

Balancing Risk & Reward

The PricewaterhouseCoopers EM20 Index 2009 Interim Update

This update of our EM20 Index reflects the fact that while the current financial and economic crisis is affecting virtually all emerging markets, some are being more adversely impacted than others. The highly-ranked countries in both the manufacturing and the services indices feature the tried and the tested investment destinations such as China, Slovakia and Chile that still represent potentially attractive long term investment opportunities. Less well-placed are the countries without significant domestic markets or those not anchored within large trade and currency blocs. With country risk levels currently being the main driver of emerging markets' relative investment attractiveness, it is now even more important to enhance the depth and robustness of your investment destination selection process.



An adjustment to our methodology

Country risk is a crucial determinant when assessing the relative attractiveness of a particular country to inward investors. In previous editions of our EM20 Index, the Risk and Reward Model that underpins the Index contained country risk premia based primarily on sovereign debt data.

This was a reasonable approach in the past, but financial market operations have been significantly disrupted since September 2008. Consequently, we have adjusted our methodology for calculating country risk premia. Using econometric analysis and World Bank data, our country risk estimation model now places a greater weight on the fundamentals behind country risk, such as political stability, regulatory effectiveness and the rule of law, while also considering government bond market data.

We believe that the resultant adjusted country risk premia (see Chart 1 opposite) present a more accurate picture of the risk profiles of the countries in the EM20 Index. All other aspects of the EM20 Index methodology remain the same.

Manufacturing

2009			2008		
Rank	Country	Index value	Rank	Country	Index value
1	Chile	95	1	Egypt	95
2	Bulgaria	92	2	Bulgaria	93
3	Malaysia	86	3	Serbia	88
4	China	84	4	India	86
5	Poland	83	5	Vietnam	85
6	India	80	6	Peru	85
7	Slovakia	80	7	Romania	85
8	Egypt	77	8	Ukraine	84
9	Thailand	77	9	Chile	83
10	Turkey	74	10	Turkey	83
11	Romania	74	11	Thailand	82
12	Brazil	73	12	Brazil	82
13	Mexico	73	13	Malaysia	81
14	South Africa	72	14	China	81
15	Peru	68	15	Poland	81
16	Philippines	64	16	Philippines	80
17	Kazakhstan	64	17	Indonesia	80
18	Vietnam	64	18	Russia	79
19	Colombia	63	19	South Africa	78
20	Serbia	57	20	Mexico	78

Services

2009			2008		
Rank	Country	Index value	Rank	Country	Index value
1	Slovakia	95	1	Poland	95
2	Chile	92	2	Chile	95
3	Poland	88	3	Russia	93
4	Bulgaria	83	4	Romania	93
5	Malaysia	81	5	Bulgaria	93
6	Romania	79	6	Slovakia	91
7	China	77	7	Serbia	89
8	Mexico	76	8	Brazil	87
9	Brazil	75	9	Malaysia	87
10	Turkey	74	10	Turkey	87
11	Thailand	74	11	Mexico	86
12	South Africa	74	12	Kazakhstan	86
13	India	71	13	South Africa	84
14	Egypt	71	14	Egypt	84
15	Kazakhstan	71	15	Thailand	83
16	Russia	70	16	China	83
17	Peru	69	17	Ukraine	83
18	Serbia	67	18	Iran	83
19	Colombia	67	19	Peru	82
20	Philippines	66	20	India	80

Global economic uncertainty

Since mid-2008, increasingly gloomy data has emerged regarding the state of the global economy. Several developed economies have fallen into recession, while many emerging markets are experiencing sharp slowdowns in economic activity. PwC's latest forecasts, like those of the IMF, suggest that global economic growth will be negative in 2009.

Not all emerging markets have been equally affected by the negative economic outlook, and therefore there is a need to reappraise the relative risks of investing in these markets. Given the significant shifts in financial and economic conditions around the world, we decided to update the PricewaterhouseCoopers EM20 Index, which aims to give an indication of the relative attractiveness of different emerging markets for foreign direct investors over the long term.

Updated EM20 Manufacturing Index

Chile, Malaysia and Poland have all made significant advances in our updated Manufacturing Index. The higher rankings for these countries are largely attributable to their country risk premia remaining relatively low in an environment of significant upward revisions of risk. The increasing importance of country risk premia is reflected in the fact that both Chile and Poland have relatively high GDP per capita levels, which is often associated with high labour costs and falling manufacturing competitiveness, but that is now largely outweighed by their relatively attractive risk profiles.

As shown by Chart 1, the country risk premia for the majority of the emerging markets analysed in this report have increased significantly since June 2008. Furthermore, the dispersion between the individual country risk premia is now much larger than was previously observed. The implication is that the extent of the credit crunch's adverse impact varies significantly across emerging markets.

China was the only BRIC country to improve its ranking in the updated Manufacturing Index. It is now ranked fourth, a significant rise from the fourteenth place it had in June 2008. As was the case for Chile, Malaysia and Poland, the movement has been largely driven by the fact that China's country risk premium has risen by less than that of most other emerging markets.

The countries that stand out amongst those whose positions have worsened since June 2008 are Peru, Serbia, Vietnam and Egypt. These countries are neither BRIC-sized economic powers, nor members of major trade or currency blocs. They rely on steady FDI inflows or access to international sources of lending, both of which have faltered recently. As such, they are typically more susceptible to macroeconomic shocks like sovereign debt defaults or currency devaluations that tend to make investors nervous.

As seen in Chart 2, there is a much larger variance in the manufacturing index values in our interim updated Index than last year. This reflects the fact that the economic climate in some emerging markets has become much more challenging, requiring a more discriminating evaluation of the riskiness of different emerging markets.

Updated EM20 Services Index

The most visible advances in the Services Index have been made by Slovakia, China and India. Slovakia and China, which now occupy first and seventh place respectively, have both seen their country risk premia fall relative to many other emerging markets. Slovakia's rise in the Services Index also reflects the country's relative political stability and its projected GDP per capita growth. The latter is an important determinant of attractiveness for businesses operating in the domestically-focused services sector, which is the focus of this Index. India, which was ranked twentieth in the 2008 Services Index, has now moved up to thirteenth place. Unlike smaller emerging markets, India's relative economic and political stability is a factor in its improved position.

Russia's position in the Services Index has deteriorated since June 2008, the primary reason being the relatively significant increase in its country risk premium.

Chart 1: Adjusted country risk premia in February 2009 compared with original country risk premia from June 2008

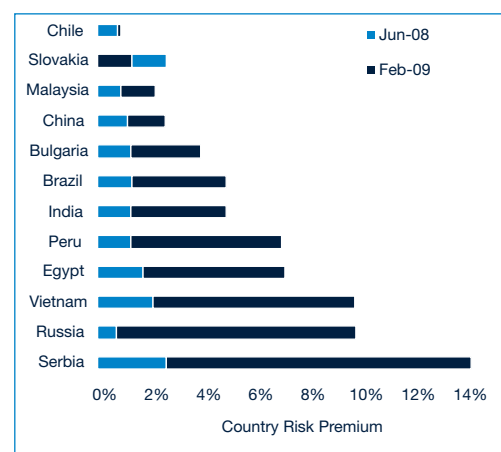
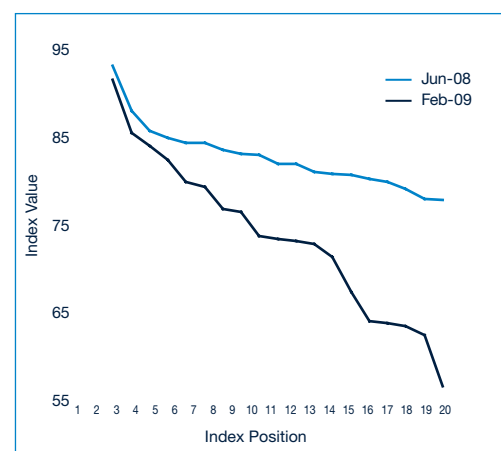


Chart 2: Comparison of Manufacturing Index top 20 in June 2008 and February 2009



Russia's GDP growth forecasts have also been revised down more dramatically than for many other emerging markets, with the implication being that the purchasing power of Russian consumers will grow more slowly than previously expected.

With the exception of Chile and Slovakia, all the countries which make it into our interim updated EM20 Services Index have a lower projected return¹ on each US dollar invested than they did in June 2008. In fact, our Risk and Reward Model suggests that around half of the countries in the interim updated 2009 Services Index could produce negative returns on investment, as seen in Chart 3 below.

Chart 3: Hypothetical US dollar returns in NPV terms from a services investment, as measured by our Risk and Reward Model



However, the returns from our model are for a stylised, one-size-fits-all investment. The actual return from an investment in any country would depend on the sector, region and structure of the deal. Therefore, while informative, the EM20 Index is not a replacement for thorough due diligence. Given the current unpredictability and volatility of the global economy, timely, precise and reliable advice is more crucial than ever.

¹ This is the return calculated by modelling discounted cash flows for a particular hypothetical services sector investment using a risk-adjusted cost of capital for each country.

The outlook for China

Economic growth in 2008 slowed to 9% year-on-year (y-o-y) in China. The 2008 growth rate was down from an upwardly revised rate of 13% for 2007 and this was the first time that single-digit growth has been recorded since 2002. Deteriorating external demand for Chinese exports alongside slower investment growth are primarily to blame for such a deceleration in growth.

Challenging export environment

China has been adversely affected by the economic slowdown in its main trading partners, notably the US, Euroland, Japan, Hong Kong and South Korea. In recent years, these countries have combined to consume more than 60% of Chinese exports, and as their economies have slowed this has had a negative impact on demand for Chinese exports. In January, exports plummeted by 17.5% y-o-y following a 2.8% drop in December 2008. With key trading partners expected to experience further contractions in their economies, future demand for China's exports looks set to diminish further in 2009.

Fiscal stimulus package

In early March, the government revised the previously announced fiscal stimulus plan designed to boost demand. Funds are to be shifted away from transport infrastructure, with a greater amount to be given to housing, healthcare, and R&D initiatives. This shift highlights the Chinese government's policy focus towards long-term socio-economic sustainability.

At the same time, the annual National People's Congress in Beijing opened with Prime Minister Wen Jiabao acknowledging the risks to socio-economic stability in China. Wen, however, failed to announce any further fiscal stimulus packages beyond those already announced with the government's overall outlook for the economy remaining quite bullish.

Recovery in 2010

Despite the recent doom and gloom, purchasing managers are becoming more positive. Although remaining below 50, indicating a contraction in output, the Purchasing Managers' Index rebounded to 49 in February, up from 45.3 in January and 41.2 in December. Improvements in the short-term outlook are likely to be the result of the Chinese government's fiscal stimulus beginning to kick in as well as recent improvements in credit conditions brought about by the central bank's easing of monetary policy.

Overall, while the growth outlook for China has deteriorated, the economy should be able to weather the global economic downturn relatively well. Our current forecasts for GDP growth in 2009 are for a slowing to 6.6% before picking up again in 2010 to grow by 8.4%.

Indicator	2008	2009 ^(f)	2010 ^(f)
GDP growth	9.0%	6.6%	8.4%
Inflation	5.9%	0.4%	1.5%
Base interest rate	5.3%	▼	◀▶
General outlook		Negative	Positive

Source: China National Bureau of Statistics; People's Bank of China; PricewaterhouseCoopers forecasts (f)

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