Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund (MSIF) Emerging Markets Leaders Portfolio

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Go Local: Why Smaller Companies May Offer the Best Exposure to the Emerging Market Consumer

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Investors in emerging markets have been whipsawed in recent months as headlines were dominated by fears about global trade growth under a Trump presidency, and then the rally in commodity prices. Out from the glare of the headlines our investment philosophy is focused on finding high quality businesses exposed to sustainable pockets of growth in the emerging markets. We look for growth trends which we believe can persist over time, such as rising consumer spending in Asia.

We look to invest in companies with resilient business models that are exposed to secular growth trends and backed by strong execution. Within the emerging markets universe, we often find companies that are lesser known, yet leaders in their markets. We seek companies that tend to be mid-sized and local to one market and serve consumers whom they understand, tracking their unique tastes and spending habits as their buying behavior changes.

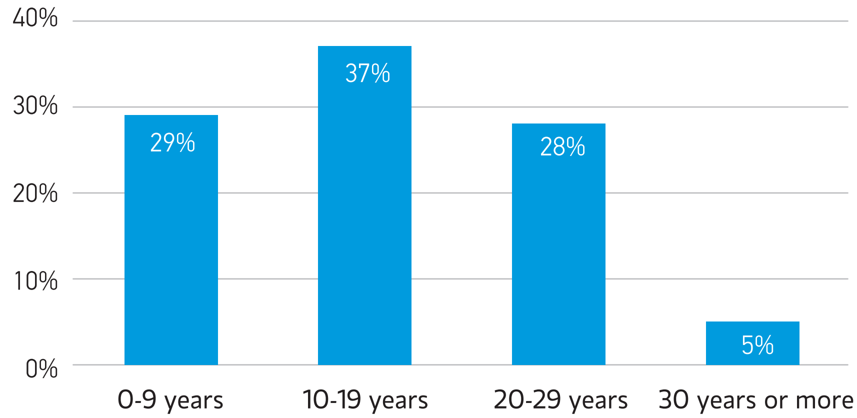
Our Emerging Markets Leaders investment process is built on three pillars: 1) Finding sustainable pockets of growth; 2) Identifying a high quality company poised to exploit the growth opportunity; and 3) Buying and selling the stock at the right price. Our work led us to two mid-sized companies with exposure to the developing Asian consumer: Korean home improvement company Hanssem (3.51% of the Portfolio as of January 31, 2017) and market expansion services provider DKSH (4.56% of the Portfolio as of January 31, 2017).

Home improvement spending unlocked as apartments age

Consumers start spending on home improvement when the market displays a combination of higher household income and an aging housing stock. When families have lived in their homes for a number of years or they move into older homes, spending on home improvement goods and services increases. Spending can include everything from a fresh coat of paint to complete kitchen and bathroom refits with new furnishings as consumers desire to update their existing home or put their own stamp on a new one. We believe the fundamentals of the market in Korea are supportive of this trend, which is still in its early stages. *Display 1* illustrates the aging of the housing stock in Korea—as many as 33% of the apartments in Korea are now over 20 years old, and another 37% are not far off.

DISPLAY 1

Korea Apartments Age Profile



Source: Citibank, as of February 2017.

One of the best ways we have found to get exposure to this sustainable growth trend is through Korean home improvement company Hanssem. Hanssem is a mid-sized company (market cap $4.6Bn[1]) and a market leader in both its two business lines: interior furniture and home remodeling. Both of these markets historically have been highly fragmented by many individual players such as non-brand mom and pop stores, without any one dominant player. We believe Hanssem is set to capture this changing market place as consumers start to upgrade from non-branded to branded home goods including their kitchen cabinets and furniture. This is an underappreciated, sustainable growth opportunity driven by structural demand growth which we believe Hanssem is perfectly placed to benefit from.

Hanssem has developed a strong and growing brand. While Hanssem has around 11% market share of the total home remodeling market (total market size is estimated to be $12.6bn),[2] it is the largest among the branded players with 33% market share.[3] Hanssem has been particularly successful in building a presence in the kitchen remodeling segment where they completely dominate the branded offering with 87% market share.[4] The company is now working on replicating this success by expanding into the adjacent categories of bathroom remodeling and wood, doors and floor renovation by leveraging its existing distribution network. Hanssem is beginning to gain market share in these nascent segments which we believe can drive further growth in its business.

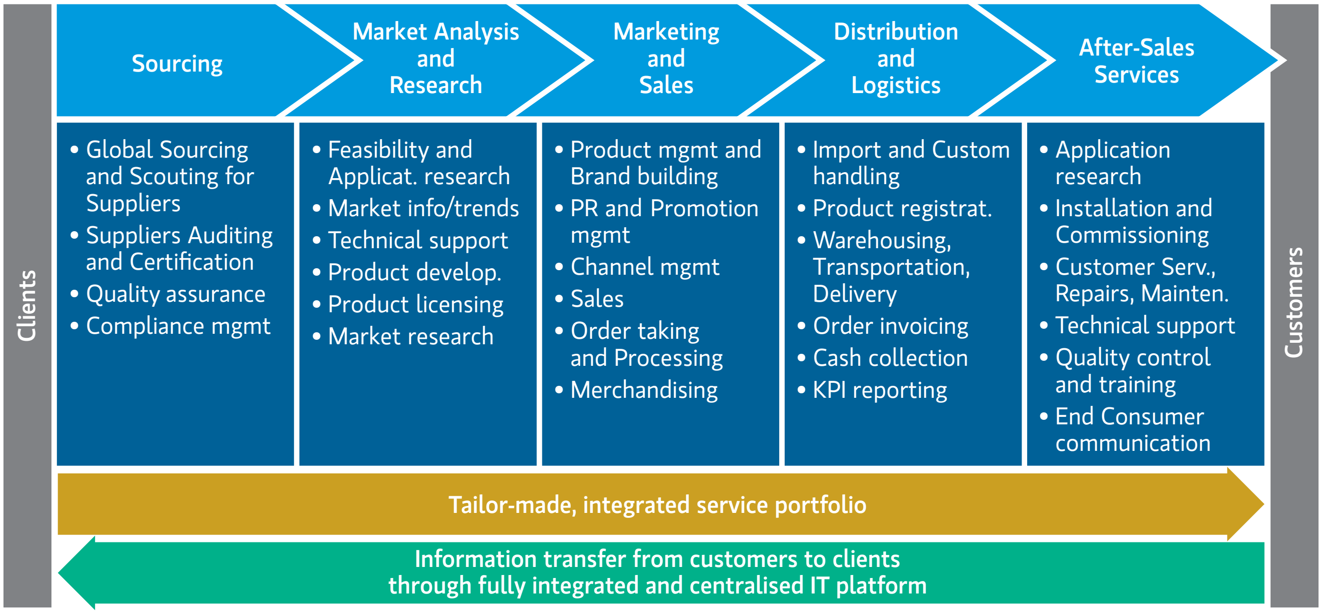
Hanssem has a strong track record of execution with sales and profits growing at a compound annual growth rate of 22.3% and 31.7% respectively between 2010 and 2015.[5] Management has demonstrated their ability to grow faster than the market through capturing market share as consumers have shifted to their product offering from non-branded goods. For instance the interior furniture market in Korea grew at 3.1% a year from 2010-2016 as Hanssem's sales in this segment grew 19.0% a year over the same period. Upon spending time with the company's management team we observed their conservative nature and they demonstrated a clear focus on return on invested capital which is reflected in the company's financials. The company maintains a net cash balance sheet, and both return on equity and return on invested capital–key metrics we look for—are well above 25%.[6]

Just as important to our investment process as identifying Hanssem as a well-run company with a long runway of growth is paying the right price for the stock. Two years ago, when we first looked at the company, the stock was trading at 61 times trailing 2014 earnings and 46 times it's expected 2015 earnings (PE).[7] Despite our confidence in Hanssem's growth trajectory, we found that those valuations were too expensive and priced in much of the potential upside. The stock then fell 60% following a short term disappointment in its revenue growth in the first half of 2016. We added Hanssem to the portfolio in Q3 2016, when it was trading at a PE of 25x 2016 expected earnings growth, taking advantage of the market reaction to build a position in a very high quality company trading at a fair price in our view.[8]

[1] Hanssem, as of February 2017.
[2] Nomura, as of February 2017.
[3] Hanssem, as of February 2017.
[4] Hanssem, as of February 2017.
[5] Hanssem, as of February 2017.
[6] Hanssem, as of February 2017.
[7] Company reports, MSIM research, as of February 2017.
[8] Company reports, MSIM research, as of February 2017.

DISPLAY 2

DKSH – Service Offering and Value Chain



Source: DKSH, as of February 2017.

Local market knowledge is the key to attracting new customers

Rising middle class incomes driving new consumption across many emerging markets, particularly in Asia, is well known. Consumer goods companies all over the world have eyes on these markets, with varying degrees of success at winning over these new consumers. Some well-known categories and brands have been successful while others have been forced into retreat, usually after significant investment has been made upfront.

Playing an important role to expand the consumer markets across the Asian landscape are Market Expansion Service (MES) providers. MES providers enable both multi-national corporations and regional brands to expand their products to new geographies and grow their business in existing markets. These services are very attractive to the end consumer goods businesses as they can reduce the market entry costs for a new product. Instead of the company building its own dedicated sales and distribution effort market by market, going through an MES provider enables them to takes advantage of both scale and local market knowledge which can prove key in winning over new consumers. The MES providers offer support along the value chain including marketing, sales and distribution, customer support and market intelligence, as illustrated in *Display 2*. The value of these services is evident by how widely they are used—it is estimated that the overall penetration of MES service providers in Asia across consumer goods, healthcare, specialty chemicals and engineered products was 20.6% in 2016, with penetration increasing 0.9% per year.[9]

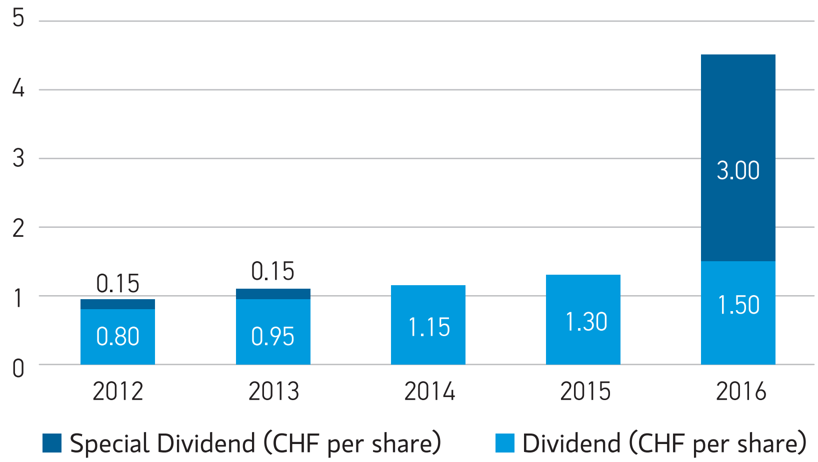
We own market expansion service provider DKSH in the portfolio, another mid-sized company (market cap $5.1bn[10]) which while listed in Switzerland generates 96% of its revenues from South East Asia.[11] DKSH has many unique competitive advantages. The first of which is its dominant presence in the healthcare and consumer goods industries across key markets of Thailand, Malaysia, Greater China, Myanmar, Singapore and Vietnam. Its competitors have tended to be either single consumer segment or single country focused. One example of DKSH's success comes from its relationship with Nestle[12] for whom it manages the KITKAT (chocolate and biscuit bar) and MILO (chocolate drink) brands in Thailand and Vietnam, and is responsible for all sales, logistics and related back office activities.

As inter-Asia trade continues to grow, the value proposition for a company like DKSH to position brands in many markets at once while able to tailor its services to the individual needs of the companies it serves will only keep increasing. DKSH is well-positioned to benefit from these trends driving the MES industry—which is estimated to be growing 6.5% per year.[13] We believe that given its unique positioning and track record, DKSH will continue to

[9] Source: Roland Berger, as of February 2017.
[10] Bloomberg, as of February 2017.
[11] DKSH, as of February 2017.
[12] The Portfolio did not hold Nestle as of 1/31/2017.
[13] Roland Berger, as of February 2017.

DISPLAY 3

DKSH Annual Dividend Payout



Source: DKSH, as of February 2017.

outperform the industry growth and deliver profit growth going forward, in line with its performance from 2009-2014 when its profits grew 13% a year.[14]

As well as being uniquely positioned to benefit from the rise of the Asian consumer, DKSH is a very well-managed company. Management has a history of progressively increasing the ordinary dividend over time, as well as returning excess capital to shareholders through special dividends such as we saw in 2015 *(Display 3)*. We view management's focus on efficient use of capital and return on invested capital as the most important metric in assessing the quality of a company for the portfolio. DKSH's management has a long track record of consistent focus on cash generation and has never compromised on the balance sheet quality to chase growth.

We initiated a position in DKSH in 2014 and have been adding to the stock over the past 2 years, particularly when the stock had been sold down due to political unrest in Thailand, which is its key market. The slowdown in the luxury market in China had also put pressure on growth. DKSH has emerged as a much stronger company following this tough period, as it streamlined its luxury business and shed its weaker lower margin clients. DKSH trades at about 12x EV/EBITDA and we expect continued growth from the company over the next three years.

Finding Leaders in the Emerging Markets

Despite the ongoing market volatility, there are still opportunities to be found in the emerging markets, often in these mid-sized local companies that are under-researched and less well known. Our combination of identifying long-term industry themes, along with disciplined stock selection, helps us find them. Our portfolio is steadfastly focused on seeking sustainable long-term growth, and our stock picking discipline revolves around finding companies with visible steady growth and respect for return on capital employed. In our view, Hanssem and DKSH exemplify this standard and are leaders in their industries.

Hanssem is well placed to benefit from increasing home improvement spending in Korea, as the housing stock continues to age and consumers shift to branded furniture, as well as being a fantastically managed company that was available at a fair price.

DKSH is capturing business using its unique capabilities across many markets and categories to help foreign companies and brands crack into the growing Asian consumer market. The company has a keen focus on efficient use of capital and continues to look attractive given its potential for growth.

Hanssem and DKSH are joined by 35 additional leading emerging market companies in our portfolio, from Asia to Latin America, and we are on the lookout for others every day.

[14] DKSH, as of February 2017.

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