM index (Total 1206)	Number stocks > 100% Return	Number stocks < 0% Return	Big win rate	Outperform rate	Underperform rate	Market RoE Current Average	Northcape Cost of Equity	Portfolio Position	Market
Mexico	59.51%	49.81%	23	4	3	17%	100%	0%	16.1%	15.2%	18.0%	Mexico
India	125.74%	62.96%	156	53	24	34%	94%	6%	16.9%	10.4%	22.0%	India
Turkey	102.51%	80.97%	16	7	3	44%	94%	6%	10.7%	37.5%	0.0%	Turkey
Poland	81.47%	72.57%	13	6	3	46%	85%	15%	14.4%	12.4%	5.2%	Poland
Saudi Arabia	77.99%	42.31%	39	12	10	31%	85%	15%	14.1%	22.7%	0.0%	Saudi Arabia
South Africa	28.06%	18.35%	29	3	8	10%	83%	17%	18.1%	21.2%	0.7%	South Africa
Taiwan	61.55%	19.35%	88	19	30	22%	80%	20%	11.5%	10.9%	16.5%	Taiwan
Philippines	23.48%	22.11%	11	1	5	9%	64%	36%	14.6%	15.4%	2.0%	Philippines
Brazil	19.39%	13.63%	41	3	19	7%	61%	39%	24.2%	20.1%	5.0%	Brazil
Indonesia	13.33%	-4.29%	17	2	9	12%	59%	41%	15.5%	13.0%	6.0%	Indonesia
Sth Korea	45.33%	-14.34%	81	8	45	10%	54%	46%	8.4%	10.9%	14.9%	Sth Korea
China	14.85%	-6.74%	404	33	228	8%	58%	42%	11.9%	22.1%	0.0%	China
Hong Kong	1.68%	-11.83%	150	13	90	9%	53%	47%	11.9%	22.1%	5.7%	Hong Kong
Thailand	-3.70%	-16.20%	25	1	15	4%	48%	52%	10.7%	17.1%	0.0%	Thailand
Malaysia	16.76%	-3.42%	30	4	19	13%	63%	37%	11.3%	12.2%	0.5%	Malaysia
Chile	-23.52%	-14.26%	11	0	9	0%	64%	36%	12.8%	14.9%	0.0%	Chile

(Source: Bloomberg LLP, Northcape Capital)

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