



The Emerging Middle Class

As part of our investment process, we spend a great deal of time reading through quarterly earnings reports from companies in a wide range of industries. A couple of years ago, we began to notice an emerging trend among companies in unrelated industries. For many domestic and internationally domiciled companies, an increasing portion of their revenue growth was being generated in fast growing emerging markets. This trend accelerated during the financial crisis, as tight credit and high unemployment deprived the U.S. consumer, long considered the main engine of global economic growth, of the ability to spend as freely as it had in the past. In retrospect, the financial crisis served as the tipping point that marked the shift in economic growth from West to East.

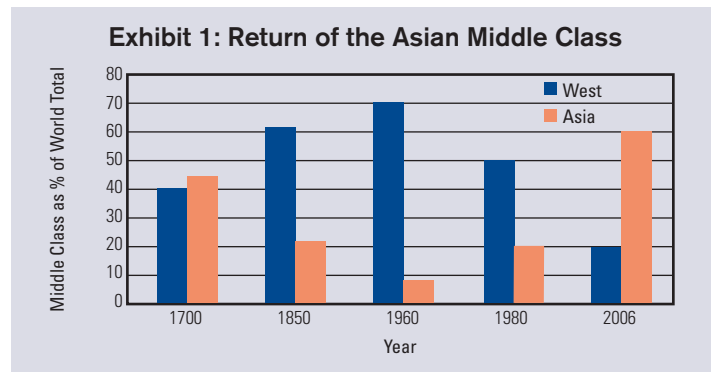
From an analytical perspective, this revelation spurred a host of additional questions. What was driving this consumption? Would it be enough to offset the reduced demand from the U.S. consumer? What were the implications for companies in our portfolios?

It didn't take long to figure out that behind the increased consumption in emerging markets lay a burgeoning middle class that, by some estimates, is expected to double over the next 20 years. According to OECD projections, by 2015, for the first time in 300 years, the number of Asian middle class consumers will equal the number in Europe and North America.¹ By 2021, there could be more than 2 billion Asians in middle class households (with China accounting for 670 million of those households, up from 150 million today).² To better understand the "emerging middle class" phenomenon and its implications for global economic growth, it is helpful to start with how the middle class is defined.

Defining the Middle Class

What exactly do we mean by "middle class"?

Qualitatively, the middle class is an ambiguous social classification, generally reflective of those who enjoy stable housing, healthcare, educational opportunities (including college) for their children, reasonable retirement / job security and discretionary income that can be spent on vacation and leisure pursuits.³ Goldman Sachs



Source: Surjit, Bhalla, *The Middle Class Kingdoms of India and China* (forthcoming)

defines the middle class as those who have about a third of their income left for discretionary spending after providing for basic food and shelter.⁴

Quantitatively, the middle class is defined in terms of income levels, with two generally accepted modes of measurement: an absolute calculation which compares populations of different countries using a fixed income range for all countries or a relative calculation that compares populations within the same country using country specific median income figures.

Absolute – using an "absolute" approach, the Brookings Institute defines the middle class as having an average daily per capita income that ranges from USD \$10 to USD \$100 in purchasing power parity (PPP) terms.⁵ Using these ranges, Surjit Bhalla (a noted Indian economist) found that the middle class' share of the whole world's population rose from one-third to over half (57%) between 1990 and 2006. According to Mr. Bhalla's study, the number of middle class people in Asia (narrowly defined as China and India) recently overtook the number of middle class people in the West for the first time since 1700.⁶ (Exhibit 1) *(continued next page)*

1 Kharas, Homi and Geoffrey Gertz. "The New Global Middle Class: A Cross-Over from West to East" Chapter 2 in *China's Emerging Middle Class: Beyond Economic Transformation*, Washington, D.C." Brookings Institution Press, 2010

2 Kharas, Homi; et al.

3 Kharas, Homi; et al.

4 Wilson, Dominic and Raluca Dragusanu. "The Expanding Middle: The Exploding World Middle Class and Falling Global Inequality;" Goldman Sachs Economic Research, July 7, 2008.

5 Kharas, Homi, et al.

6 Parker, John. "Burgeoning Bourgeoisie;" *The Economist*, February 12, 2009.

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Relative - using a “relative” approach, the World Bank defines the middle class as ranging from the average per capita income of Brazil to the average per capita income of Italy in terms of PPP. Using household-survey data at 2000 PPP, that translates into roughly \$12-50 a day per person.

For discussion purposes, we’ve assumed a blended approach and defined the “middle class” as the portion of the population making between \$10-\$50 per day (roughly \$3,000 to \$18,000 per year). By that measure, the World Bank estimates that the middle class population of emerging markets was about 250m in 2000 and 400m in 2005, with a projected population of 1.2 billion by 2030.⁷ While that number is quite staggering, individually, these consumers do not spend as much as consumers in the U.S. This means that in terms of purchasing power, emerging markets still lag the U.S., at least in terms of aggregate consumption. That said there are signs that these consumers have already overtaken the U.S. consumer in some key categories, including:⁸

- **Cars** - In 2008 the number of cars sold in the big emerging markets exceeded those sold in America for the first time. Today, China is the world's largest auto market, with 13.6 million vehicles sold in 2009, well above the 10.4 million sold in the U.S.
- **Cell Phones** - China recently emerged as the world's biggest cell phone market with 700 million subscribers. In 2008, Nokia had net sales of \$8.2 billion in China, more than three times its U.S. revenues.
- **Business Services** - since 1994, business services in emerging markets including India and Brazil have grown by 250-700% compared to 100% in Europe and America

Furthermore, over the medium to long term, China and India are expected to contribute meaningfully to the world economy, accounting for over 40% of middle class consumption by 2030, according to a study by Homi Kharas at the Brookings Institute.

This is noteworthy, given that India did not crack the “top ten” list in 2009. (Exhibit 2)

In determining whether the middle class in emerging markets will pick up the slack for the U.S. consumer, the short answer is – it depends. It depends on the time horizon (over the short term, not likely; over the medium to long term, very likely), as well as the specific industry under consideration. To better gauge which industries are likely to be most impacted by the emerging middle class, it is helpful to understand the motivations underlying consumption patterns for middle class consumers in emerging markets.

Consumption Patterns

“Consumption is primarily a social process and...in societies such as our own, much of the function and motivation for consumption derives from social communication and symbolic action, rather than the drive to meet basic needs such as food, shelter, or clothing.” ~Sociologist Juliet Schor

As a general rule, as incomes increase, consumers with discretionary income start to move away from buying things as commodities, and look to buy things because of what they represent. Put another way, as incomes rise, spending patterns change in accordance with Maslow’s hierarchy of needs. According to this theory, once a person’s basic physiological needs including food, shelter, sex and sleep have been met, they move on to more aspirational needs, including “belonging” (acceptance, affiliation) and “esteem” (self-respect, social status, approval of others). Consequently, as consumers move up the hierarchy and buy more discretionary and aspirational luxury items, the share of the household budget that goes toward food, clothing and other necessities shrinks. (Exhibit 3, next page)

With 1.5 million people entering the global middle class on a daily basis, the entire life cycle of the middle class consumer presents enormous opportunities for investment. (Continued)

Exhibit 2: Total Middle Class Consumption, Top 10 Countries 2005 PPP\$, Billions and Global Share

	2009			2020			2030		
1	U.S.	\$4,377	21%	China	\$4,468	13%	India	\$12,777	23%
2	Japan	1,800	9%	U.S.	4,270	12%	China	9,985	18%
3	Germany	1,219	6%	India	3,733	11%	U.S.	3,969	7%
4	France	927	4%	Japan	2,203	5%	Indonesia	2,474	4%
5	U.K.	889	4%	Germany	1,361	4%	Japan	2,286	4%
6	Russia	879	4%	Russia	1,189	3%	Russia	1,448	3%
7	China	859	4%	France	1,077	3%	Germany	1,335	2%
8	Italy	740	4%	Indonesia	1,020	3%	Mexico	1,239	2%
9	Mexico	715	3%	Mexico	992	3%	Brazil	1,225	2%
10	Brazil	623	3%	U.K.	976	3%	France	1,119	2%
Total Top 10		\$13,019	62%	21,289	62%	37,857	68%		

Source: Kharas, Homi, “The New Middle Class: A Cross-Over from West to East,” Wolfensohn Center for Development at Brookings

⁷ Parker, John. “Who’s in the Middle?” *The Economist*, February 12, 2009.

⁸ Kharas, Homi and Geoffrey Gertz. “The New Global Middle Class: A Cross-Over from West to East, Chapter 2 in *China’s Emerging Middle Class: Beyond Economic Transformation*, Washington, D.C.” Brookings Institution Press, 2010.



Exhibit 3: Where They Spend It

Economic Section - Industry	Share of Consumption				Portfolio Stocks	
	India		China			
	2004	2005	2004	2005	Basic Needs	
Food, Beverage, Tobacco	41%	24%	35%	24%		AmBev, Coca-Cola FEMA, Pepsi
Apparel	6%	5%	12%	7%	Nike	
Housing, Utilities	12%	10%	9%	17%	CPFL, Energia	
Household Products	2%	2%	6%	4%	Unilever, Colgate	Discretionary
Personal Products & Services	8%	11%	3%	4%	Apple, Activision, Google	
Transportation, Communication	19%	26%	13%	15%	RIMM, AsiaInfo, Chunghwal, Telecom	
Education, Recreation	5%	9%	15%	16%	Priceline.com	
Health Care	7%	13%	7%	13%	Herbalife	

Source: "Global Consumerism at the Crossroads," Citigroup Global Markets, March 27, 2009; MCM Analysis

As you can see, our portfolio is well represented along the entire spectrum of consumption, from basic needs (beverage makers) to higher end discretionary expenditures (online travel websites and smartphones). We believe this trend is likely to continue, and will therefore be an added consideration in future stock selection.

In conclusion, we are at the beginning of a profound and formidable transition in the global economy, with the economic center of gravity slowly shifting from West to East. The emerging middle class will play a pivotal role in that transition as it competes with the U.S. consumer in driving global economic growth. ■