Emerging Market Entry: a Necessary Good

Why, Where and How Should You Go

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Introduction

Many – especially large companies – have entered emerging markets decades ago. Although few will regret the decision to have gone overseas, lessons learnt were often painful and costly, including occasional withdrawals. However, most mid-size companies are still largely dependent on their home market. Internationalization – if any – is often modest in turnover share and limited to a few neighboring countries. Reasons given for not taking more ambitious steps away from home are plentiful and sometimes opposite:

- Perceived healthy growth potential in the domestic market vs. the need to concentrate on protecting the home market
- Perceived shareholder resentment against high and risky investments without short term returns
- Fear of overstretching, fear of an non-level playing field, fear of partner disputes, etc.

The 2012 cool down in emerging markets like China, India and Vietnam, well publicized withdrawals of western players from developing countries (e.g. the top 4 international retailers Walmart, Carrefour, Tesco and METRO have all exited from several countries), and an embryonic but inflated insourcing trend (some western producers returning their production to their home markets as initial labor cost advantages in emerging markets have partially disappeared), provide more ammunition for those weary of emerging market entry. While none of the above is untrue, it doesn't negate the fundamental superior attractiveness of emerging markets for decades to come. This article is meant to be an enthusiastic but realistic plea for international expansion of mid-size companies. The examples given pertain to Asia and especially China, but the messages are equally valid for Latin America and to some degree Africa. It is not intended as a detailed "how to" guide, as the challenges are too rich and complex to be fully covered in such a short paper. We will subsequently look at the Why, Where and How of emerging market entry.

Why You Should Go (Now)

The advantages, and even the necessity of emerging market entry, outweigh the risks. We will look at some of the key factors driving the need for international expansion. Many of these reasons are well-known, and if you are already convinced of your company's need to expand internationally, you can skip this section and proceed directly to the more interesting "Where You Should Go" section.

Your shareholders want absolute cash-flow growth, and emerging markets are most likely to provide this through population and GDP per capita growth

The earlier mentioned shareholder hesitation with the long term risks associated with emerging market entry is ironic, as these same shareholders request ever growing financial returns. Long

term shareholder revenues are foremost driven by absolute cash-flow growth. Market share gain in slow-growth developed markets through e.g. innovation, and cost cutting – two feats hard to combine – deliver at best temporary gains. In the long run growth is best served by joining those markets that possess a fundamentally higher growth potential.

Over the past few centuries, the global GDP share of Europe and later North America has been disproportionally high. Since a few decades, and for many more decades to come, this historical imbalance is being corrected. In 50 years from now, the correlation between global population and GDP contribution will be much higher than today (yes, the world is becoming more equal). Steady purchasing power growth of especially rapidly growing middle classes in emerging markets will continue to drive their GDP growth. In contrast, the growth outlook of developed markets – even once the financial and debt crisis will be resolved – will remain much bleaker.

By staying at home you won't escape competition from emerging markets

Most likely your business is already facing stiff competition from emerging markets now. This competition can come in several shapes. Your "domestic" competitors may have moved their sourcing and/or production to emerging markets, and import these cheaper products into your home market. Or emerging market competitors are exporting highly competitive products to your back garden. But a newer trend is that cash rich companies from developing countries are increasingly buying western assets. Especially Indian (e.g. Tata) and Chinese (e.g. Haier) companies show a growing appetite for international acquisitions. Chances are that today's "domestic" competitor – or you (!) – will be foreign-owned tomorrow. There is no better way to get to know your future competition than joining them in their home markets today.

Proximity to innovation is increasingly complementing low cost production and access to large markets as internationalization driver

Many production companies initially entered emerging markets to reduce manufacturing costs through access to cheap labor, and to export these products back to their home markets. However, this rationale often has an expiration date, as labor costs rise faster than GDP growth, and are not always compensated by productivity growth. If it were only about lower production costs, many western companies would have already closed shop in southern China's Guangdong Province, and relocated their plants to cheaper Vietnam, Cambodia and perhaps Bangladesh. But for most companies, close access to large consumer markets is much more important that low production costs alone. Depending on the industry, up to 90% of the production of Guangdong's factories is not exported, but consumed by China's huge domestic market. This fact is mirrored by the sourcing of foreign packaged goods retailers in China, who purchase up to 95% of their merchandise domestically. "China for China" is increasingly true. For these same retailers, access to large consumer markets was and is the key internationalization factor.

But there is an emerging additional reason why few companies can ignore emerging markets. More and more, innovation is coming out of developing countries. One factor driving this is western companies shifting their R&D centers close to those consumers who are most numerous and whose spending power is increasing fastest. Adidas and Philips Electronics are just two examples of companies who have shifted the focus of their new product development efforts and hence R&D centers east. Rather than imposing western ranges on Chinese customers, products tailored to the taste of Chinese consumers may increasingly see the light of day in western markets. Whereas companies out of developing countries are mostly known for smart (and sometimes shameless) copying of western innovations, it is only a matter of time that even Chinese companies will be respected for true innovation. Just one example, the functionality of

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Chinese e-commerce sites and social media applications puts their western counterparts to shame. A fast rising number of Chinese patent applications should serve as an additional warning. Again, rather than being surprised tomorrow by your now unknown future rivals' innovations, it is much smarter to follow them closely in their domestic market today.

Today is not great, but tomorrow is worse

Even in hindsight not everything is easy, and this holds especially true for international expansion. Still, if more had predicted the stellar emergence of Vietnam, India and China over the past decades, many companies would have ventured there earlier. What looked and was difficult 10 years ago, looks even more daunting today. Some of the labor cost advantages have disappeared, the competitive landscape is more crowded and more sophisticated, and economic growth has come down. Some of the low hanging fruit may indeed have been plucked, but the emerging market garden is infinitely larger than your domestic one and still contains many regional white spots. Your business can ill-afford to wait any longer.

Where You Should Go

Now we move on to the more challenging question of what market your company should enter. The answer is even less straightforward than it appears. Here we can only provide general advice. Specific answers are industry and company-specific, and require detailed information gathering and analysis.

Do not overstretch

The question is not what countries you should enter, but what region or city *in one country* you should conquer. This is probably the most common mistake in emerging market expansion. China and India are not countries, but continents. Few American companies would make the mistake of trying to conquer all of Europe at once. Yet, many western companies have entered China and started marketing their products – or opening their retail outlets – in dozens of cities hundreds and thousands of kilometers from each other. Not only did this lead to prohibitive supply chain costs and marginal market shares, but growth was fundamentally compromised as local consumer tastes were poorly catered to. What sells well in Finland is no guarantee for success in Portugal. Yet companies have tried to sell the same in Harbin (northeast China) and Kunming (southwest China), a five hour flight apart, with poor and costly results. China and India are much larger than any European country, and are much more culturally diverse than the United States. In the meantime both western packaged goods manufacturers and retailers have retreated from several provinces to concentrate on a few regional strongholds. They are more carefully expanding to other regions once they have sufficient local scale to generate the positive cash-flow required to help fund further expansion.

On an even grander scale, some companies have entered several Asian countries as large as India and China at the same time, only to discover later that they merely had funds to support growth in one. This makes the initial country choice even more important, as you may not have resources to successfully enter another one for at least a decade, after which you may be too late. A recent example is the aborted attempt of METRO Group to enter Indonesia with its Cash & Carry format, as it discovered that the on many accounts hugely attractive market was served by prohibitively well entrenched competition. To summarize, the where you should go decision is one that requires deep analysis, focus and a long term commitment. The good news is that even individual cities in Indonesia, India and China – let alone provinces – offer a potential that would dwarf many European countries. Establishing a moderate market share in just a limited number of these focus regions would satisfy the growth ambitions of the most demanding shareholder. But which regions or cities?

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Go for absolute available market growth

There is a reason why China, India, Indonesia and Vietnam are most often cited in emerging markets entry and growth discussions: people. These countries are the most populous in Asia (Japan as well but suffers from decade-long economic malaise not unrelated to its declining and aging population. Pakistan is often overlooked because of regional political instability, but its economic track record over the past 10 years is remarkable). We mentioned that shareholders want absolute cash-flow growth, which is strongly correlated to absolute GDP growth, which in turn is driven by population and GDP per capita growth. Even if countries like Cambodia or Malaysia would post similar *percentage* GDP growth as China and India, it would be modest in *absolute* amounts due to the small scale of their economies, which is directly linked to their modest population base. This limits their long term absolute growth potential and therefore attractiveness.

The same is true for cities within countries. Many "smaller" (<5 million people) and less developed cities in western China grow faster than the megacities like Beijing, Shanghai and Guangzhou. Yet these mega-cities keep an enduring attractiveness, as their economic base is so huge that even a few *percentage* points lower growth still means a higher *absolute* growth.

So, is the answer to go for a few of the largest cities in one large country? Unfortunately it is not that simple. It is about absolute *available* market growth. The size and hence attractiveness of China's eastern megacities has eluded few, leading to a very dense competitive landscape. This spoils a lot of the fun for everyone. In many cases it pays to go for a region or city with a more modest size (but still huge by international standards) and enjoy a relatively sheltered competitive climate. And it pays to be an early mover. Since a few years there is a somewhat exaggerated trend in China to go west (e.g. Chengdu and Chongqing). The good news is that it is not too late yet to jump on this train, especially as there are dozens of cities between 1 - 5 million people that are below the radar screen of many foreign and sometimes even domestic companies.

For reasons of simplification we spoke about market growth in general. The reality is more complex. In many industries, there are specific household income thresholds above which consumption really takes off. That's why the rise of the middle class is so important, as the jump in consumption from low to middle class in many categories is substantial. It is critical that for your category and ideally your brand (premium, mainstream or price-entry), you know the consumption take off point in specific countries. Cities where the equivalent GDP per capita is just below this point promise imminent consumption growth in your category. These are the cities where you want to be first, provided that they are large enough to provide scale, but this is rarely the problem in the before mentioned markets.

Analyze again, and again, and again

Companies and executives new to emerging markets are often blinded by numbers. The scale and potential is so huge that a frequent argument goes like this: "If we would only capture 1% of this market, we would already sell $xxx million". Whereas the calculation is correct, it negates the central issue of how difficult it is to achieve this apparently modest market share. Part of the answer is that national market share is not relevant in large countries, and that the same $xxx million equates to a much more difficult to achieve 20% market share in a specific region or megacity. In general, the more in-depth the analysis is, the less attractive and hence more

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realistic the attractiveness picture. Let's take an example. The retail attractiveness of Vietnam for the past 5 years has ranked top 5 in the world. It has a sizeable population (over 90 million), a structurally high economic growth between 5-8% (although hurt by recurring inflation surges), and limited international competition (only German METRO and French Big C have sizeable footprints). Yet, there is no Walmart, no Carrefour, no Tesco and no Auchan. Why? Vietnam's middle class population is concentrated in a few big cities, where land is scarce and expensive. For big box hypermarket operators, this is a serious obstacle. Vietnam's government welcomes foreign direct investment, but getting permits beyond 2 stores (nationwide) is challenging out of protection of domestic retailers. A low and slowly growing footprint severely hurts sales growth and profitability. No matter how mundane these factors may appear, in many industries similar aspects are often overlooked as one is blinded by general macro-economic numbers and the desire to go. It is critical that you uncover these for your industry in the markets that you are considering. Depending on the size of the country, you may only enter one in a decade. You'd better get that one right, if not a costly and humiliating withdrawal may await.

How You Should Go

Here we'll tackle the final question of *how* your company should prepare and proceed. The same caveat applies to the previous *where* you should go section. The advice given is by necessity general, and by no means meant to substitute the detailed information gathering and analysis required to provide in-depth answers to specific companies.

It's not a sprint, but a marathon with many hurdles

A successful entry in a new country requires endurance and patience. All the obstacles that you can think of are likely to materialize, as well as many more unforeseen ones. A thorough preparation reduces the chance of a cold shower later on – or in extreme cases the need for withdrawal – but doesn't eliminate it. Demand may be smaller than anticipated, competition (incl. retaliation and copying) more fierce, suppliers less professional, customers less trustworthy, your partner less well connected, and authorities (e.g. permits, level playing field) less supportive. You need to prepare for this, have back-up plans for those problems that you can foresee, and improvise for those that you didn't. You'll need to possess large doses of a key east-Asian cultural quality: resilience.

You and your shareholders need to be prepared that turning break-even in the first 5 years, let alone payback, would be exceptional. Most international companies that entered China did not realize this, in part due to overstretching (see where you should go). Can your main business fund the substantial negative cash-flow of your "expansion project" for 5+ years? Will your initial supporters continue to be committed in the long run? This will be a true endurance test – financially, organizationally and mentally. The start is difficult. What comes next even more so.

Don't go about it alone: partner-up

In many emerging markets, for many years, entering without a local partner was legally not an option. In most industries, a joint-venture with a local – sometimes state-owned – enterprise was the only ticket to entry. Conflicts with these partners are a question of when rather than if, and some disputes have been extremely painful and well publicized (e.g. Danone and Wahaha in China). In more and more countries and industries, teaming up with a local shareholder is no longer an obligation. Yet, with all the additional complexity and potential risks of local partners, one should not underestimate the inherit advantages. To name just a few, local partners can provide access to:

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- Instant and detailed knowledge of the local market landscape, otherwise very difficult and time-consuming to obtain
- Potential suppliers, customers (including themselves) and government contacts
- Sites/locations for manufacturing or retail facilities
- Preferential local financing or provide financing themselves, a welcome contribution to lighten the burden and risk of your international expansion

These benefits are obviously more important in the initial years of your venture, and it is prudent to agree upfront on the conditions under which you can buy out your local partner. The choice of a local partner is both important and difficult. Not all potential parties will score equally well on the abovementioned criteria. But even more important that these are two qualities that are key to any business and personal relationship: commitment and trust. Unfortunately these aspects are not easy to gauge, but it is possible to get indications, e.g. through assessing:

- Track record of your potential partner in other joint ventures
- What's at stake for the partner (size of investment and other)
- Aspirations of your partner (be wary if your partner's main motivation may come from access to your technology and knowhow, and/or the desire to learn from you before entering your industry by themselves)

Yet, notwithstanding all the risks, it is harder to live without a partner than to live with one.

Prepare for the worst: how to exit

No one starts a venture with the aim to prematurely abort it. But this doesn't mean that you shouldn't prepare for an early exit. This can avoid some although not all of the financial and mental pain of a withdrawal. You may think that this won't happen to your business, but respected companies have withdrawn from developed and emerging markets at often great cost. Sometimes this is to generate funds to cover problems elsewhere (e.g. Ahold and Carrefour in several countries), but more often this is because the emerging market reality was much darker than the business plan that everyone wanted to believe (e.g. Walmart in South Korea and METRO in Indonesia). Many more companies have considered exiting from markets but (often wrongfully) estimated that staying and working towards a turnaround was the most viable solution. But after the nth turnaround plan has failed, a future exit will be even costlier.

Preparing for an exit plan requires deep financial and legal knowledge, but common sense would be to:

- Negotiate exit clauses with your key stakeholders (e.g. landlords, secondary investors, suppliers, etc.) limiting your financial exposure in the case of a withdrawal
- Push the majority of payments forward as much as possible. An example would be to negotiate free or reduced rent for the initial years, at the expense of higher rents in the future. Chances are that you will never have to pay the higher rents in case of a withdrawal, but hopefully you will as by that time your cash-flow will be substantial enough to afford it
- Identify potential parties – including your venture partner – which could be interested in buying you out ahead of time

There is only one thing worse than an early exit… a late exit.

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Dedicate adequate senior management attention to your expansion, but don't risk your main business

Few companies will be prepared for the time, intensity and dedication required to successfully enter any foreign, but in particular an emerging market. It is almost impossible to over-estimate the additional burden on senior management. And herein lays the danger. Many companies – unwilling to get too distracted from their main business – will dedicate insufficient or insufficiently senior leadership attention to the emerging market entry challenge. This will obviously put the success of the entry at peril. Many other companies – conscious of this mistake – will want to ensure that the entry will get the required senior management dedication, but at the dangerous neglect of their home market.

So how to go about it? Well, again no easy answers here. Being aware of this dilemma is a good start. A general recipe would be to clearly assign responsibilities in your management team, with some mainly focused on the home market, and others predominantly on the emerging market entry. Naturally key decisions on both require full board attention and approval. But the foreign market conquest in addition requires a *dedicated* project team of your smartest middle managers, combining cross-functional expertise, and excellent analytical, project management and communication skills. And most likely – given the extra-ordinary nature and comprehensiveness of international expansion – your organization will benefit from some kind of external support.

Get the right support early

If emerging market entry were a frequently recurring or even continues challenge, your company would likely be adequately organized for it in terms of people, skills and knowledge. Fact is that international expansion only appears on the agenda occasionally. Hence chances are that you do not have all the available resources in house, or even if you would, you would not be able to liberate these from their important day to day tasks. So your business likely needs some help. Here are a few pointers for obtaining the right support:

- Start with an in-depth project plan, which list requirements as well as available internal resources. Where do you fall short most? In what functional areas (e.g. marketing, finance, legal) and in what knowledge & skills (e.g. knowledge of your industry in specific emerging markets, analytical skills, project management skills)? Regarding the latter, be aware that few companies will have the project management capabilities to handle a project of this magnitude and complexity
- Once the required support is identified, get it early. The uncertainty / degrees of freedom are largest at the initial stages of the project. You want to make sure that you narrow down the scope and key choices as soon as possible, and this is one key area where outside expertise can help. Also, you will want to reduce and phase out external support at later stages of the project. Not only because of financial reasons, but also for internal ownership
- Never completely outsource emerging market entry projects. This is so fundamental to the future of your business that it requires your organization's daily contribution and buy-in. Hence any outside support should be mirrored with internal resources by at least a factor three
- And don't break the bank. There are renowned management consultancies who have the capabilities to do an excellent job, but their fees may push your potential break-even forward with a number of years. Make sure that any support is fit-for-purpose

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Conclusion

International expansion in general – and emerging market entry in particular – is a classic example of high risk / high reward. But it's also a topic that benefits from being tackled as early as possible. Early mover advantages rapidly evaporate. The later your entry, the costlier it will be. Many other companies have preceded your organization and have learnt to flourish overseas, although it may have taken more time, effort and pain than anticipated. Your business can unlikely afford not to go – and even if you wouldn't – globalization has already entered your back yard. So the question is likely not *if* or *when*, but *where* and *how*. This article can only provide a superficial overview of the key challenges, as well as general advice. Fortunately there is more detailed guidance available.

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The author André van Regenmortel has a successful 20 year track record in Strategy Consulting and Industry Marketing in Consumer Products, Business Services and Retail. He draws from extensive experience at among others Philips Electronics, McKinsey & Company, Danone, and METRO Group. For the latter two companies, he occupied Board positions in Vietnam and China, being P&L responsible for businesses of up to $2 billion.

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