



investment styles ebb and flow . . . fundamentals never go out of favor

Emerging from Developed Profit Pools

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The generational march of the baby boom population influenced everything from pop culture to global economic activity to the manner in which we impart our wisdom to Facebook genYers. Inexorable, predictable and independent of economic conditions, post World War II boomers in the U.S. and abroad formed the basis for sociopolitical collaboration and confrontation, government policies and predicaments, social mores and taboos, business successes and failures – in short, baby boomers consumed and largely subsumed the world as we know it.

Alas, the baby boom generation is yesterday's news. This prevailing post-war demographic theme has been succeeded by a pervasive geodemographic boom.

The next inexorable, predictable and independently derived wave is to be found in the rise of emerging/developing markets – think of all geographies excepting the U.S., Canada, Western Europe, Japan and Australia. The BRICs immediately come to mind, though EM's extend well beyond BRIC borders.

Investor preoccupation with developing marketplaces reminds me of a print ad I read recently. The ad reads, "A man who stole my whiskey used the defense that no one could refuse a bottle of Jameson. I had no choice but to testify on his behalf." The emerging markets carry much the same message – hard to deny, even more difficult for investors to ignore.

Undeniable as the appeal is, prudently accessing the emerging markets is more easily said than done.

HS Management Partners' approach is well suited to purposefully, albeit wisely, harness emerging market opportunities. Indeed, in a business noteworthy for its humbling nature, we continue to learn from our experiences with an eye toward applying our best thinking. Our approach has traditionally served clients well. This consideration, together with our usual dose of common sense, form the means by which we plan to attain the investment world's Holy Grail.

The Opportunity Set

Much has been written and debated about the anticipated growth of the emerging markets and the tectonic shifts in political, economic and military force that such changes may yield. While the implications are no doubt significant, we are also mindful that the absolute levels of economic activity in developed markets not only make them worthy of investor attention, but provide the stability of cash flows together with modest growth that will facilitate multinationals' ability to invest in developing markets. We take a holistic perspective and appreciate the size and scope of developed market profit pools as a means of self funding developing economic participation.

According to the International Monetary Fund's October 2010 World Economic Outlook, advanced economies (mainly G7 – U.S., Japan, Germany, France, Italy, United Kingdom, Canada) represent 53% of global GDP yet house only 15% of the world's population. Developing economies (dominated by Brazil, India, China, Russia though including Eastern Europe, the Middle East, Latin America and the Caribbean, and Sub-Saharan Africa) represent 47% of global output though are home to 85% of the civilian population. Advanced economies are expected to grow 2.7% and 2.2% in 2010 and 2011, respectively, approximately one-third of the pace the IMF anticipates in developing markets (7.1% and 6.4%, respectively).

A recent presentation by one of our portfolio companies effectively captured the emerging market opportunity. Over the next decade, 94% of global population growth – an estimated 750 million people – will come from developing and emerging (D&E) markets, and a staggering 72% of incremental consumer expenditures – \$23 trillion – will be spent by D&E consumers. By 2020, 13 of 15 countries with populations exceeding 100 million will reside in D&E nations, flanked by the U.S. and Japan.

And yet, developed markets hold enormous potential. As Coca-Cola management observed in late February, "...30 million new people added to the population in the next 10 years of the United States; the third-highest teen population, 31 million teens. In fact, if you slice and dice world demographics any way, you put up countries on a page like Indonesia, like India, like China, like Pakistan, like Nigeria, you could put Ethiopia up there, which is one of the fastest-growing populations in the world. The only western nation that comes up into that same cluster is the United States of America, no other nation. That's why we're so bullish about our prospects for growth in a country that has huge population, growth in population, great demographics and incredible disposable income. So that's why we remain bullish."

The Importance of Presence; A Proven Ability to Execute

Many of our portfolio companies have maintained a long standing presence in emerging markets, a testament to the foresight and willingness of successions of management teams and board members to commit meaningful financial and human capital long before a return on such investments was the least bit visible. We see evidence that early mover advantage does indeed have its privileges.¹

Unilever has operated in India since 1888 (through Hindustan Unilever), Brazil since the 1920s, and the Philippines since 1928. Today, the company is recognized as having a highly diverse management team, and that managerial profile coupled with a deep understanding and footprint in emerging markets has proven rewarding to Unilever owners. Through a combination of organic growth (60% of capex in 2010 was dedicated to emerging markets) and acquisitions (Romanian/Eastern European ice cream business in 2009), Unilever has realized a 9% compound annual growth rate in revenues over the past 20 years within emerging markets and today such markets occupy 53% of the €44 billion in composite revenues, more than double the 20% realized in 1990. Management has publicly acknowledged that EM can represent 70% of global shipments in the foreseeable future.

Nestle today derives approximately CHF 39 billion in revenues from emerging markets, comparable in size to its Western European activities and only modestly behind the Americas. With just under 150,000 employees in these geographies, Nestle is well positioned to accelerate growth with recognized brands – 13 countries enjoy CHF 1 billion in sales, and an 11.5% organic growth rate was achieved in developing markets last year. The company continues to invest ahead of anticipated demand, with 2011 projected EM capital spending of CHF 2.5 billion up nearly fourfold since just 2008, and at a faster pace than in developed economies. Ambient culinary, soluble coffee, powdered beverages and pet care – high margin, high ROI categories – are at the core of investment spending.

Coca-Cola Chairman/ CEO Muhtar Kent is of Turkish descent and has experience operating business units in Turkey, Eastern Europe, Central Asia, Eurasia and the Middle East. Today, Coke is served 1.7 billion times a day through a network of 300 bottling partners around the world. Minute Maid Pulpy is Coke's first \$1 billion brand launched outside the U.S. (in China) and the drink is the premier juice brand in 16 countries. Together

with rapid population growth, markets like China and India offer meaningful per capita consumption opportunities; with per caps of 34 and 11 in China and India respectively, the runway to the U.S. (394) or Brazil (229) is indeed long.

Heinz enjoys a burgeoning presence in emerging markets and has recently accelerated the pace of innovation and acquisition while raising its anticipated growth rate in developing regions. Heinz’s proposed acquisition of Brazilian based Coniexpress S.A. (Quero brand of tomato-based sauces, pastes, ketchup and condiments) and the purchase of Foodstar (soy sauces and bean curd serving southern China) for \$165 million in November highlight the emphasis management continues to place on developing economies. And Heinz’s infant/toddler formulas and baby foods in China and India avail them of markets where annual birth rates equal 25 million and 16 million, respectively; for perspective, it would take ten years at the U.S. birth rate (just over 4 million) to equal the annual birth rate in China and India. Heinz recently suggested EM could provide as much as 30% of revenue within the next five years, rivaling the North American platform for which the company is known.

The list goes on and on: ABInbev’s 50/50 split between emerging and developed markets (including a 70% share in Brazil); International Flavors & Fragrances 45%-50% EM presence tied to local flavorings, fragrances, and a ramping innovation cycle among its diverse customer base; Disney operated schools (15+ in Shanghai and Beijing), and Shanghai theme park slated for 2015; 3M’s EM innovation pipeline and one-third (and growing) developing market representation; McDonald’s locally conceived menus; Western Union’s global money transfer system network (47% EM). We also know Western media content travels well and that the worldwide cinematic box office last year exceeded \$30 billion – in no small measure attributable to an ever expanding appetite within the urban corridors of Brazil, China, and Russia, among others. Hasbro, TimeWarner, and Disney play there.

Our concentrated quality growth portfolio continues to emerge from developed profit pools.

Activation: HS Management Partners’ Concentrated Quality Growth Portfolio

Identifying the opportunity set and the quality business franchises in a position to profitably capitalize on such opportunities is only part of the puzzle. The mosaic is made more complete by our ability to assemble a concentrated portfolio of such businesses at valuations we find compelling while remaining vigilant with respect to attendant risks.²

| Performance Returns Through December 31, 2010 | | | | | | |
|---|----------------|------------------|----------------|----------------|------------------------|------------------------|
| | Annualized | | | | Since Incept. (4/1/07) | Cumul. Since Inception |
| | Latest Quarter | Latest 12 Months | Latest 2 Years | Latest 3 Years | | |
| | HSMP (Net) | 10.0% | 16.4% | 25.4% | 0.8% | 4.8% |
| MSCI ACWI (gross) | 8.8% | 13.2% | 23.8% | -3.8% | -0.7% | -2.5% |
| Relative Outperformance | 1.2% | 3.2% | 1.6% | 4.6% | 5.4% | 21.5% |

As shown, our performance to the MSCI All Country World Index has been positive over each distinct measurement period dating to the April, 2007 inception of our performance track record. Although we are benchmark agnostic, we recognize the marketplace typically compares us to the S&P 500 and the Russell 1000 Growth Indexes and we will continue to publish our quarterly results against these indices. However, given the groundswell of interest in emerging markets, and the topic of this piece, we thought the MSCI ACWI – comprised of large and mid cap companies from 24 developed and 21 developing markets – would be the most representative benchmark for purposes of this discussion.

We subscribe to the view that fundamentals never go out of favor and we approach the selection of all equities with a bottom up, fundamentals first mentality. Accordingly, we model each business we own on the basis of its unique profile, competitive position and anticipated capital deployment, among other considerations. Our revenue and earnings growth rates are aggregated to arrive at a range for our portfolio, though that range consists of the discreet 20-25 models comprising our holdings at any given time.

Our fundamental work suggests top line growth approaching 6%-8% will be accompanied by only moderate margin improvement (no more than 100 basis points or so given realized productivity gains, commodity headwinds, and investment / brand spending) over the next 3-5 years. Our portfolio enjoys a free cash flow yield of 6.6%, 450 basis points above the nearly 2.1% composite dividend yield. We believe high single digit operating income gains can be levered with debt extinguishment, bolt on acquisitions, and share repurchases to deliver 12% earnings growth (10%-15% range) in the next five years.

We periodically take a step back to evaluate whether our company specific analysis bears resemblance to the macro reality in which our businesses operate. To paraphrase Buffett, we'd prefer to be vaguely right than precisely wrong.

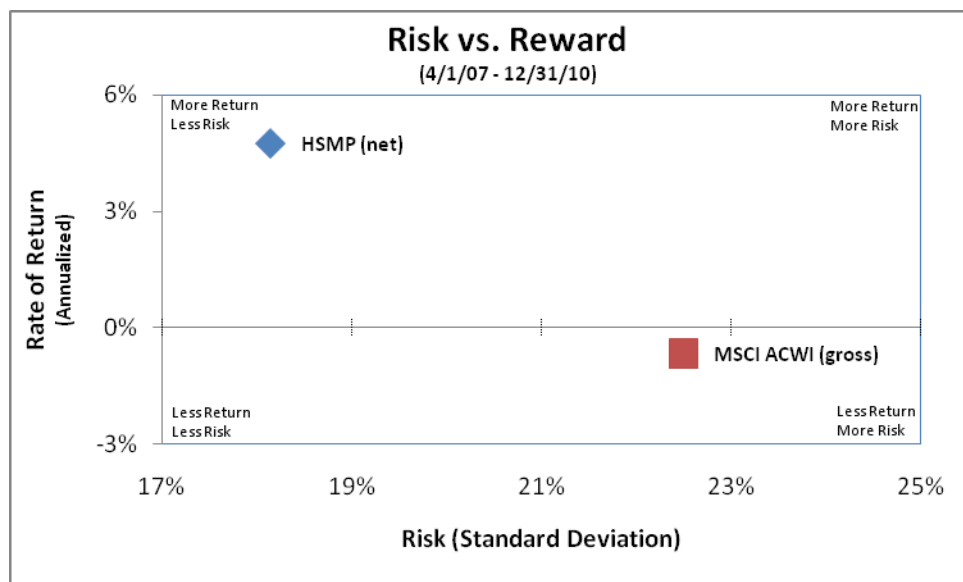
At present, a bit over 50% of portfolio revenue is derived from the U.S., and the emerging markets account for approximately 20% (and growing). The balance is made up largely of developed economy sales in Western Europe and Japan. Assuming developed economies grow at a 3% real rate over the next five years, on average, and at approximately 5% nominally (i.e., 2% inflation), and emerging markets grow at double those rates (6% real, 10% nominal), the reality check yields anticipated earnings growth (weighted for portfolio holdings) consistent with our company specific analysis. While we know from experience we'll be precisely wrong, we believe our thought process is apt to make us vaguely right.

As we commence year five of our performance track record in April, we feel good about the businesses we own and not at all extended from a valuation perspective. Our portfolio is trading at 14.8x forward 12 month anticipated earnings with a 6.6% free cash flow yield and a 2.1% dividend yield. Each of these metrics is highly attractive from a historical perspective. In addition, we believe the prospect for positive revaluation exists as the presence of advancing emerging market profits coupled with the stability and sustainability of developed market participations leads investors to conclude the duration of the ride may extend for longer than is now anticipated.

A Good Night's Sleep

As the events of the last few weeks in the Middle East have demonstrated, the capacity of the Facebook generation to abruptly effect influence on social, political and economic/investment markets in the blink of an eye (or the click of a mouse) is equal parts startling and fascinating. We are very mindful of the enormous capital flows the emerging markets have attracted in the last several years and the prospect that too much money chasing a good thing often has unintended (and sometimes quite negative) consequences. While ever restless over certain incalculable risks – The Black Swan – we feel somewhat less threatened by such imponderables by virtue of the world class franchises we own. The tragic event of the earthquake and tsunami in eastern Japan is a sobering reminder of this, and our hearts and minds go out to the people of Japan. We also have a clear understanding of the rules of engagement: an accepted regulatory framework; uniform accounting standards; mandated disclosure requirements; and a commitment to financial market liquidity.

Our normal practice of assessing business and investment risk has allowed us to deliver against seemingly incongruent goals. Since inception, our above market returns have been accompanied by below market risk.²



HS Management Partners takes a straightforward, common sense approach to the management of client assets. Identify quality business franchises across the growth continuum, up and down the cap scale, and around the globe operated by professionals of integrity; assemble a concentrated quality growth portfolio capable of advancing the earnings and cash flow streams consistently over time; and employ proven valuation tools so as to maintain discipline with regard to the price we are willing to pay for the earnings stream we prize.

At HS Management Partners, this is what we do.

Amidst the consistency and duration of our approach, clients may rest a bit more comfortably at night, secure in the knowledge that the importance we ascribe to emerging market participation is balanced with the developed market landscape we know so well.

¹ Note that as an active manager, the examples below are merely illustrative, and may not be held in client portfolios in the future.

² Past performance is not indicative of future results. HSMP results are presented net of fees and include the reinvestment of all income.

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