An Analyst's Approach to Valuation

Artisan Partners Emerging Markets Team

PORTFOLIO MANAGER
Viewpoints

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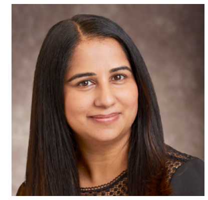
Artisan Partners Emerging Markets Team is built upon two foundational beliefs about emerging markets. First, that emerging markets are growing and will continue outpacing developed markets over the long term. Second, that emerging markets will remain relatively more turbulent than developed markets. As a result, the team believes that companies possessing unique access to growth and/or a sustainable competitive advantage are better positioned to capitalize on emerging markets growth over time.

Given emerging markets' inherently more volatile nature, the insight and good judgment that come with experience are critical to successful investing. As such, the team takes not just a local but an indigenous approach to researching potential investments, focusing on those with the most direct exposure—those that the team believes are the best and truest representations of the long-term, risk-adjusted upside potential in emerging markets.

Once the team identifies a company it believes has unique access to growth and/or a sustainable competitive advantage, it employs a rigorous investment process to determine whether the opportunity is a good fit for the portfolio. Here, Gurpreet Pal, Emerging Markets team analyst who covers India, discusses how the team thinks about valuation in the context of emerging markets investing.



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Analyst

14 Years Investment Experience

Maria Negrete-Gruson, CFA
Portfolio Manager

26 Years Investment Experience

A Bottom-Up Approach to Emerging Markets Investing

Our team's approach to valuation is a natural extension of our stock-selection process. Our rigorous, bottom-up approach is designed to identify compelling opportunities in the emerging markets which we believe are attractively exposed to long-term secular trends and which possess a sustainable competitive advantage.

Given the inherent volatility of many emerging markets countries, building conviction in names for potential portfolio inclusion can take some time. Our idea-generation process starts with extensive team travel. We do not believe any universe-screening process could identify in advance the critical characteristics we seek in potential investments. Further, because many emerging markets companies have relatively shorter track records and don't necessarily have the rigorous processes and reporting capabilities that their more developed counterparts do, we prefer to repeatedly observe companies in their natural habitats. As a result, building sufficient conviction in a company can take many months or even years—an effort we believe worthwhile to ensure we are introducing quality companies that best represent the long-term growth potential of emerging markets.

Once we believe we've identified a company possessing unique access to growth and a sustainable competitive advantage, we begin our in-depth financial analysis—which is also time-consuming but critical—including a historical analysis of the income statement, balance sheet and cash flows. Our goal here is identifying companies that are undervalued relative to their sustainable growth earnings potential. For each target company, we start with a five-year forecast for the company to understand the drivers of its success.

We then conduct a strategic analysis to understand the competitive environment in which a company is operating, as well as the corporate governance factors which could impact its sustainable growth potential. Next, we perform a rigorous country risk assessment to evaluate how macroeconomic factors unique to each country may impact a potential holding's valuation and target price. We believe this is crucial to our process as each emerging markets country is in a different phase of its economic, social and political development, and not all countries face the same risks. Therefore, we believe it is important to compare a country to its own history and development, identifying improvements or deterioration over time and assessing how those factors may impact a company's ability to capitalize on its competitive advantages.

Assessing Valuations in a Changing Marketplace

The final step in our bottom-up, stock-selection process is determining an appropriate valuation and developing a target price. To do so, we consider a company's country risk, its valuation relative to its peer group and its own history, and other company-specific factors. Once we establish a normal sustainable ROE and a target valuation, we are able to determine a price target for that security.

Given how rapidly circumstances can change, we typically won't automatically eliminate potential investments based on high valuation alone—whether at the country or individual stock level. Though we may believe a company or country overall to be richly valued relative to peers, those valuations could be justified. (And the reverse can be true—a cheaply valued stock (or country) may be cheap for a reason.) Then, too, valuations change—revaluing to a point we find interesting in the future. We also believe it is important to consider valuations in the context of sustainable earnings and material upside, and to remain patient with companies we believe possess these characteristics.

A Case Study in Valuations

The best way to understand our rigorous approach to valuation is to examine it in practice. General consensus is that valuations in India have been too rich. Against a backdrop of heightened volatility and operational issues, many investors have been particularly wary of Indian banks—which is understandable given many banks' track record over the last decade-plus. As commodities and industrials boomed in the mid-2000s, Indian companies, like many of their global peers, loaded up balance sheets with debt—which wasn't necessarily problematic so long as growth continued. However, following the global financial crisis, Indian companies continued borrowing in an attempt to finance ongoing growth, despite the meaningfully slower macroeconomic environment.

At the same time, the combination of stricter environmental regulations and the Indian government's decision to recall licenses in some industries hampered industrial projects and made it that much harder for heavily indebted companies to repay loans. The resulting combination of over-levered balance sheets and slowing business pressured many Indian banks, which were exposed to these stressed assets. It also slowed new loan growth meaningfully as demand waned.

Compounding the banks' issues, for many years India was one of the slowest major economies to resolve insolvency issues. The country's relatively feckless bankruptcy regulation—which primarily protected company owners at the expense of creditors—meant banks often faced years-long battles to collect what they were owed. As the banking sector became increasingly bogged down by this lack of regulation and clarity, the Indian government heightened its focus on non-performing assets (NPAs). Together with the Reserve Bank of India (RBI), the government implemented various measures aimed at speeding the bankruptcy process and giving banks more recourse—a positive move for the banking sector. For example, the RBI established the Indian bankruptcy code in 2016 to allow proceedings against large NPAs. While progress has been slow, the resolutions of these NPAs—whether debt restructuring, liquidation or allowing a new buyer to step in—are anticipated over the short- to mid-term and should result in a better-functioning banking system with more clarity.

Another meaningful change to the Indian banking system has been the continued recapitalization of public sector banks (PSBs). Together, these measures should allow Indian banks more capital freedom and improve their ability to begin meaningfully lending again. Contributing to growing optimism about India's improving lending environment is a particularly reform-minded government which has already announced initiatives aimed at affordable housing and road improvements. With elections in the offing, the current government is incentivized to continue showing progress and growth in these areas.

These developments in the Indian financials sector over the last decade have not gone unnoticed by investors. Many have been drawn to franchises such as HDFC Bank, one of India's largest private banks, which has benefited from its avoidance of some segments of higher risk corporate debt. Investors' conviction in HDFC Bank's consistent growth, lower stressed asset exposure and premium multiple has attracted those seeking to more conservatively invest in India's growth.

While we understand the features that make HDFC Bank attractive, we believe there are other, underappreciated (and consequently, lower valued) beneficiaries of the improved backdrop. For example, we have held ICICI, another of India's leading private banks, throughout this asset quality cycle.

We first purchased ICICI in 2012, before much of the ongoing reform was underway and despite its relatively high exposure to stressed assets. By that time, the company had started consolidating its loan book and also had a strong capital position relative to both private-sector peers and public-sector banks. We believe ICICI is well positioned for growth ahead, with a clear sustainable competitive advantage in the form of its solid brand, well-scaled franchise and extensive domestic branch network. It also possesses unique access to India's ongoing domestic economic growth as well as the return of corporate capital expenditures.

Importantly to our team, ICICI's valuation remains compelling, particularly in comparison to its peers—for example, its price to book as of this writing is nearly one-third of HDFC Bank's. We believe the company is well positioned to drive sustainable earnings growth in the future, particularly as the lending and regulatory environments in India improve and reforms take hold. This investment in a quality business with unique access to growth and a sustainable competitive advantage was one we might miss if we were to be deterred simply by dint of country-level valuation or the factors unique to ICICI.

Valuation as Part of a Successful Approach to Emerging Markets

We believe valuation discipline is a key aspect of emerging markets investing—particularly given the challenging nature of conducting in-depth, in-person research in countries with varying degrees of development and risk levels. We believe our first-hand, indigenous experience in emerging markets, combined with our extensive travel, focus on meeting with management, rigorous financial and strategic analysis and disciplined approach to valuation, allow us to invest in what we believe is the best representation of the emerging markets' growth potential.

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Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by calling 800.344.1770. Read carefully before investing.

International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations. Securities of small- and medium-sized companies tend to have a shorter history of operations, be more volatile and less liquid and may have underperformed securities of large companies during some periods.

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For the purpose of determining the Funds' holdings, securities of the same issuer are aggregated to determine the weight in the Fund. Securities named in the Commentary; but not listed here are not held in the Fund(s) as of the date of this report. The holdings mentioned above comprise the following percentages of Artisan Emerging Markets Fund total net assets as of 31 Mar 2018: ICICI Bank Ltd 1.5%.

Return on Equity (ROE) is a profitability ratio that measures the amount of net income returned as a percentage of shareholders equity. **Price-to-Book Ratio (P/B Ratio)** is a valuation measure used to compare a stock's market value to its book value.

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