Securing the next level for growth
Second Tier Emerging Markets

Opportunities, challenges, strategies

Content

Executive Summary

In their quest for new sources of profitable growth, companies are increasingly shifting their focus towards lesser known but fast growing second tier emerging markets like Vietnam, Indonesia, Nigeria, Angola or the rapidly growing second tier cities of India and China.

These second tier emerging markets include the newly fast growing economies of Asia, Latin America, the Middle East and Africa. They are already being grouped in numerous acronyms such as CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey, South Africa) or the Next 11. These countries may not match the larger, tier one emerging markets (Brazil, Russia, India and China) in terms of size, but they are growing at a tremendous pace. Second tier emerging markets have become compelling investment destinations for companies, with year-on-year growth rates anywhere between 6 and 10%. Imports and consumer spending are also growing at twice the rate of developed economies. A key distinction between these markets and the traditional first tier markets is that competition is still relatively limited. This means that newcomers to second tier markets can leverage first mover advantages, exploit untapped consumer demand and establish a strong market position.

However, while growth opportunities are significant, investing in these markets can be equally challenging. Underdeveloped infrastructure, high levels of corruption, shortage of skilled manpower and ever-changing regulation are only some of the many obstacles investors are faced with when entering second tier emerging markets. Overcoming such obstacles requires an excellent understanding of the market dynamics, growth potential, consumer needs and competitive outlook (apart from a thorough knowledge of regulations in these countries). In other words, it requires an entry framework specifically designed for selecting the right market and building a sustainable strategic advantage.

When choosing which role to pursue in a new market, companies weigh the potential addressable market size against the investment required to build the required capabilities. The risks they are willing to take are highly dependent on their objectives when entering a new market (e.g. to become market leader). Deloitte has developed a framework which helps companies decide the best strategy to enter or grow in second tier emerging markets.

Emerging markets are still "hot"

At a time when the economies of the European Union and United States are showing signs of weakness (weak consumer confidence, declining GDP growth), investing in emerging markets remains a hot topic on many company agendas. The economies of emerging markets have been growing at a much higher pace than those of developed economies, with imports growing twice as fast. Emerging markets currently account for nearly half of global retail sales. Today, emerging markets account for over 50% of global FDI inflows and 25% of global FDI outflows. Their combined GDP is projected to exceed that of developed economies by as early as 2015.[1]

Within the emerging markets universe, however, the emphasis of investments is also gradually shifting. For the last two decades, investing in emerging markets was synonymous with entering the "big four": Brazil, Russia, India and China. Cities like Shanghai, Beijing, Mumbai, Jakarta, Manila and Bangkok have seen exponential GDP growth, better living standards and higher consumer spending. For entrepreneurs, this has led to rising business costs, intense competition and growing market saturation. These factors are putting pressure on companies to look for new opportunities, with lower production costs, more attractive tax incentives and overall less competitive intensity.

Leading international companies are increasingly shifting their focus towards second tier cities:
- In India: Ahmedabad, Bangaluru, Jaipur, Hyderabad, Chennai, Pune, Kolkata
- In China: Tianjin, Wuhan, Chongqing, Dalian, Xiamen, Changzhou

or second tier markets like Vietnam, Indonesia, Nigeria and Angola. These markets offer higher growth potential, lower overhead costs and less competition than first tier emerging markets.

Better growth opportunities in 2nd tier emerging markets

Second tier emerging markets are the fastest growing economies in the world (Figure 1). Looking at cities, moreover, thirteen second tier emerging cities in China, India and Vietnam are projected grow by 10-12% year-on-year. This exceeds the growth rates of mature cities like New York or Hong Kong, but also of first tier emerging market cities like Beijing, Shanghai or Mumbai. These differences between emerging cities are already on the radar of companies like Starbucks. They are earning relatively high profits in these markets, thanks to limited competition and lower wage costs.

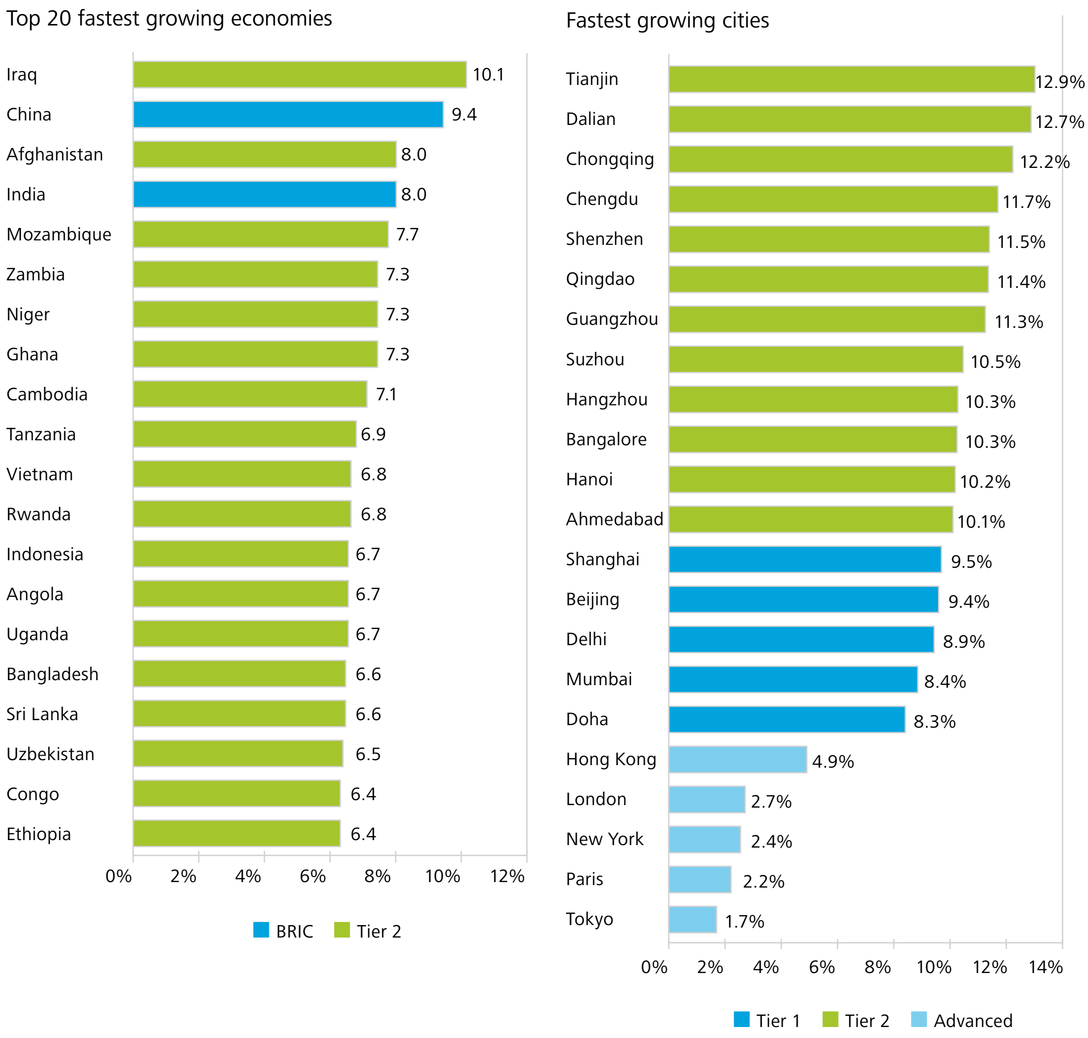
Case Study Starbucks[4]

Coffee Retailer Starbucks has a substantial presence in China with over 500 stores and 10,000 employees. It expects China to be its second largest market after the USA by 2015, projecting 1,500 stores by that year. The company will be present in more than 70 Chinese cities by 2015, and expansion through smaller cities is "most definitely" a viable way to grow, according to John Culver (Head of China & Asia Pacific).

1) IMF World Economic Outlook Report, September 2011

4) Bloomberg, Wall street journal

Figure 1 Average Annual real GDP growth 2011-2016 [2]



2) IMF GDP Growth Forecasts; EIU global city competitiveness data

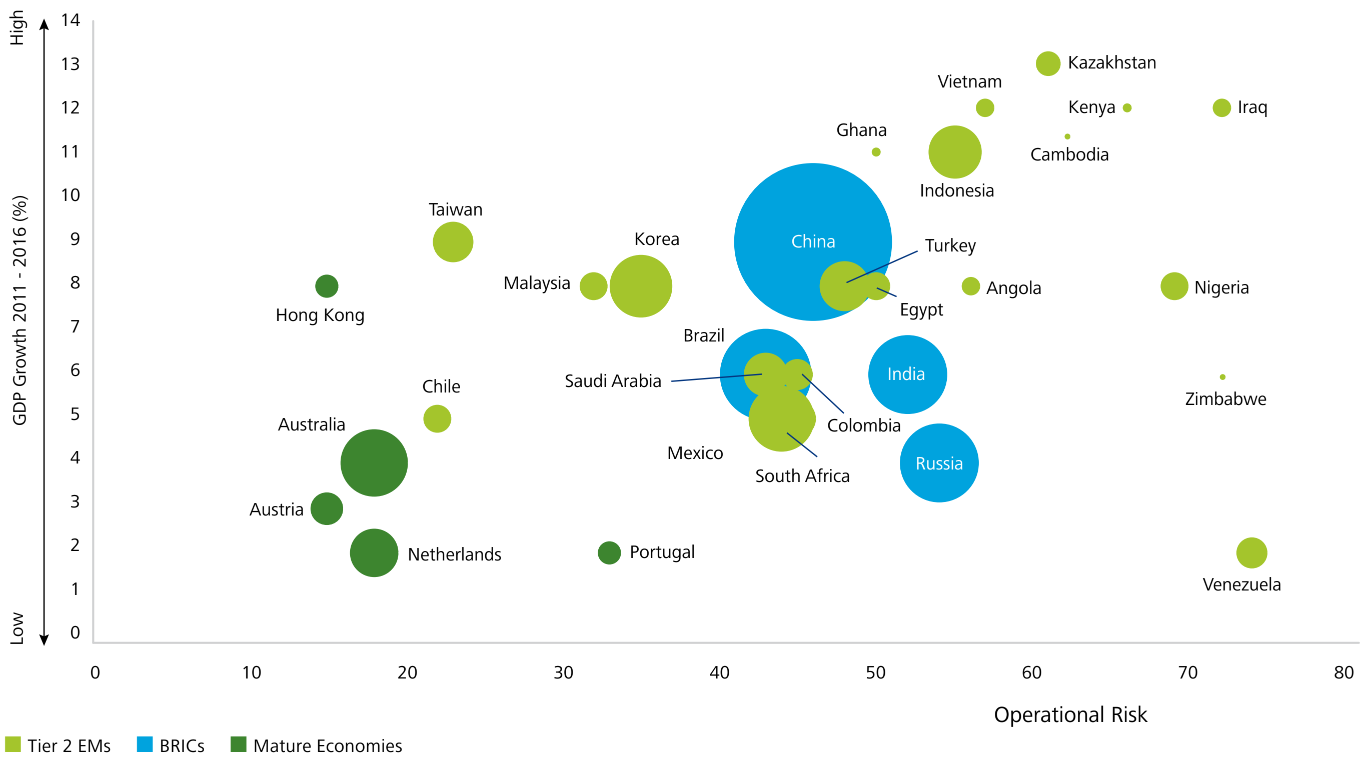
The attractions and the challenges

While the growth outlook for the second tier emerging markets is attractive, there are also significant challenges to bear in mind. The new wave of emerging markets features many of the challenges already encountered in BRIC markets:

- high levels of corruption
- poor quality of labour and shortage of critical skills
- vague and changing regulatory environment
- political instability
- low purchasing power
- poor infrastructure

Yet successive market reforms, trade liberalisation and more established legislative and financial frameworks are gradually turning these markets into more stable business environments. Still, these new second tier emerging markets are not necessarily the same as first tier markets. Successfully entering today's fastest-growing markets worldwide represents a unique challenge: one that often requires a deep understanding of the consumers in these markets, and a rethinking of traditional business models and market entry strategies.

Figure 2 Risk and GDP growth in mature and emerging markets[3]



Note: Bubble size indicates GDP (billions) as of 2011

Source: EIU, Worldbank, Deloitte analysis

3) Economist Intelligence Unit

The right approach is key

Deloitte has significant experience in supporting major companies as they enter and grow their businesses in emerging markets. Successful companies have been the ones that chose the right markets to invest in and entered these markets with the right operating model, specially geared to capture the additional opportunities.

The right market

The first step in selecting a market is an analysis of its potential. GDP growth, cultural factors and market structure are among the many factors that must be taken into consideration. For tier two markets, such information is not always readily available. Specific local research is essential to correctly estimate the potential of the market.

Second, a thorough analysis of the market attractiveness determines whether a company can become profitable in the market. Many companies, like FrieslandCampina in our case study, want to become number one or two in the market. Market attractiveness is determined by analysing the business environment, infrastructure, suppliers, institutional and regulatory settings, as well as factors like competitive environment.

Case Study FrieslandCampina

FrieslandCampina is a Dutch co-operative of farmers selling dairy products worldwide. Emerging markets are important to their growth strategy as markets in mature countries are no longer growing. FrieslandCampina is already active in China and India, but the focus is increasing to developing second tier emerging markets. By thorough preparation and research FrieslandCampina has managed to gain #1 or #2 position in markets such as Laos and Cambodia. These markets are relatively small but steadily growing and the strong position in the market allows for a high profit margin.

The right moment

Timing is critical to success in second tier markets. Entering these markets prematurely, without adequate preparation, can result in business problems, mismanaged partner relations and reputation losses, and ultimately a quick exit. Given the high dependency on local contacts in these markets, a premature entry and quick exit can make re-entry difficult in the future, as the following case study shows.

Another common mistake is overinvestment in the initial phase, again largely a matter of misjudging the investment opportunity. With the right information on market potential and attractiveness as well as knowledge of local laws and potential business partners, pacing investments is much easier.

Case Study Heavy Engineering Specialist

A heavy engineering specialist entered Kazakhstan in the early 2000s in partnership with a local company. A lack of local knowledge on environmental issues resulted in the company facing punitive fines from the environmental regulator. The company's management decided to exit the market, and their local partner was left with the responsibility of paying the fine. Years later, when the market had become much more attractive, the company was unable to re-enter the market, as their former local partner leveraged political connections to keep them out.

> "Many companies are moving in too fast and too optimistic. These companies will have setbacks as they do not understand local markets and customs. All big companies have paid their dues when entering China 15 years ago"

The right partners

Most companies entering new second tier markets enter into a partnership with a local business.This helps overcome the unfamiliarity with local customs and institutions and also gives access to local key contacts. FrieslandCampina, a dairy producer, prefers organic growth when entering second tier emerging markets. Acquisitions in such countries are often expensive, and still require large investments in capital replacement and staff training; so the company believes that starting with a local partner is a safer approach. For FrieslandCampina, this approach has proven highly successful.

The type of partner and collaboration determines a company's market entry options. If the local partner is an important player in the local market and the collaboration is set up as a joint venture, the partner can adapt the international products to local preferences and quickly reach a large part of the market. The alternative would be to distribute unadapted products to the local market. In this case, the company would be entering as a participant in its own right. This entails less risk exposure but also a smaller piece of the market.

The Ricoh case study shows how flexible companies need to be when choosing a partner.

Case Study: Ricoh

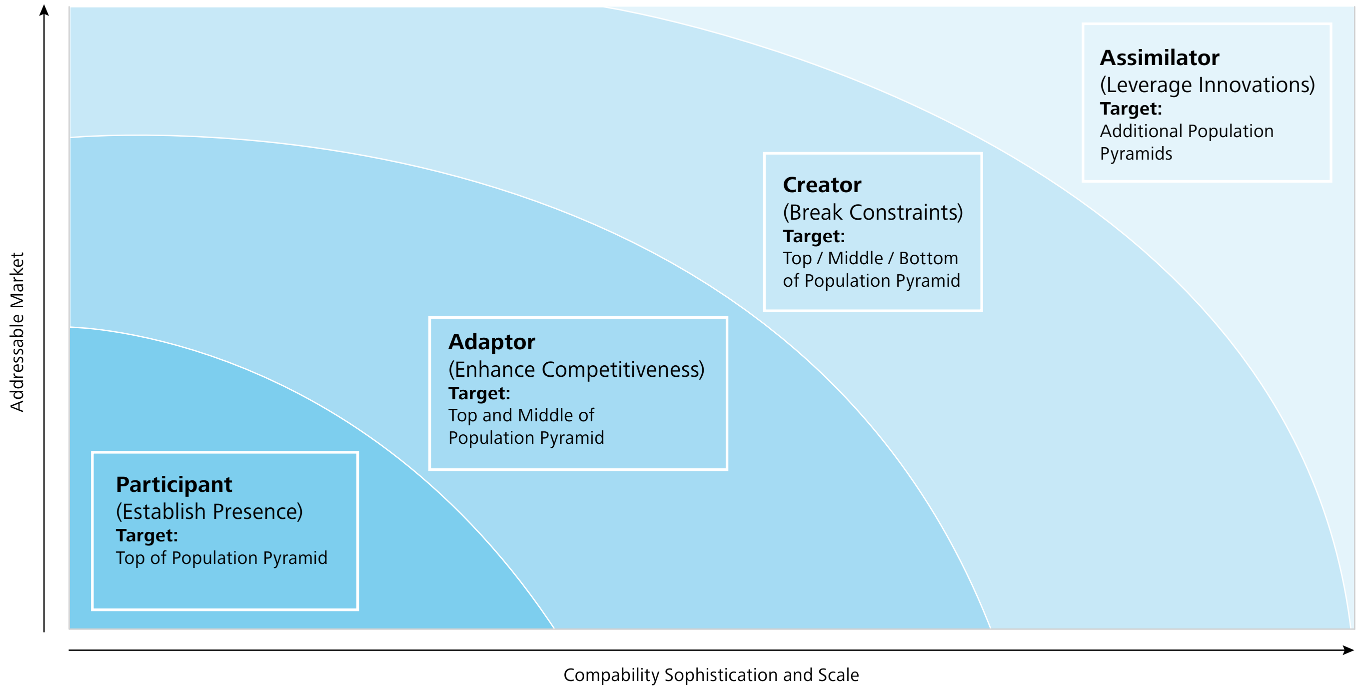
Ricoh, a leading manufacturer of imaging equipment worldwide, serves with the Ricoh International BV division, based in the Netherlands, more than 70 countries in Europe, Middle East and Africa via a diversity of indirect sales channels through its Distributor Partner network. Focus on emerging markets is a key priority; as markets in Africa attract top management attention. Managing global customer relationships is a key priority, and Ricoh understands that the big players in emerging markets, active on the African continent are often far more demanding clients when compared to traditional Western multinationals. To better engage with Non-Western organizations coming out of India and China, Ricoh aims to better understand business potential by exploring Indian and Chinese connections in Africa, who can, potentially, better understand and service the needs of these new companies.

The right operating model

Deloitte believes there are four ways that companies can position themselves in emerging markets, represented by the following archetypes:.

- **Participant** - Sells global products to the high end of the local market, e.g. Apple or Louis Vuitton
- **Adaptor** - Adapts global products to cater to a larger share of the local market. For example: BMW 7 series with longer back seat for the Chinese, who prefer to be chauffeured
- **Creator** - Creates new products to serve the entire population in the emerging market, e.g. Nokia Siemens Networks - Village Connection, which brings voice and internet connectivity to village communities where GSM networks are too costly
- **Assimilator** - Sells innovations made in emerging markets back in home markets, e.g. Tupperware's Eco Bottle, which was developed in India for the local market and exported back to US and Europe

Figure 3 Emerging Markets Growth model



When choosing which archetype to pursue, companies must weigh the potential addressable market size against the investment required to build the required capabilities. This is also highly dependent on the objectives a company has when entering a new market (e.g. to become market leader).The framework offers various options for building sustainable growth.

The simplest market entry option is through the Participant archetype, in which a company normally opens up a representatitive office or contracts a distributor, in the target country and sells standard global products (often to the high end of the market). The revenues opportunites are often limited, however, so companies look to make the progression to the next achetype, the Adaptor. This is where the company adapts some of its global products and becomes more relevant locally. While progressing from one model to the next expands the addressable market, this also increases the scale and complexity of the capabilities required (see Figure 3). Choosing the right time for these investments is key to maintaining success and increasing market share, as the following case study and other examples show.

Finally, moving to the Creator or Assimilator archetype creates scope to further expand the market opportunity. Success in these models is often the result of investing in training of local staff and giving them significant autonomy to innovate and create new products. However, managing the enthusiasm of local staff for cost-effective innovation needs to be balanced with maintaining the integrity of international brands. Companies often consider creating a local “fighter” brand to address these segments of the market, or work with different conditions in the emerging market.

Case Study: Medical Equipment Specialist

A leading medical equipment manufacturer has presence mainly representatives in most African markets. In its experience, upgrading to a direct distribution model from only a representative office at the right time leads to substantive gains in market share. In order to ensure its timing is correct, the company regularly monitors macro-economic and other social and political factors in these countries given the relatively high investments needs to build and train direct distributors.

Closing remarks

Case Study: Philip Morris cigarettes

Philip Morris used the strategy in 1998, when a sudden devaluation of the ruble quadrupled the price of its internationally produced Marlboro cigarettes in Russia, rendering them unaffordable to many smokers there. Rather than lose share to local competitors, the company concentrated its efforts on its locally made fighter brand Bond Street. When the ruble's value returned to normal, consumers came back to Marlboro, which had retained its premium pricing and brand equity.

While business growth opportunities are attractive, investing in second tier emerging markets is also challenging. Choosing for the right entry strategy can make the difference between success and failure. In-depth market research and a detailed screening of your business' strengths and weaknesses is a first step towards gaining a good understanding of the market potential. Equally important is finding the right partner or collaboration model which can allow your company to leverage local expertise and mitigate the risks of doing business in these markets. Especially in large, complex markets, joint ventures or strategic alliances with local partners who understand the market and local customs are particularly important.

Developing an entry strategy in new growth emerging markets is by no means a one-size-fits-all exercise. It needs to be tailored to each particular market and to take into account business-related factors but also tax, regulatory and legal differences. Ultimately, success or failure is determined by your capacity to understand the market, by your experience and international expertise and by the level of resource commitment you are prepared to make.

Seeking advice upfront can help you grow your business by helping you understand what entry strategy best suits your company and how you can adapt your operating model and global value chain to best position yourself in these markets, gain a competitive advantage and mitigate risks.

Interested in discussing how Deloitte can help your company leverage new growth opportunities in second tier emerging markets? Just contact:

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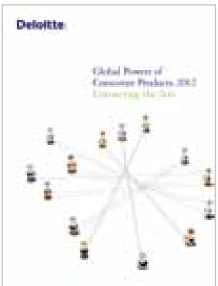
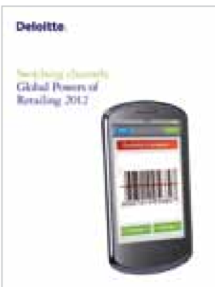
Thought Leadership/Research Samples

Consumer 2020: Reading the signs
There is no such thing as a global consumer but this report examines how the global trend will most likely shape consumer spending patterns and the world of consumers more broadly.



Global Power of the CPI 2012
– Connecting the dots
This report examines trends for companies to consider as they plan their growth strategies, provides a global economic outlook for retail, and discusses "Q" ratio - a way of drawing inferences about the future performance of retailers by examining current financial information.



Global Power of retailing 2012
– Switching Channels
This report identifies the 250 largest retailers and provides an outlook for the global economy including trends to consider for the retail industry

“The ethical agenda also helps in hiring the right people”

Consumer Industry market leader in emerging markets