STAR GAZER

DAN LEVITAN
co-founder of Maveron

Dan Levitan co-founded Maveron, a venture capital firm, in 1998 with Starbucks chief executive Howard Schultz. They hit the jackpot with their early investments in eBay and drugstore.com. Dan was previously a managing director at Schroders, where he headed consumer investment banking. I asked Dan for his advice to investors. (To read my full interview with Dan Levitan, visit www.findingthenextstarbucks.com.)

The way to be successful in investing in tomorrow's stars is having some combination of curiosity, looking at a lot of things, being incredibly open minded and, last, giving yourself a glass of cold water and applying a healthy set of discipline in terms of understanding where the weaknesses are that could prevent the execution of an otherwise good idea. If you blend that curiosity, passion, and discipline and spend the time to really look at a company from not just your own perspective, not just management's perspective, but from the customer's perspective and the marketplace's perspective, I think you have an interesting opportunity to find some things that can be really big.

→ MEGATREND 8: OUTSOURCING

"Don't focus on how to spend less money. Focus on how to make more money."

—LYNDON FORMAN

After Lou Dobbs aborted Space.com to return to his earth-based chair on CNN's *Moneyline*, he took on the crusade against offshore outsourcing. His 2004 book *Exporting America* advocates balanced trade over globalization.

Dobbs created an "Exporting America" list that calls about every company I can think of traitors to America: 3M, Accenture, Albertson's, AMD, Agilent, American Express, Apple, AT&T, AOL, Applied Materials—and that's just through the As!

The reality is that in an ever-increasing global marketplace and in a world where time and distance have collapsed due to the Internet, the outsourcing toothpaste isn't going to be squeezed back into the tube. While outsourcing isn't a new trend, it is a megatrend that is with us to stay.

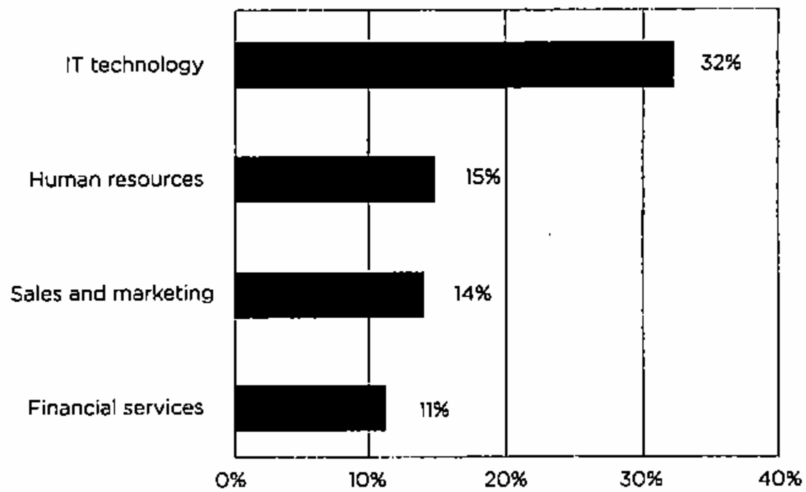
Reasons Companies Outsource

Save money and cost
Focus on core business
Improve service
Gain access to experts
Flexibility

To compete and to win, leading companies need to determine what their core competencies are and outsource basically everything else. The origins of outsourcing were in saving a buck, but today it's about comparative advantage and optimizing time and resources.

IT technology is the most prevalent area for jobs to be outsourced, with 28% of all outsourced jobs in the IT areas, and the global IT service market being an estimated $1.2 trillion in 2006. Global investment banks are expected to invest $356 billion in India for outsourcing projects. Human resources and sales and marketing are the other areas most commonly outsourced.

PERCENTAGE OF INDUSTRY OUTSOURCED



Source: CIO magazine.

Leading growth companies of the future will be aggressive outsourcers to produce the highest-quality, lowest-cost products. Think of the movie studio model of assembling the right actors, producers, writers, marketers, and distributors to make a particular movie who then go their separate ways after it's completed. This model may be adopted in many other industries.

Not only will leading growth companies be companies that outsource, but outsourcing companies will continue to be leading growth companies. BPOs (business process outsourcers) will continue to thrive. Payroll, benefits, customer service, human resources, and procurement are a few areas that will continue to benefit from the outsourcing megatrend.

Sectors That Will Benefit from Outsourcing

Payroll
Benefits

Customer service
Tax compliance
Human resources
Procurement
Research
Internet services
Voice network management

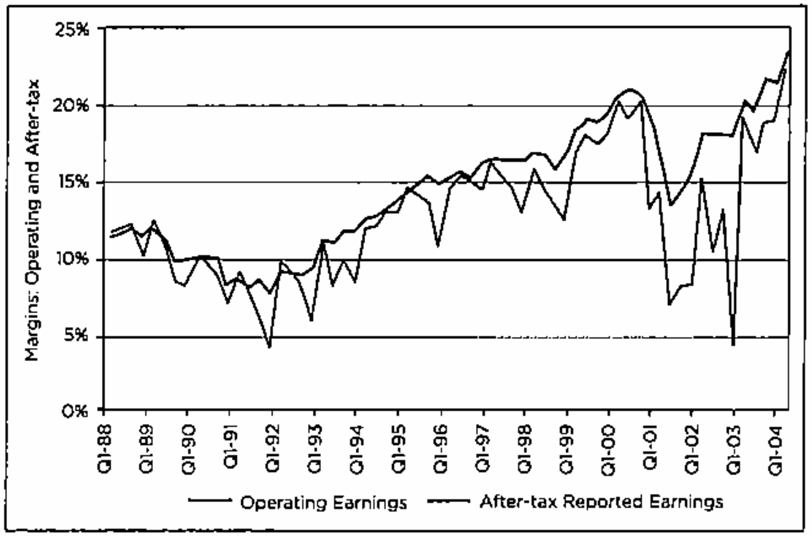
Outsourcing will continue to evolve beyond simply shedding noncore activities to outside companies and shifting production to low-cost labor markets such as India, China, and the Philippines. Outsourcing will continue to extend into higher areas of a company's value chain, including those once considered core competencies. This trend is already rapidly emerging, with an increased number of functions being outsourced from within companies' executive and R&D domains—both traditionally considered the ultimate of core competencies.

One of the commonly overlooked side effects of successful companies is the growth of noncore activities and infrastructure investment, such as customer service, IT infrastructure, and "back-office" functions generally, each of which limits a firm's flexibility to maintain a focus on their actual business. With information and telecommunications technologies enabling specialized firms to cost-effectively target these activities inside of companies, growth opportunities are opening up in an increasing number of outsourceable markets.

Cumulatively, the trend toward outsourcing is raising business profitability, enabling companies to extract greater profit from each dollar of sales as well as to increase the return on invested capital. This is evident not only in rising profit margins throughout the business sector, but also in the record net corporate cash flows achieved even since the last economic downturn—currently up nearly $400 billion since the first quarter of 2001. This has important consequences for how companies fund future growth, making them less reliant on external financing and better aligning internal capital sources with investment opportunities.

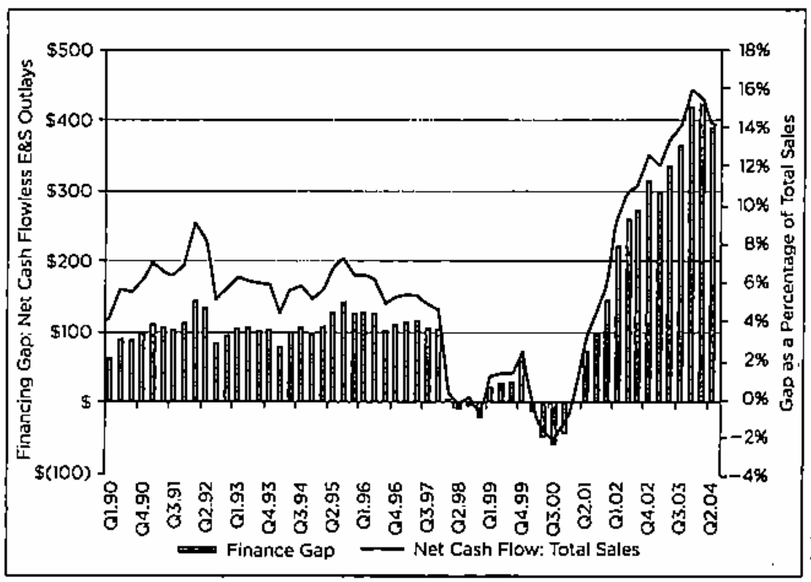
As implied, outsourcing continues to evolve from being a cost-conscious consideration to being a strategic value proposition, enhancing companies' total return on investment (ROI) and competitiveness.

Outsourcing contributes to profits going up



Source: ThinkEquity Partners.

Outsourcing contributes to cash increasing



Source: ThinkEquity Partners.

Firms are increasingly embracing outsourcing, leveraging cost-savings opportunities (contract manufacturing, customer support) helping to enlarge profit potential in their addressable markets, as well as utilizing highly specialized services (intellectual property rights management, contract R&D) to recognize the benefits of increased business flexibility. Combined, this leaves them to concentrate on new opportunities and future products, and it positions them to better capitalize on their innate strategic strengths.

The general rule of thumb is that the more knowledge-intensive a business or industry becomes, whether due to technological, production, or global marketplace complexities, the greater the number of functions that will need to be outsourced to others to sustain competitive advantage.

The ability of a company to innovate and meet customers' changing needs is progressively more dependent upon how effectively it manages organizational change around its most strategic assets. With production becoming increasingly services-dominated and services becoming more technical, companies that embrace outsourcing at every opportunity will create sustainable competitive advantage in their marketplace by remaining focused on their core competencies.

GLOBAL LEADERS IN OUTSOURCING

REGION	MARKET SIZE	TOP-RANKED COUNTRIES	UP-AND-COMERS
Central and Eastern Europe	$3.3 billion	Czech Republic, Bulgaria, Slovakia, Poland, Hungary	Romania, Russia, Ukraine, Belarus
China and Southeast Asia	$3.1 billion	China, Malaysia, Philippines, Singapore, Thailand	Indonesia, Vietnam, Sri Lanka

REGION	MARKET SIZE	TOP-RANKED COUNTRIES	UP-AND-COMERS
Latin America and the Caribbean	$2.9 billion	Chile, Brazil, Mexico, Costa Rica, Argentina	Jamaica, Panama, Nicaragua, Colombia
Middle East and Africa	$425 million	Egypt, Jordan, United Arab Emirates, Ghana, Tunisia	South Africa, Israel, Turkey, Morocco

Source: BusinessWeek, from A. T. Kearney Global Services Location Index, 2005.

STAR GAZER

CLIFF GREENBERG
portfolio manager of the Baron Small Cap Fund

Since 1997 Cliff has been the portfolio manager of the $2.8 billion Baron Small Cap Fund, where he invests in classic growth companies, fallen angels, and special situations. His performance is impressive when compared to his peers: Baron Small Cap has outperformed 90% of the funds in the small-cap growth universe over the past five years. (To read my full interview with Cliff Greenberg, visit www.findingthenextstarbucks.com.)

I'm not looking for great companies; I'm looking for great investments. I'm looking for the opportunity to make big returns as a shareholder. The best way to do that is to find unique companies with big opportunities that have defensible niches and have entrepreneurial managements and cultures that can take a little idea, a little company, and turn it into a big company. Its shareholders can really prosper along the way. And that's what I do for a living: try to invest in small companies that I believe are special and different enough and run by really good people and can grow much larger than they are when I purchase them, and make myself and my investors a lot of money.

→ POSTSCRIPT

I expect the dynamic developments that took place over the past 15 years to continue to thrive and to serve as the cornerstones of future growth opportunities.

Accumulated advancements in information technology (IT) and organizations restructuring around IT, as well as exponential growth in knowledge networks (internal, business-to-business, and business-to-consumer) are catalyzing the growth of knowledgecentric industries. Dynamic and simultaneous demographic shifts (baby boomers, the echo boom, and abroad, the aging of Japan and Europe) and growing international market opportunities are increasingly globalizing labor markets, changing human capital requirements, and blurring the distinction between foreign and domestic.

The emerging knowledge economy remains in its infancy, with the so-called information economy from which it is to grow still relatively mired in data overload. Only recently has the information economy truly flourished, with information being extracted from the mountains of data within organizations, the tastes of multiple demographics, and the latent regional and global markets, as well as from the entrenched business-to-business processes.

As companies increasingly capitalize on the reams of data now being turned into useful and accessible information, their accumulated intellectual capital and knowledge assets are enabling growth in more strategic and profitable directions. Until this point in the modern corporate economy, success has brought with it the side effects of growth—internal operations (IT equipment and software included) and services infrastructure that are peripheral to a company's business.

With increasing information, history, and analytics to benchmark and assess the strategic value of retaining or outsourcing these assets and functions, companies are recognizing improved profitability and higher returns on investment by being able to invest in what they know—the products and services of their business—while minimizing or avoiding altogether growth in noncore operations. Technology will help large companies to have continued growth.

A consequence of outsourcing is the emerging development of economic and industry clusters, where companies provide services specifically catered to an industry's needs. This enables the principal industry players to grow unencumbered by the side-effect demands of their primary business. Ultimately, this enables a company's growth to internally finance the primary business and not the services that grow with their success, while unlocking new market growth opportunities from within established service sector industries.

With the increasingly successful integration of IT and reorganization around it, emerging technologies are being developed that press forward with information and communications technology being embedded into virtually everything ordinary, and enabling extraordinary tools as well. In other words, the application of IT to areas outside of IT and into everyday products and business processes is enabling enormous efficiency gains in established markets, driving the digitization of products and services in one form or another, while creating new market opportunities to manage business processes and end-market customer relationships differently, meaning better than before.

Small-scale technology, such as digital tags, is poised to replace existing technologies while driving growth in new and existing markets. Tags can perform the same function as bar codes and do it far better by embedding *information* at the edge of a business's network, rather than

storing a piece of *data* within a single company's network. Retailing, as an example, brings automated accounting and real-time inventory management nearer to reality and minimizes costly supply-chain float.

RFID tags represent an enabling technology that extends what companies have been learning to do with earlier technologies—better track and manage inventory, cut costs, and streamline supply. Moreover, processes and information that result from the implementation of RFID will drive demand for Web services, wireless devices, and wireless enterprise software, as well as reinvigorate growth in more mature markets such as enterprise resource planning (ERP) and supply-chain management applications.

Globalization will continue to expand new growth markets for current and future products and services, though, even more important, the global marketplace will serve as a means to "economize" through a combination of labor market cost advantages, production efficiencies, and increased varieties of products available to global consumers.

It is widely appreciated that rising global trade between developed and developing countries has important benefits such as holding down inflation in mature economies and promoting rapid growth in developing economies. What is underappreciated is the growth in product variety. Most think of expanding global trade as having a substitution effect on a country's production and consumption (i.e., replacing a domestic industry or product through foreign competition). The reality is that rising global competition increases variety, giving consumers as well as businesses more choices. In fact, rising competition couldn't occur without an increase in variety.

While increasing variety due to rising global trade will improve global consumer welfare, it will also introduce new challenges, ranging from supply-chain logistics to brand equity. Consumers will have to sift through more choices before making purchases. In turn, retailers will need to establish stronger brands in order to compete in an ever-increasing market.

These are just a few brief perspectives on what is currently under way that will increasingly be recognized as an opportunity or enabler of a significant opportunity in the years ahead.