



William Blair & Company®

Emerging Markets: Essential
Sources of Global Economic Growth



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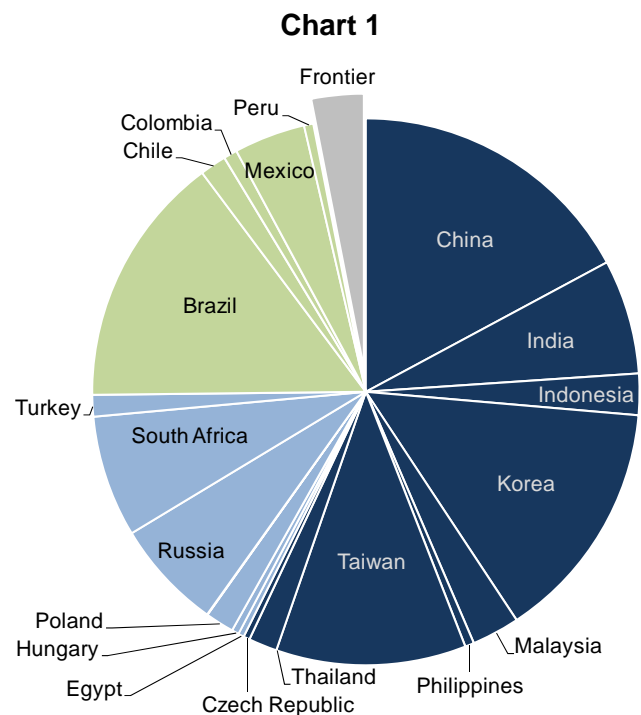
August 2011

Emerging markets have transitioned from being the beneficiaries of global growth to global growth drivers, and have become an increasing part of the global opportunity set. This trend was exemplified by the 2008 financial crisis, a time when emerging markets were not at the epicenter of the crisis and, as a result, rebounded more quickly. These disparities have surfaced again in 2011 as credit rating agencies have downgraded European and US country debt. This trend over time has benefited global investors, developed companies, and emerging markets investors alike. Developed market countries are facing slow growth, a stop and start recovery, and are dealing with significant debt that has accumulated as governments tried to jumpstart their economies following the 2008 recession. A number of European countries, including the UK, have established austerity measures to get debt under control. Spending cuts have also been an area of focus in the United States, as well as in other parts of the developed world, again in an effort to reduce the debt burden. Governments are also discussing revenue increases through tax hikes, closing of tax loopholes, and better enforcement of tax policy. Conversely, emerging markets are not generally dealing with the same issues generally. While it varies by country, inflationary concerns are the primary focus in emerging markets, as growth has been strong. However, emerging markets generally have a few key trends in their favor: they generally maintain more financial flexibility, they have a younger population, and they are benefiting from the “catching up” phenomenon, all of which has translated into positive emerging markets growth trends.

Trends in the Emerging Markets Universe

Emerging markets are generally defined as economies that are earlier along in their economic development, have lower income/capita, and generally have smaller size and liquidity within their equity markets. Chart 1 reflects the definition of emerging markets as reflected by MSCI, a popular index provider.

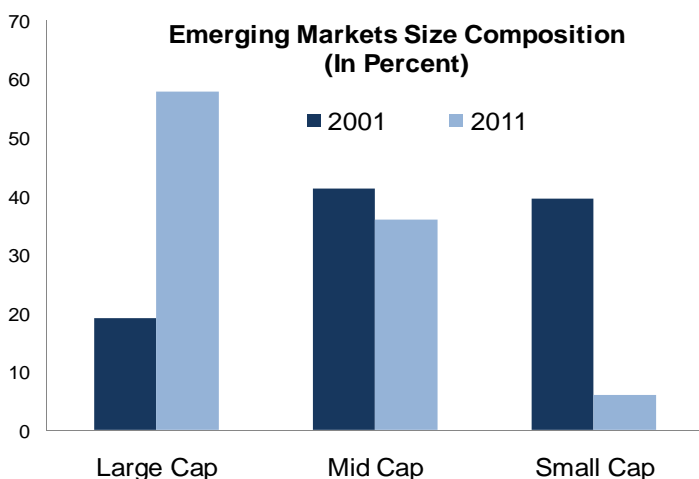
Approximately 17% of the emerging markets universe is represented by China, with Brazil and Korea representing 15% and 14%, respectively. This compares to 2001 when Taiwan, Korea, South Africa and Mexico each represented approximately 11% of the universe, while China was a mere 6%. The ascendance of China represents strong growth that the economy has experienced over the last decade. This is the reason a number of economists and industry observers focus on China – because it is a large part of the emerging markets opportunity set, and because it is a large contributor to global growth. There are a number of countries that have moved from emerging markets to developed markets in recent years. Israel was moved to developed markets during 2010. MSCI, the Index provider, is contemplating moving Taiwan and Korea, and has asked investors about these countries as well, given that they have attained the minimum economic stability, economic development, size and liquidity requirements. Of course, countries can move back to emerging markets status: Malaysia for instance, was moved to emerging markets from developed given the capital controls the government established following the emerging markets crisis in the late 1990s.



Source: MSCI & FactSet

The complexion of emerging markets has also changed significantly in terms of contribution to global market capitalization. Ten years ago, approximately 80% of the emerging markets universe was considered small-mid capitalization (<\$15 billion in market capitalization), as shown in Chart 2. Today, the capitalization of the market reflects the changes that have occurred in emerging markets – approximately 58% of emerging markets companies are considered large capitalization, while now 42% are in the small-mid capitalization size range. Four of the largest ten global companies globally, as measured by market capitalization, are based in the emerging markets, as shown in Chart 3.

Chart 2



Source: MSCI & FactSet

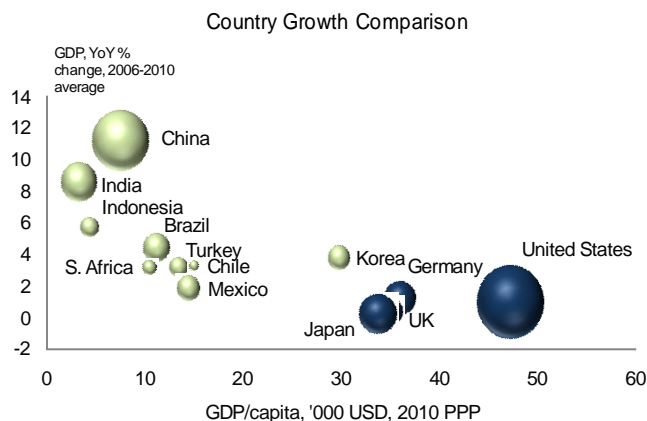
Chart 3

Company	Country	Total Market Cap (\$B)
Exxon Mobil	USA	411,180
Apple	USA	321,629
ICBC	China	292,590
PetroChina	China	265,444
BHP Billiton	Australia	262,632
China Construction Bank	China	235,949
Royal Dutch Shell	UK	227,696
Petrobras	Brazil	220,928
Chevron	USA	210,898
Microsoft	USA	210,859

Source: MSCI & FactSet. The individual securities shown are presented for informational purposes only and do not constitute advice or a recommendation to purchase or sell a particular security.

While developed markets maintain a significant premium in GDP/capita over their emerging markets counterparts, emerging market growth rates have far exceeded developed markets over the last five years. The size of the bubbles in Chart 4 reflects the size of the economy as measured by contribution to global output. The United States is still the largest single contributor to global output, but China is catching up, and India also makes a significant contribution, particularly when compared to Germany and Japan, two of the larger developed economies. This underscores the concept that emerging markets are increasingly drivers of global growth, rather than passive beneficiaries of it.

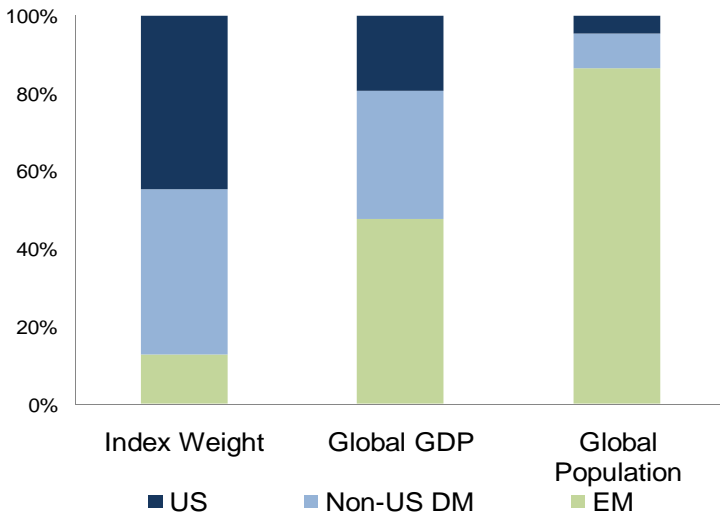
Chart 4



Sources: IMF April World Economic Outlook



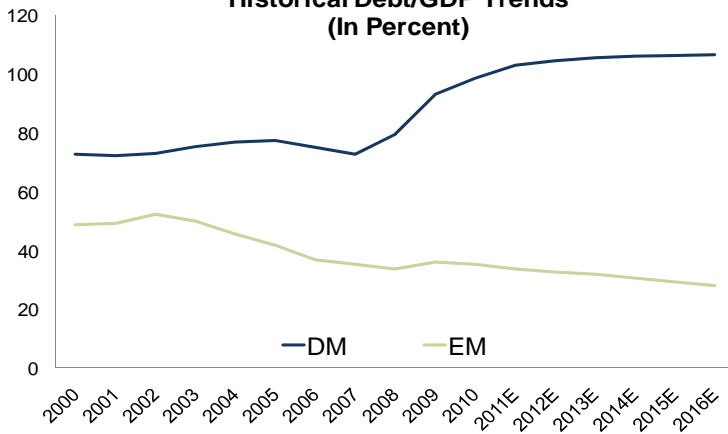
Chart 5



Sources: IMF, MSCI & FactSet

Chart 6

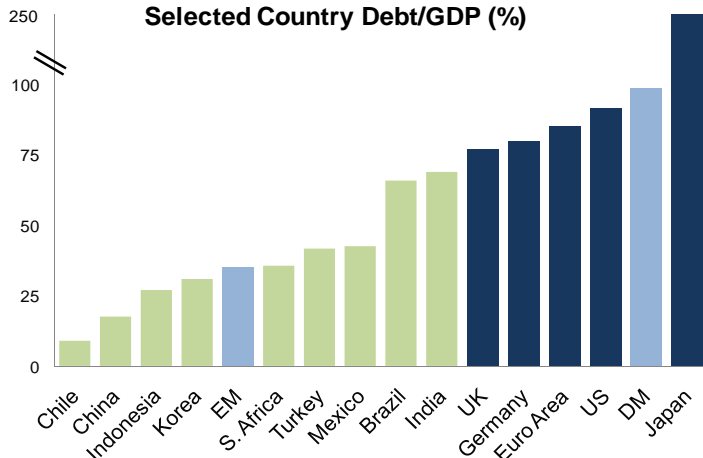
Historical Debt/GDP Trends (In Percent)



Sources: IMF April World Economic Outlook

Chart 7

Selected Country Debt/GDP (%)



Sources: IMF April World Economic Outlook

What does the opportunity set look like when evaluating it from a different perspective – global output and population? What metrics should investors use in determining overall allocations to emerging markets across their equity portfolios?

As of May 31, approximately 13% of the world's equity market was in emerging markets, as estimated by MSCI. Contrast that with the United States and developed ex-US, which were 43% and 44%, respectively. Most investors do not have allocations of 13% of their equity investments in emerging markets, either through strategic allocations or through managers that will invest opportunistically in these regions. Emerging markets represents nearly half of global output, while 86% of the world's population lives in these regions. The significant population in these markets represent an opportunity for investors, as well as companies looking to harness that growth as more emerging market consumers attain middle class status, as infrastructure improves, and as those countries catch up in productivity growth and wealth.

Since the emerging markets crises in the 1990s, these countries have successfully reduced their indebtedness as a percentage of output from approximately 48.7% as of 2000 to 35.1% as of 2010. Conversely, developed market countries have significantly increased debt/GDP over the same time frame, due largely to the step up in spending following the 2008 financial crisis.'

As of year end 2010, debt/GDP averaged 98.8% across the developed world, with the major European and US economies at 85% and 92%, respectively. As a result, potential austerity measures, revenue increases and their potential growth impacts are being debated. As emerging markets emerged from the financial crisis of 1997-1998 fiscal policies improved, aided significantly by strong economic growth that afforded these countries financial flexibility so that in the case of the 2008 financial crisis, they had the wherewithal to invest in infrastructure spending and consumer programs, but not significantly expand debt relative to output.

Like countries, companies are benefiting from similar trends. Historically, emerging markets companies have enjoyed higher growth rates relative to their developed market counterparts. What has changed over the last decade is that emerging markets corporate quality has improved as well. Chart 9 highlights that emerging markets return on equity (ROE) equals 19.3%, higher than the 17.3% US ROE or 14.5% developed ex-US ROE. Return on equity is a general reflection of quality, but other financial metrics would reflect this trend as well, along with generally improved transparency, accounting standards and focus on shareholder value, although of course there is a wide range across companies and countries. From a leverage perspective, emerging markets companies generally have lower leverage, although this varies across sectors. Returns have increased as well, as reflected by the cash flow return on invested capital of nearly 20%, shy of the 21.7% in the US, but well above the 16.7% in developed ex-US. As a result, investing in emerging markets is not for diversification benefits anymore; rather, it reflects a broader quality and growth opportunity set.

Chart 8
Blair LTG

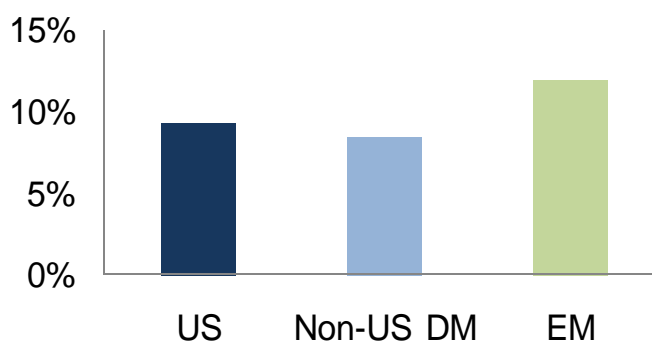


Chart 9
ROE

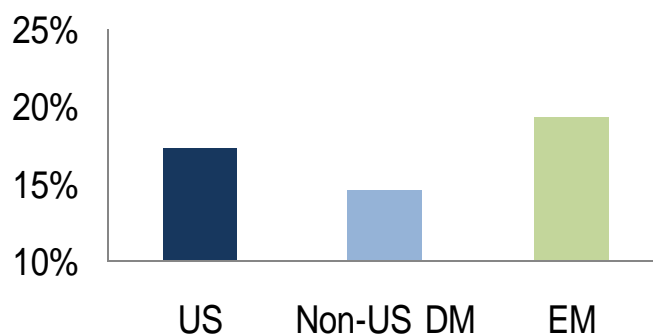


Chart 10
Debt/Equity

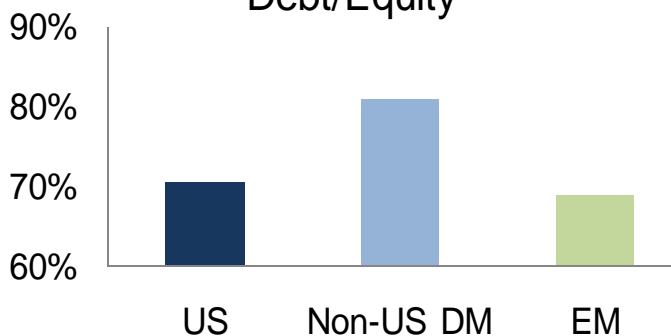
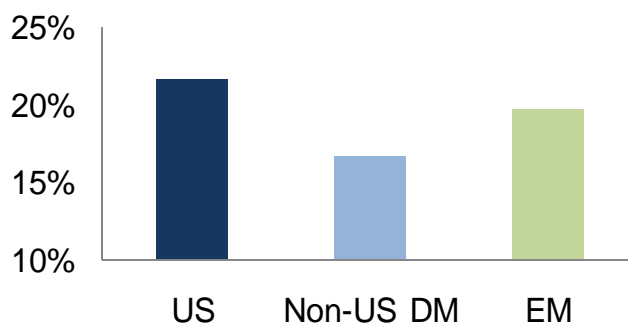
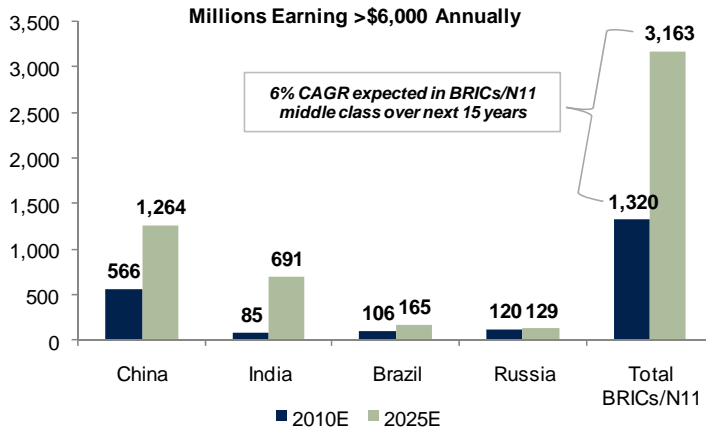


Chart 11
Cash Flow ROIC



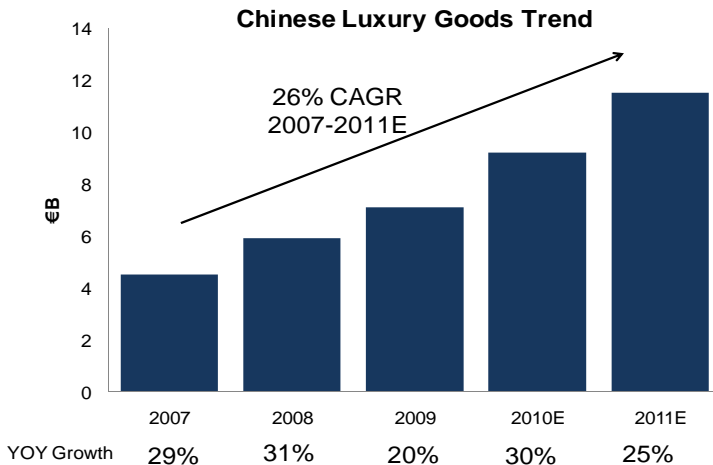
Sources: FactSet, MSCI. As of May 31, 2011.

Chart 12



Sources: CLSA, UN Population Division, World Bank, OECD, Bain, and Goldman Sachs Research.

Chart 13

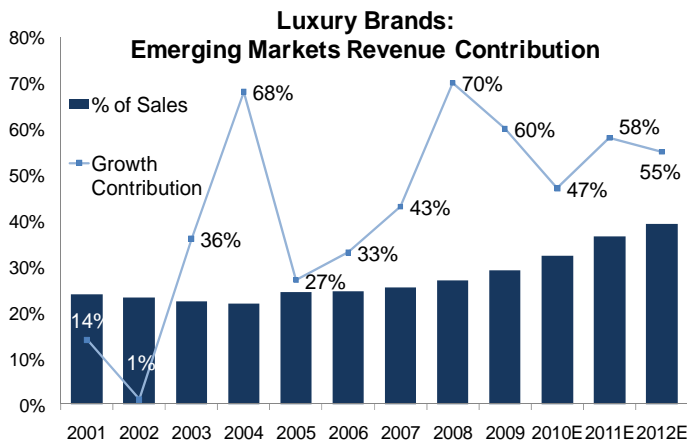


Sources: CLSA, UN Population Division, World Bank, OECD, Bain, and Goldman Sachs Research.

One of the primary trends that has occurred in emerging markets is the rise of aspirational consumerism as economies and individuals get wealthier. The number of consumers attaining middle class status is growing significantly. Growth has been driven by labor and capital productivity improvements, but wages are also now increasing. For example, 20% minimum wage growth has been reported across Chinese provinces over the last several years. CLSA recently conducted a survey of Chinese consumers versus US consumers to juxtapose the two economies. One of the findings in the survey was that 42% of the Chinese sample indicated that their incomes increased over the past year compared to only 10% in the US. Of course US wages are starting from a higher base, but higher emerging markets wages mean more discretionary income for consumers and higher buying power. Aon Hewitt estimates that Indian wage growth will approximate 13% in 2011. These wage increases, while positive for consumer spending, has led to concerns about increases in core inflation.

This trend has not gone unnoticed as companies around the world – from McDonalds to Burberry, from BMW to MeadJohnson - have increased investments in these markets. An example of this trend is the luxury retailing segment. In China, luxury goods demand is on a tear as the luxury goods annual growth rate is expected to average 26% over the 5 year period ending December 31. Bain estimates that China will be the third largest market for luxury goods sales in 5 years. This is a significant change. China has the law of large numbers behind it, given its population size – as only a 10% increase in the population able to purchase luxury goods – the aspirational consumers – is going to make a difference.

Chart 14



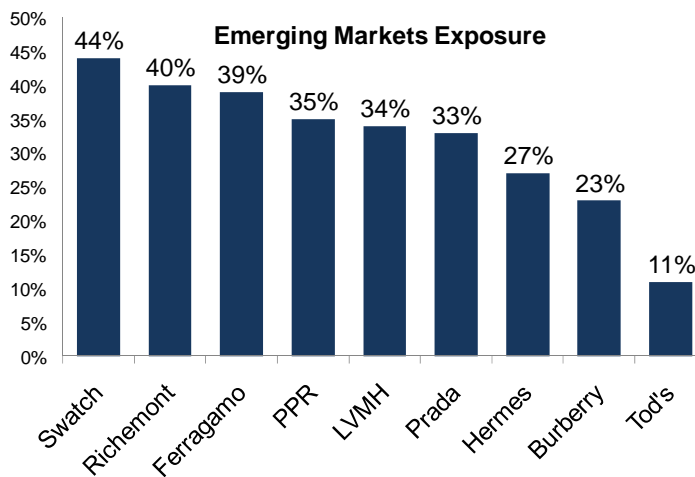
Sources: Bank of America Merrill Lynch Global Research, Company Reports. Past performance does not guarantee future results.

How has that translated into a changing revenue picture for the luxury goods providers?

The percentage of sales from emerging markets has steadily increased over the last decade, while the contribution to growth has also been significant. Approximately 30% of sales are generated in emerging markets versus 20-25% at the turn of the century.

It is interesting to see how these broad trends translate into individual company exposure and growth strategy, as indicated in Chart 15. Swatch, the Swiss watch company, has somewhat of a first mover advantage, and has 44% of revenues generated in emerging markets. This company has established a strategy where they own their own stores in emerging markets and they also invest as a minority shareholder in key emerging markets partners. Hengdeli Holdings, which is a Chinese watch retailer and wholesaler (recently expanding into jewelry), is 9% owned by Swatch. Rivoli in the United Arab Emirates is 15% owned by Swatch. This approach is the way in which Swatch is trying to grow its emerging markets exposure.

Chart 15

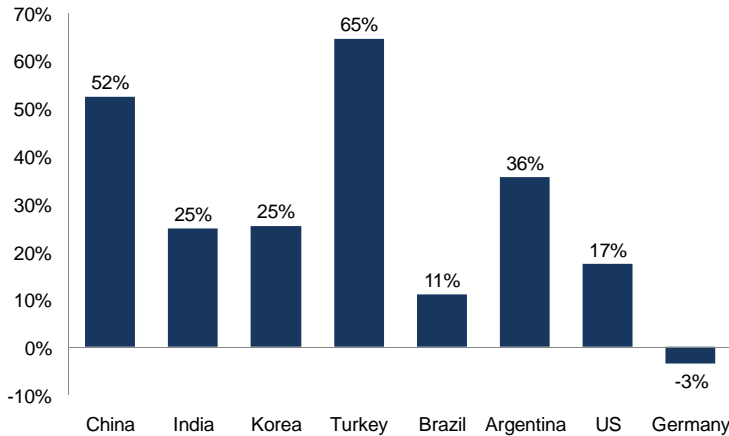


Sources: Bank of America Merrill Lynch Global Research, Company Reports. Past performance does not guarantee future results.

Richemont, the Swiss watch and jewelry company, is another early entrant. It, too, is a significant partner to Hengdeli Holdings, which has a 30% market share of the Chinese watch market. Its Cartier brand was recently voted as the best jewelry brand in China. Louis Vuitton was named the best luxury brand in China and has approximately 34% of its revenues driven by emerging markets. Historically a significant proportion of its revenues have come from Asia: in 2000 approximately 37% of its sales were generated in Japan. Today it is 9% with emerging markets taking up the slack through faster growth and expansion. Burberry has recently acquired its franchisee in China where sales of the acquired stores are growing in excess of 30%. It has been aggressively marketing the brand locally, having launched its Beijing flagship store in April with a multimedia fashion show viewable in real time globally on the internet.

Chart 16

Global Auto 2 Year Unit Growth Rates



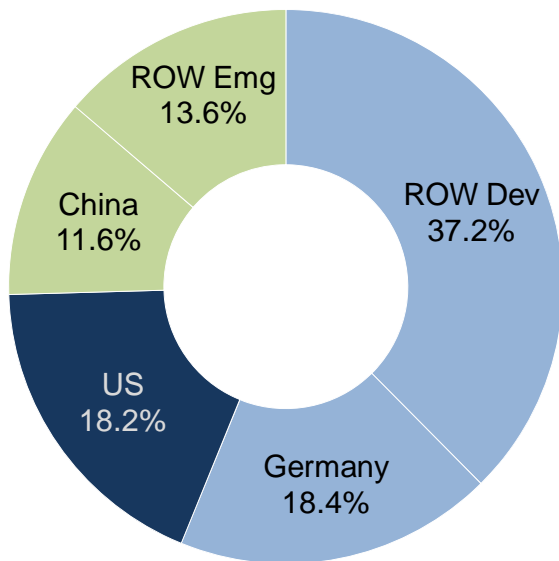
Sources: Goldman Sachs, Company Reports. Past performance does not guarantee future results

The auto market is another significant emerging markets growth area, with many emerging markets outgrowing the large German and US markets, which are highly penetrated. This trend is occurring across regions. There are local winners such as Great Wall Motor, the Chinese auto manufacturer with a focus in SUVs, or Bajaj Auto in India, focusing on the lower end Indian segment. There are joint ventures such as Dongfeng Motor Group and others that are partnering with other auto companies in manufacturing and selling their cars, two- and three wheelers. The traditional luxury car makers have also capitalized on this underpenetrated and fast growing market.

BMW has capitalized on this trend by increasing penetration in emerging markets, as in 2010 approximately one quarter of BMW's revenues were generated by emerging markets. It plans to double its Chinese dealers to 350 from 175 over the next five years. Currently, China is BMW's largest end market for the Series 7 sedan and X6 Sports Activity Coupe. In addition, profitability per car is higher in China relative to developed markets. This growth is not without difficulties, however. Given significant congestion in Beijing and Shanghai, the government has instituted license plate quotas and higher taxes on the OEMs. There are also rumors of higher local content laws to benefit Chinese companies. BMW has stated its goal is to limit China to 20% of revenues and has discussed its next expansion opportunities in Mexico or Brazil.

Chart 17

2010 BMW Regional Sales Mix

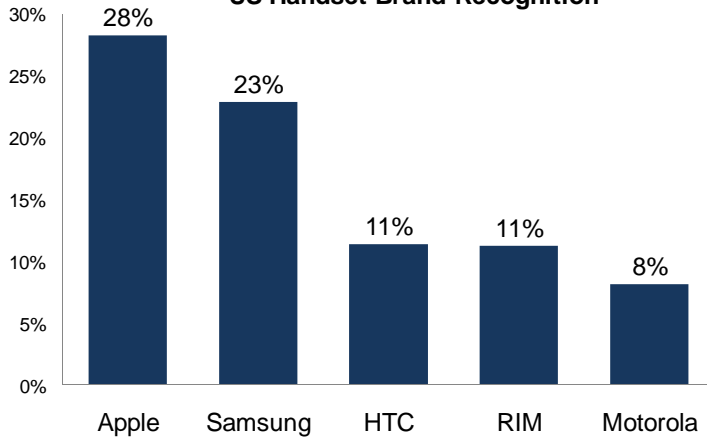


Sources: Goldman Sachs, Company Reports. Past performance does not guarantee future results. The Individual securities shown are presented for informational purposes only and do not constitute advice or a recommendation to purchase or sell a particular security.

Another primary emerging markets trend that is changing the global competitive landscape is the emergence of global competitors. Whereas historically emerging markets were viewed as suppliers to the world, increasingly companies are attempting to move up the value added chain and compete directly with developed market companies. Hyundai is a good example, as it has benefited from its focus on fuel efficiency vehicles, its streamlined cost structure, and its improved vehicle design and quality. As a result, when the US car companies were impaired in 2008-2009 and the Japanese auto companies had safety issues and then supply chain disruptions following the earthquake, Hyundai benefited. Other companies that have used M&A as a means to gain developed market credibility and market share include Geely, the Chinese auto company who bought Volvo, and Tata Motors, who purchased Jaguar Land Rover. These companies are focused on expanding their global footprint and use acquired technologies to compete head to head with developed and emerging markets competitors alike.

Chart 18

US Handset Brand Recognition

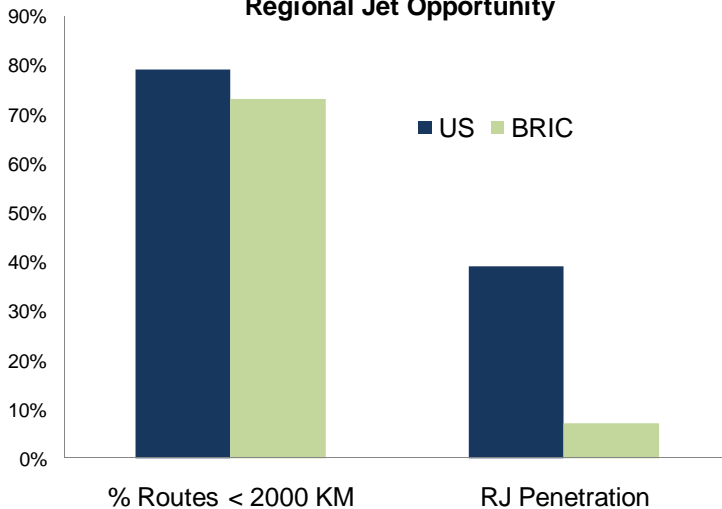


Sources: Daiwa Capital Markets, Company Reports. Past performance does not guarantee future results.
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One such area that this competition occurs is the smartphone arena. Two of the five top recognized handset brands in the US are Samsung and HTC, which are only behind Apple in their popularity. These companies are not low cost competitors – they are competing directly on technology, using Google’s android platform. Specifically focusing on HTC, approximately 63% of the company’s revenues are derived from developed markets. Approximately 82% of its revenue is related to the android operating system, which has been a powerful growth driver more recently, as Google estimates that there are 500,000 android device activations daily. It is looking to invest strategically in this area by acquiring video content providers and is expecting to roll out new models to capitalize on 4G and enhanced video capabilities. HTC is not a cheaper version of Nokia’s brands: it is competing head to head with Apple, RIM, Samsung, Motorola, Nokia, and others. It has also benefited from the perception that RIM and Nokia are behind the technology curve.

Chart 20

Regional Jet Opportunity



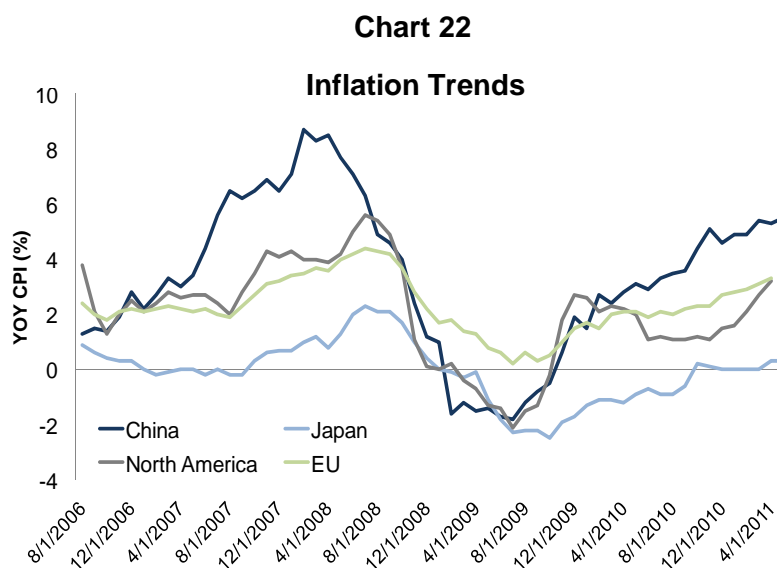
Source: Company Reports, Goldman Sachs. Past performance does not guarantee future results.
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Another example of a global competitor is Embraer, the Brazilian jet company, where it competes directly with Bombardier for the regional jet market. This market is expanding significantly as more carriers are using regional jets for longer trips, which is more efficient. Approximately half of its revenues are generated outside of emerging markets.

Embraer is also expanding in the business services area – corporate jets – which has been a significant part of its growth trajectory. The company went from not competing in that market at all to capturing a 15% share of the market. This is a company that has transformed itself from a governmental-owned firm founded in 1969 to provide aviation for Brazilian defense systems, to one with 70% of the regional jet market globally, compared to Bombardier’s 30%. The runway for growth is significant as well, as the percentage of routes less than 1200 miles is high relative to regional jet penetration.

Current and Prospective Issues

Emerging markets have faced a traditional inflationary cycle over recent months, as growth has been strong following the financial crisis. Emerging markets had more liquidity, they did not have significant toxic asset exposure, they did not have the same amount of leverage, and therefore were able to generate a significant recovery. That recovery, however, precipitated inflationary pressure in commodities, but was also exacerbated by issues with food chain supply.



Source: FactSet. Past performance does not guarantee future results.

As a result, monetary policy has been tightening across emerging markets. China's central bank was one of the earliest to begin tightening monetary policy, as inflation significantly picked up in China. With the exception of Japan, most developed markets including those in North America and Europe, have also felt inflationary pressures.

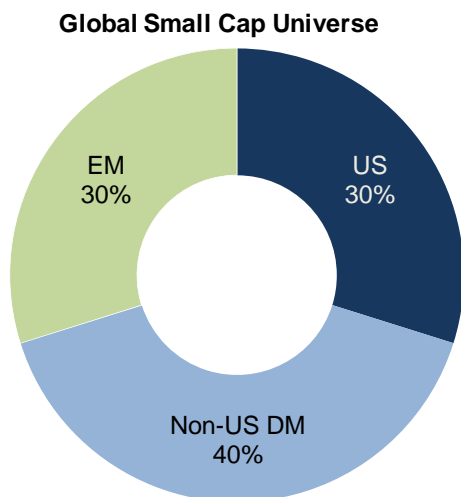
Over the intermediate term, one of the key concerns about emerging markets is the status of infrastructure development – how do these countries transition from infrastructure-focused economies to those driven by domestic demand? As 2012-2013 approaches, we believe this is one of the key issues that investors will be contemplating, including the effects on growth, country financial systems, and structural changes that occur in terms of economic development.

New Emerging Markets Frontiers

Emerging markets are an integral part of the equity opportunity set; as such, the diversification benefits for investing in emerging markets are dissipating. However, there are parts of the emerging markets universe that are relatively unexplored. Small capitalization emerging market companies are areas where most investors are under-represented. Most investors have small cap funds, but these are generally concentrated in the US, with some representation outside the US. Emerging markets represent approximately 30% of the small cap universe, as reflected in Chart 22.

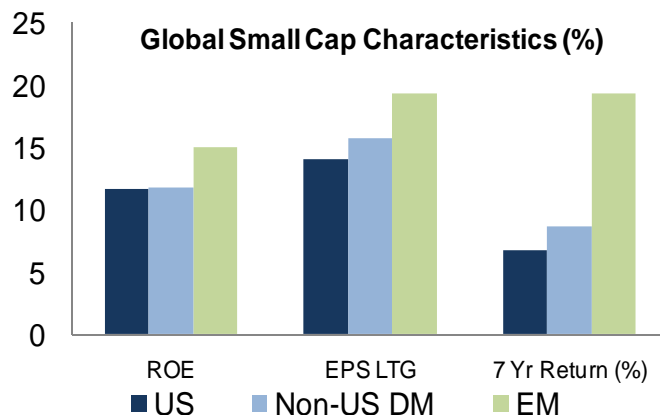
Emerging markets small cap stocks are an exciting part of the broader universe, as reflected by characteristics versus the rest of the global small capitalization equity universe, but are very underowned globally. Some emerging markets strategies incorporate emerging markets small cap as part of their universe, but a large percentage are focused on the blue chip companies, missing this entire opportunity set.

Chart 24



Source: MSCI, FactSet As of June 30, 2011. Returns are Annualized. Past performance does not guarantee future results.

Chart 25



Source: MSCI & FactSet. The individual securities shown are presented for informational purposes only and do not constitute advice or a recommendation to purchase or sell a particular security.

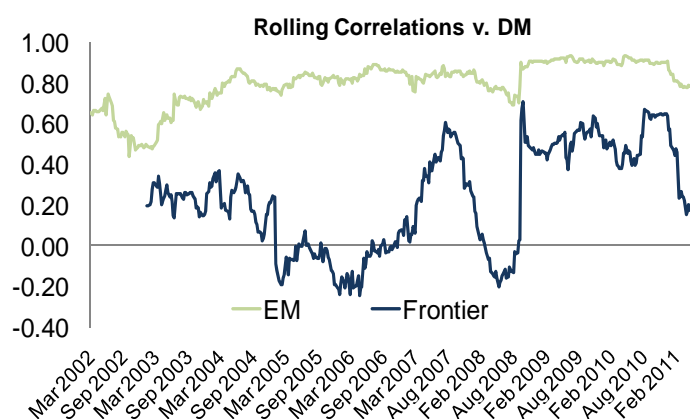
Chart 26

Frontier Markets		
Argentina	Kuwait	Serbia
Bahrain	Lebanon	Slovenia
Bangladesh	Lithuania	Sri Lanka
Bulgaria	Mauritius	Trinidad & Tobago
Croatia	Nigeria	Tunisia
Estonia	Oman	UAE
Jordan	Pakistan	Ukraine
Kazakhstan	Qatar	Vietnam
Kenya	Romania	

Source: MSCI.

Frontier markets are another part of the “emerging” emerging markets opportunity set, where economic development, liquidity, and market breadth/depth are all relatively low. The list of these countries as defined by MSCI is displayed in Chart 26. While this is an inefficient market, there are barriers to entry: limited liquidity, securities law, shareholder rights, and registration requirements to name a few. Countries vary significantly in this regard. Diversification benefits also exist within the frontier markets subset, as highlighted in Chart 27, as these countries are generally not as correlated to the broader market and are more domestically focused.

Chart 27



Source: MSCI & FactSet. The individual securities shown are presented for informational purposes only and do not constitute advice or a recommendation to purchase or sell a particular security.

An example of a frontier market that has largely been ignored by most mainstream investors is Africa (other than South Africa and select North African countries). Chinese companies and the Chinese government have recognized that this continent could be a significant growth area. Chinese companies have invested strategically in Africa for natural resources, as has been reported in the media. However, the trade balance between China and Africa is virtually equal, as a number of Chinese companies export consumer products to Africa. It is a growing part of the market, an area that a number of companies have not tapped, and could be a good opportunity prospectively.

Summary

Emerging markets are global growth drivers, not simply beneficiaries of global growth. The changes that countries and companies have made in improving governance, spurring growth and improving quality have made this universe an integral part of the equity landscape. Not only does increased domestic demand in emerging markets benefit companies domiciled in these regions, but also developed markets companies who are viewing emerging markets as a new and expanding growth market. This trend will provide growth opportunities as well as a more diversified revenue stream for developed market companies and investors. The new frontiers in emerging markets are in the small cap area, which is underpenetrated. Frontier markets also provide an interesting opportunity set as investors seek diversification benefits and companies / countries earlier in their growth trajectories.



Stephanie G. Braming, CFA, Principal

Stephanie Braming joined William Blair & Company in 2004. She is a member of the international and global teams, participating in decision-making meetings, conducting portfolio analysis and communicating current portfolio structure and outlook to clients, consultants, and prospects. Prior to joining the firm, Stephanie was a Principal at Mercer Investment Consulting, where she was responsible for the strategic investment direction of Public Fund, Corporate, Health Care and Foundation clients. In addition to her client responsibilities, Stephanie served on Mercer's United States Research Rating Committee, which assessed research ratings for investment manager strategies. Prior to her role at Mercer, Stephanie worked at the Federal Reserve Bank of Chicago. She is a member of the CFA Institute and the CFA Society of Chicago and recently served a three year term on the Society's Board of Directors. Education: B.A. DePauw University; M.B.A., University of Chicago Booth School of Business.

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