

Emerging Markets Summit 2008

A new economic reality for global businesses

September 23rd-24th 2008
London Marriott Hotel Grosvenor Square, Mayfair

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A new economic reality for global businesses

CONSTRAINED by sluggish economic growth in the US and Eurozone, and by the most serious financial crisis for more than a generation, multinational companies based in developed countries increasingly view emerging markets as their most promising source of future growth. A variety of factors, including strong economic performance in China, India and elsewhere, rising personal wealth in some of the world's most populous countries, and improvements to the regulatory and legal infrastructure, are combining to present a highly attractive package for overseas investors. Indeed, without the potential for growth in emerging markets over the next few years, the prospects for many companies in developed markets would be decidedly bleak.

The perception of emerging markets is changing rapidly. Ten years ago, companies may have viewed countries such as India and China primarily as sources for low-cost manufacturing and labour. Today, that perception is outmoded. As the BRIC economies and others continue their rapid growth trajectory, a vast middle class is emerging with unprecedented disposable income and aspirations.

Despite the scale of the opportunities, the operating and risk environment in emerging markets can be challenging. There are numerous difficulties to overcome, including talent shortages, competition from fast-moving domestic players, legal and regulatory challenges, differences in business culture and political uncertainty. Successful investment in emerging markets requires companies to navigate carefully through these challenges and demands a number of key qualities including agility, patience, a long-term focus, and the ability to develop strong relationships on the ground.

The Emerging Markets Growth Summit, held in London on September 23rd and 24th, 2008, set out to consider the ingredients for successful investment in emerging markets, and to examine the challenges and opportunities that lie ahead for both multinational companies and emerging market champions. Distinguished panellists and invited guests from both developed and emerging market companies ensured that a diverse range of perspectives was represented, and provided important insight into the future prospects and challenges for the industry.



Market opportunities in emerging markets

FOR multinational corporates from developed markets, these are testing times in which to achieve growth in their domestic economies. Although inflationary pressures may ease in the next 12 months and although oil prices may remain below their recent high, economic growth is likely to remain sluggish, particularly in those countries, such as the US and UK, where the financial services sector plays a strong role in the economy. For example, in 2007, the US grew by 2% and the Euro area by 2.6%. Both, however, are forecast to either dip into recession or have zero growth in 2009.

This situation contrasts sharply with the recent performance in key emerging markets, such as China (which in 2007 had growth rate of 11.9%), India (growth of 9%), Russia (8.1%) and Brazil (5.4%). Even though these rates are forecast to slow over the next couple of years, and although the argument that these economies can effectively “decouple” from the US and Eurozone now holds little water, it is clear that their trajectory is very much on an upward trend. As a result, the BRICs, along with other leading emerging markets, hold huge appeal for multinationals from developed markets seeking to offset weak local performance. They should be considered as essential for any growth strategy.

Emerging markets are no longer primarily destinations from which to source low-cost labour and services; they are also huge markets for consumption that rival and even exceed the scale of the largest developed countries. Today, domestic demand in the BRIC economies is roughly equivalent to demand in the US. Another factor that draws western multinationals to these regions is that domestic markets for many industries are largely saturated. For these mature sectors, growth prospects are not hugely promising unless they can either innovate or diversify.

Prosperity in many emerging markets is increasing considerably. Since 2000, per capita income in China has increased by about 50% from US\$4,000 to almost US\$6,000. In Russia, average incomes have more than doubled since 2000, reaching around US\$16,000 this year and on track to surpass US\$20,000 by 2011.

A huge emerging middle class, hungry for new products and services and with high lifestyle aspirations, presents massive opportunities for companies from developed markets that are prepared to make the investment. China, in particular, is shifting its economy away from being export-based to instead becoming consumption-based, and companies in developed markets would do well to recognise this shift.

An outmoded perception?

Many companies have an outmoded perception of the difficulties involved in operating in emerging markets, which causes them to pass up important opportunities. Although all markets have their challenges, there is a strong overall trend towards greater transparency, rule of law and a more transparent regula-

tory system. Moreover, each market is different, and it is essential that both direct and financial investors research carefully the environment of a particular destination and form a detailed assessment of its opportunities and challenges. To consider emerging market assets to be a homogenous entity is, however, is both simplistic and anachronistic.

To deepen or to broaden

As companies consider how to strengthen their investment in emerging markets, there are two broad approaches that they can take, either in isolation or in combination. Some companies, which already have investments in leading BRIC economies, will be looking to deepen their investment. This means that, in addition to building a presence in the more established investment destinations, such as the coastal cities of China, they will also be looking further afield. For example, they may be seeking to deepen their investment into less familiar regions, such as the north-east of China.

The alternative strategy is for companies to broaden their emerging market footprint, taking in additional countries beyond the more established BRIC economies. Companies questioned in an Economist Intelligence Unit survey point to a wide variety of countries that may form part of this strategy. Vietnam is seen as the most favoured destination, followed by Mexico and the United Arab Emirates.

Each has its advantages and disadvantages. Vietnam has a sizable population and low wages, which make it attractive as export base, but it also suffers from a relatively challenging operating environment. Mexico has a large consumer market but, in recent years, has posted lacklustre economic growth rates. The United Arab Emirates has attained western levels of wealth in a short period, but it has a tiny population compared with many other non-BRIC emerging economies.



Operating in emerging markets

THE nature of the emerging market business environment may be ill-suited to the established approach to management and investment. All too often, multinationals will rely on traditional decision-making processes, which may involve lengthy, bureaucratic discussions at the head office before an investment is approved. If they are to invest successfully in emerging markets, companies must be able to act quickly and take advantage of opportunities when they arise. This requires agility, rapid decision-making and the minimisation of bureaucracy.

Business leaders at multinationals must also become accustomed to giving autonomy to country managers on the ground in emerging markets. This will empower them to take decisions in an environment that rewards quick thinking.

Bridging the gap

Many participants expressed the view that companies based in developed markets need to bridge the gap between the head office and the emerging market subsidiaries. One speaker noted that boards can often be cut off from the reality on the ground in emerging markets. It was suggested that one approach to remedy this was to ensure that senior executives visited sites on a regular basis so that they become familiar with the operating environment and the local business customs. It was felt that this could help to foster an understanding that the head office approach may not be appropriate all around the world, and that regional managers need to be given greater autonomy so that they can react appropriately to opportunities.

Many participants recognised that multinationals cannot succeed in emerging markets by maintaining a single, global business model. Instead, there needs to be a local approach to doing business with multiple models that are appropriate for each environment. This requires a global strategy, but local implementation. "You cannot develop a penetration strategy from 1,000 miles away," noted one participant.

Do emerging market multinationals have an advantage over their peers in developed markets when it comes to operating in the BRIC countries and beyond? Many participants felt that they did: for example, emerging market multinationals are familiar with operating in a difficult environment and in dealing with public authorities that lack stability or reliability. They also have a higher degree of readiness to take risk, and are able to take decisions much more rapidly than their developed market peers. By contrast, there is a tendency among developed market companies towards a bureaucratic, over-cautious approach. This can mean that, once they are ready to capitalise on an investment, the opportunity has already gone.

The evolution of the model

One participant described how the engagement of multinationals with emerging markets evolves as they make the transition to becoming a truly global company. The first stage is "west to

east", whereby innovation takes place in North America and is sold to the top of the market in emerging markets. The second stage is localisation, which is still a west to east approach but with an added layer of adapting products for local markets. Then comes east for east, when products sold in emerging markets are developed and manufactured locally; and finally comes east to west, which requires companies to think about the trends that affect the entire population of the planet and develop solutions that are appropriate for a global market.

Companies from developed and emerging markets also differ in their approach to innovation. Firms from regions such as the US and Eurozone are innovating downwards, converting existing products and R&D approaches into a model that is more appropriate for the emerging market customer. Rising levels of wealth in the BRICs and elsewhere, and the emergence of a huge middle class, are encouraging companies based in China, India and other emerging markets to innovate upwards, changing their focus from bottom of the pyramid audience to the middle class customer. Over time, it is likely that these two opposing approaches will converge.



Managing talent emerging markets

For many of the participants, shortages of talent in key areas represent perhaps the single most important constraint on investment in emerging markets. Although the situation varies considerably between markets, having the right skills in the right place at the right time is a foundation for successful operations. The identification, development and retention of talent was felt to be a vital issue – and perhaps the dominant theme throughout the conference.

The mix between expatriate and local

In the past, companies operating in emerging markets have largely relied on expatriate managers to lead their subsidiaries. The notion is that these individuals provide the cultural link back to the head office and ensure that overseas markets benefit from the resources of the corporate headquarters.

While expatriate managers will continue to form an important part of the talent mix, they should not be relied upon exclusively to lead emerging market subsidiaries. One participant noted that there can be cultural problems with the expatriate approach. For example, local managers may resent the presence of expatriate managers, particularly if, as is often the case, they are paid significantly more than local executives. Local managers can also be concerned that they have limited options for career progression in a company that continues to rely on expatriates to fill its leadership positions. This can lead to retention problems, with talented local executives seeking a more promising career path in emerging market companies, where they may perceive that there are more opportunities to climb the ladder.

Some multinational companies, which have been operating in emerging markets for a number of years, reported a more enlightened approach. They described how a long-term investment in local talent, and the promotion of local managers to senior positions, had paid significant dividends in terms of high retention rates and a constant flow of local expertise.

Participants note that emerging market managers can possess material advantages over their peers from developed markets. One common difference is that emerging market professionals can be more aware of the need for self-reliance – being unaccustomed to a huge corporate infrastructure and an array of middle managers, they will be prepared to take a hands-on approach and make rapid decisions. This can be a valuable quality in an environment in which companies need to respond quickly to fast-changing external conditions.

One participant pointed out that the nature of business in many emerging markets is highly local and that, in order to succeed in these markets, it is essential to become embedded in the local culture. In such an environment, the promotion of emerging market managers to senior positions can be a very positive move. Ultimately, however, it was recognised that the mix between expatriate and local talent is not a binary issue: both are important and the key is to identify good people and develop them.

The rising aspirations and expectations of a local workforce are leading to demands for wage increases. For some participants, the growing cost of labour in emerging markets was a concern; equally, however, there was a recognition that skills levels and productivity have increased dramatically, and that this needs to be reflected in the wages paid.

A seat at the table

Participants noted the importance of involving emerging market leaders in the overall corporate decision-making process. According to this approach, leaders from China, India and elsewhere should be given a “seat at the table”. One participant suggested a relevant measure for assessing how far this shift had progressed: when the company has a meeting to bring together the top leadership of the company, they should count how many are from emerging markets. At companies that have made the transition from multinational to global, the proportion will be noticeably higher.

In order to manage talent successfully in emerging markets, the human resources function needs to be empowered to play a strategic, rather than a tactical or transactional role. The HR director needs to work closely with the chief executive in order to steer this process. Some companies have taken the lead in this regard by giving the HR director a seat on the board, or by rotating HR and operational roles in order to give both a better understanding of the challenges and opportunities ahead. Talent management is not the responsibility of the human resources function – it is something that needs to be led by the business – but HR can play an important role in providing an understanding of the process and supporting the business in its objectives.



Brands

ONE advantage that many developed world multinationals have is brand. It was noted that consumers in emerging markets are highly brand-sensitive. Western brands are well-known in emerging markets, particularly by the younger generation. In this respect, developed world multinationals have a head start of several decades over their emerging market peers. However, brand leaders in the west should not take for granted recognition of their brand in countries such as India and China.

Local brands in emerging markets are becoming much stronger, and this creates a new layer of competition. It was noted, however, that brand perception depends on the industry. For example, technology companies from India, such as Infosys and Wipro, have developed strong brands on the back of a recognition of the country's renowned technology capabilities. For companies in other industries – say, consumer goods companies in China, the brand-building process may take slightly longer, although these organisations are following a well-trodden path forged by hi-tech companies from Japan and South Korea, which both developed extremely strong brands on the back of a reputation for quality.

Understanding the customer

Western companies seeking to build a brand in emerging markets should start with gaining customer insight, and should spend time getting attuned to and understanding a particular market. They should aim to “walk in the shoes” of their potential

customer base and seek to recognise a need that has not yet been met. They should also understand that they will need to be in the market for the long term – volatility often accompanies rapid growth, and companies should be prepared for this. One participant pointed out that it is becoming more expensive to build brands in emerging markets, not least because advertising costs are rising, and because many companies are seeking to achieve the same goals at the same time.

Multinational companies seeking to expand into emerging markets need to be flexible with their brands. They should not be dogmatic and they should be willing to adapt brands to suit local markets, needs and price points. One participant pointed out that a brand does not need to be consistently the same globally, but it should be coherent. The key is to find a mechanism and message that works in each market, and that may mean tinkering with the brand around the edges.

It was agreed that protection of brands is of paramount importance in emerging markets. Western companies should be careful to ensure that their intellectual property is protected, and should seek legal redress if they encounter any infringement. Product security is also very important: companies operating in emerging markets need to work closely and supervise distributors in the supply chain to prevent product tampering and the introduction of fakes. The strength of a brand can quickly be eroded if these problems are not checked at an early stage.



Entrepreneurship

RISING incomes in emerging markets and the shift from an export to a consumption model in countries such as China are creating a wide range of new opportunities for entrepreneurs in emerging markets. Today, the emerging middle class in these countries has more than ever before to spend on leisure pursuits such as eating out, travel and tourism, and health and fitness. This creates a fertile breeding ground for consumer-based innovations and enterprises.

Entrepreneurship reinforces economic growth – in countries where conditions support new enterprise, we can expect the most significant improvement in the economic situation.

Innovation is on the national agenda in China, and the government is making a significant push into fostering an environment that is conducive to entrepreneurship. Universities are being upgraded, and there is a programme to bring back the educated Chinese diaspora. Technology parks have been built in some cities on a massive scale – some are incubating more than 500 companies in sectors such as ICT and biotechnology. China, along with India, is also attracting a huge wave of venture capital investment and, for many entrepreneurs, funding is currently not a problem.

The changing identity of entrepreneurs

An important trend that we are seeing in many emerging markets is the shift from “subsistence entrepreneurs” – who start businesses because they have no other employment options – to “opportunity entrepreneurs” – who choose to start businesses in order to capitalise on a particular business opportunity. In countries such as China and India, the balance is shifting gradually towards the opportunity entrepreneurs.

The kind of individuals who are launching enterprises in emerging markets is changing. One exciting development is the increase in numbers of highly educated entrepreneurs with deep industry experience who are giving up the security of regular employment to develop new ventures. More and more of these entrepreneurs are first generation, and do not come from established family businesses. The belief that entrepreneurs need family or government connections to succeed appears to be on the wane.

There are several important reasons for this shift. Chief among these is liberalisation – across the vast majority of emerging markets, it is clear that regulation is becoming simpler and less onerous. Another important reason is the growth of knowledge industries, such as information and communications technology and service businesses. In many of these industries, business owners do not need large amount of capital or fixed assets to start a company.

Governments must be willing to promote ongoing programmes of liberalisation, economic reform and regulatory change. There should be adequate property rights in place, because innova-

tion typically explodes with the right to have and hold. Entrepreneurs need unobstructed access to funds and the ability to develop a flexible business model that can adapt to a changing environment.

Another factor is the increased social acceptance of entrepreneurs. Until the 1980s, it was commonly believed that, in order to succeed, business owners in emerging markets needed to cut corners, such as by taking bribes. People are now beginning to see that this approach is unnecessary and unwelcome. Cultural barriers to entrepreneurship are also crumbling. For example, until recently, many communities in India looked down upon entrepreneurs. Today, however, these barriers no longer exist and entrepreneurship has become more socially acceptable and financially viable.

There are growing numbers of local role models whom budding entrepreneurs can emulate. Previously, most successful entrepreneurs came from overseas, but as local businessmen and women become more visible in the local media and economy, the aspirations of other potential entrepreneurs increase. This trend has huge symbolic value.

Categories of innovation

There are two main categories of innovation that are being seen in emerging markets. At the most basic level, there are replications of existing models that are successful in the west, whereby local entrepreneurs take a concept and adapt it for local markets. Examples of this include Baidu (the Chinese version of Google) and Naukri (the Indian version of Monster.com). A second category is what could be termed needs-driven innovation. An example of this is the Aravind Eye Hospital chain in India, which has developed a business model that enables it to offer free eye care for the majority of its patients funded by a small proportion of customers who can afford to pay.



Ethics

COMPANIES that operate in emerging markets must pay careful attention to ethical behaviour, against a backdrop of tightening global standards for compliance across a range of issues. Although the business environment in some emerging markets may be conducive to corruption and the transgression of ethical conduct, it was widely agreed that there is absolutely no room for compromise on this issue. Even if an unbending approach led to a loss of business in some instances, that that should be accepted as a price worth paying for probity.

A code of conduct

There was a strong consensus around the importance of developing, and sticking to, a strict global code of conduct that was promulgated and understood throughout the organisation. This should cover the full range of management behaviours, including how the company trades with suppliers, how it manages its labour force, how it deals with bribery and corruption, and how it addresses health and safety. For some companies, this code of conduct forms part and parcel of managers' annual review and incentive programmes.

The guiding principles of a company's code of conduct and ethics need to be understood worldwide, but the detail should be adapted so that it applies at a local level. There is no one size fits all approach to ethics in emerging markets. For example, one participant illustrated the difficulties of setting maximum working hours on a global basis. He pointed out that, while there may be a desire to restrict working hours, in some countries this will not be acceptable. In Thailand, there is no maximum number of working hours, and if a company attempted to curb working time in its factories there, workers would simply leave to work for other companies that did not have this constraint in place.

Some participants noted that a consistent and proactive approach to compliance and ethics could serve as a source of competitive differentiation. Once a company is seen as a trusted partner that has zero tolerance for transgressions, such as ac-

cepting or paying bribes, it will quickly attract business. As one participant noted, doing good is good business.

Relations with communities and suppliers

One important aspect of ethical behaviour relates to the way in which a company treats its employees. In addition to what may be termed the "hygiene factors" of ensuring that the company meets appropriate labour standards, companies keen to promote ethical behaviour should look at questions such as whether there is an unspoken glass ceiling for local managers. Issues such as the promotion of equal opportunities should be seen as a key component of ethical behaviour.

Companies need to think carefully about how they are perceived in the community. There was a recognition among participants that long-term investment requires a win-win approach, whereby it is not just the investor that benefits but the local population and community as well. One participant, with operations in China, recounted how his company helped to fund an extensive programme of reconstruction in the wake of the Szechuan earthquake with the help of donations from employees. If multinationals are to maintain and enrich their licence to operate in markets such as China, they need to be in the front line of these efforts. This helps to build relationships and strengthen bonds with the local population, governments and businesses.

Companies should also examine carefully the ethical performance of their suppliers on an ongoing basis. Many companies insist that their suppliers comply with management guidelines and a code of conduct, and will insert relevant clauses into contracts in an effort to promote ethical behaviour. Some participants recognised, however, that enforcement of these clauses, and ensuring that the company has a good knowledge of its suppliers' activities, can be challenging. To remedy this problem, a combination of approaches is possible, including working closely with suppliers, putting in place an independent review mechanism, and setting up a self-assessment programme.



Governments and the law

LEGAL and regulatory risks were identified in a recent Economist Intelligence Unit survey as being the most serious that companies face when they enter emerging markets. Nevertheless, it should be remembered that these are risks that can be identified, managed and mitigated, although not actually eliminated.

When companies enter an emerging market, it is essential that they put in place mechanisms to protect their assets and enforce the commercial agreements that have been made with local partners. They also need to assess whether, if they do end up in court, they will get a fair hearing. Without a clear understanding of these issues, there can be no predictability about investment returns.

Proper due diligence is essential. Unfortunately, this takes time and can be expensive, but there is no substitute for conducting thorough research, going through the legal codes and systems, and understanding how they relate to a potential investment. Companies need to get to know the political environment of the country in which they plan to invest, as this goes hand in hand with understanding legal risk. They need to develop a view about the stability of the country, not just at a national level but at a regional level.

Conclusion

Constrained by a major financial crisis and sluggish growth in domestic markets, western multinationals now view emerging markets as offering the best opportunities for growth in the medium term. A variety of factors are contributing to this trend, including structural reform in many of these countries, along with the transition of leading emerging markets from being export-based to consumption-based.

Companies that are considering investment in emerging markets must develop a thorough knowledge of conditions on the ground, and research specific aspects of the business environment carefully. They should seek insight into customer needs and aspirations, gain full understanding of the legal and political environment, and recruit local know-how to fill gaps in their knowledge. In many cases, this improved understanding will lead them to adapt products, services or brand to suit local markets.

To succeed in emerging markets, western multinationals must learn to act quickly and take advantage of opportunities as they arise in a fast-changing environment. This requires a global strategy, but a recognition that implementation should be local. For many, this will mean devolving greater autonomy to emerging market subsidiaries, developing and nurturing local talent, and minimising bureaucracy. Companies should

Good relationships with the government are important, but companies should think through what might happen if there is a change of power. For example, if the company builds a close relationship with a particular government, can this work to its disadvantage if there is a transition of power? Will the new government have scores to settle that might undermine the investing company's position?

Protectionism

Growing protectionist instincts were perceived to be a concern by some participants. Representatives from emerging market multinationals, in particular, noted rising protectionist sentiment, with greater restrictions being placed on investment in some jurisdictions. Companies from developed markets, too, described how government ownership or part-ownership of industries in some emerging markets could deter or make difficult investments by foreign businesses. It was also noted that, compared with a decade ago, emerging markets have more to protect. It was felt that this would be likely to increase the chances of defensive moves in the near future, but that this was largely a temporary trend that would ultimately be overcome.

also look to emerging market champions that have prospered in these environments and learn from their experience, as it is likely that they will have an unparalleled knowledge of how to succeed in these exciting markets.

