The Siren Song of M&A in Emerging Markets
How consumer products companies can add value and avoid the rocks

Emerging market growth has become the Siren Song of the consumer products (CP) industry. Earnings calls, analyst briefings and industry confabs are typically filled with pronouncements about strategic intent and concerted efforts to capitalize on mergers and acquisitions (M&A) in emerging markets. Like sailors in Greek mythology, CP company leaders can be lured by the enchanting music and lyrical voices of emerging market opportunities only to find themselves shipwrecked on the rocky coast of a remote island with little or nothing to show for the risks they took by heeding the calls to grow. To avoid the rocks, companies should instill focus and pursue targets that can add near-term value and provide long-term positional advantages.

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Emerging markets are, well, still emerging

The hard truth is that emerging market M&A is an essential but insufficient basis by itself for growth for most consumer products companies. In the near term, few emerging market deals provide sufficient revenue or earnings to make a large change in a CP company’s performance. To illustrate this point, consider the case of a hypothetical consumer goods company with $20 billion in revenue and aspirations to grow seven percent annually while maintaining a 10 percent pre-tax margin. Also assume that mature markets generate many of the company’s current sales, which means organic growth may generate a two to three percent increase in the top line and yield $40-60 million in incremental pre-tax margins. As a result, the business’s corporate development leaders would likely search for targets that offer the potential for nearly $1 billion in acquired revenue. Herein is a specific challenge in emerging market growth: According to data from Thomson Financial, the average consumer goods M&A deal in emerging markets involves targets with revenues of around $100 million. If two percent of identified targets make it through a company’s deal funnel (assuming the company has the resources to identify a suitable list of targets; many of them don’t), leaders may end up sifting through 500 targets to generate the desired level of growth. In most companies, that is neither tenable nor sustainable.

In the medium term, emerging market deals can be attractive strategies when compared to alternatives such as introducing a stream of product extensions and/or packaging or formulation innovations in developed markets. Driving incremental growth using these approaches can cost tens of millions of dollars, requires the company to secure and retain space on retail shelves, and is often predicated on taking market share from a competitor. In emerging markets, a rising tide raises the ships, contributing to potentially higher growth rates over time. Over a longer horizon, the growth of a new middle class in many emerging markets, increases in consumer discretionary income, and a resulting heightened demand for new products and services can portend unrivaled opportunities for companies seeking growth.

The upshot: Companies seeking growth opportunities in emerging markets should consider pursuing targets that can add value in the medium term while providing long-term positional advantages. Emerging markets can represent an attractive avenue for growth but, as evidenced by their name, they are still emerging; consumers’ disposable incomes and consumption rates per capita are a fraction of mature markets and may take years to develop. In addition, supply chains, distribution systems, and other infrastructure requirements in emerging markets are still developing, which can create challenges to achieving growth even if consumer demand exists. Yet, history shows that companies may be ill-advised to postpone entry until markets mature; early entry can potentially bring sustained competitive advantages, as evidenced by one carbonated soft drink company’s market dominance in Russia.

“Emerging markets can be complicated but certainly worth pursuing from an acquisition strategy.”

Senior Vice President and General Manager
Global Ingredients — Dairy Foods (and former head of corporate strategy), U.S. consumer products company
They’re playing our song: Why emerging markets are so alluring

Why is the pull of M&A in emerging markets so alluring to many U.S. consumer products companies? First, they may provide a solution to the age-old challenge of organic versus innovative growth. Many of today’s large CP companies are experiencing low organic growth rates in the United States and other established markets such as Western Europe; a specific strategic driver, therefore, is to identify new, innovative platforms that can offer (potentially) higher growth rates over time. Emerging markets — from giants such as China, India, and Brazil to next-wave focus areas such as Peru, Colombia, Argentina, and certain areas of Africa — can provide opportunities for CP companies to expand their customer base, enlarge their geographic footprint, and grow their product portfolio by means of joint ventures and/or full purchases. Many multinational CP companies often use M&A in emerging markets to add popular local/regional products and brands to their portfolios; smaller CP companies typically employ M&A as a way to establish a presence in a particular market, introduce some U.S. products and brands via the new distribution channel, and adapt product formulations, packaging, etc., to align with local consumer preferences and see how consumers react to them. Each market presents different selling environments and can offer smaller U.S. entrants valuable (if not risky) learning experiences.

Another reason some CP companies may decide to pursue M&A in emerging markets is to support customer growth there. For example, major retailers with global ambitions (Figure 1) can generate 15-20 percent of many CP companies’ revenues. As these retailers expand their presence globally, their specific partners are likely to follow and provide guidance for that growth.

“When operating in emerging markets, you have to have a business that can withstand a volatile business environment. Unexpected circumstances may arise that impact your business that you may have not anticipated. One must be nimble enough to be able to course-correct to respond to rapid market changes.”

Senior Vice President and General Manager
Global Ingredients — Dairy Foods (and former head of corporate strategy), U.S. consumer products company

Figure 1: Retailer Global operations

<table>
<thead>
<tr>
<th>Retailer</th>
<th>2010 Sales ($B)</th>
<th>Countries of operation (2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Walmart</td>
<td>$418.9</td>
<td>16</td>
</tr>
<tr>
<td>Carrefour</td>
<td>$119.6</td>
<td>33</td>
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<tr>
<td>Tesco</td>
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<td>13</td>
</tr>
<tr>
<td>Metro AG</td>
<td>$88.9</td>
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</table>

Source: Deloitte Global Powers of Retailing, 2012
Within emerging markets, which types of organizations do U.S. consumer products companies consider to be attractive acquisitions and/or strategic partners? Some potential targets are smaller, privately held, family-run companies in product, customer, or geographic areas that the acquirer is looking to grow. These middle-market targets may be appealing because: 1) they are already familiar with or have an existing, successful connection with one or more U.S.-based companies; or 2) they can offer local stability and access that can help a U.S. company (particularly a new market entrant) navigate government and cultural roadblocks to expansion. The challenge with these smaller, bolt-on acquisitions can be gaining sufficient long-term benefits. When a CP company overlays the potential acquisition onto its existing business strategy, the initial advantages — a new distribution channel or product portfolio addition, for example — may appear obvious; however, it can be difficult for large CP companies to achieve longer-term growth goals solely through middle-market deals.

Other attractive targets in emerging markets are those with strong multinational or regional brands and scale within one or several geographic markets. Revenues at these companies can be greater than $US 1 billion, reducing the need for the acquiring organization to build an on-country infrastructure (facilities, staff and distribution channels) from scratch. However, scarcity value and competition for these targets can be fierce, driving up the purchase price and deal multiples. Many acquisitive CP companies are typically willing to pay a premium price for desirable entities, viewing these acquisitions as an investment; a strategic play to establish a presence in a specific market and position the company for future growth.

Many U.S. or multinational CP companies choose to enter an emerging market through a joint venture (JV) agreement, as evidenced by recent activity in China, India and other regions. Full purchase of a local company presents more risks, especially if the market is not as stable as desired or the acquiring company does not have broad knowledge regarding the local political structure, workforce, distribution channels, and customer preferences. If, after a period of time, the JV confirms the market’s viability and the relationship proves effective, the CP company may decide to move to a full purchase. If a strategic joint venture is the preferred market entry strategy, it is important to clarify how the JV will be run, as the local business partner may have a different view of the world than its U.S. counterpart. Also, the JV agreement should contain specific language regarding governance, buy-out provisions, and the associated mechanism that will be used to determine the proposed purchase price.

“Transaction structuring is ten times harder in emerging markets than what buyers are generally accustomed to in the U.S. For example, you can't structure to avoid liabilities in Brazil. In China, you need structural protections other than contract terms, which will often be ignored. It is very time-consuming to get any deal done in these markets due to the difficulty of conducting due diligence, getting necessary approvals, and other issues.”

Vice President
Corporate Development, U.S. consumer products company
Beware the rocks: Emerging market M&A risks

Each emerging market presents a different set of M&A risks. To avoid crashing on the rocks, CP companies should be aware of the following potential issues and concerns when embarking on an acquisition or strategic joint venture:

Market

- **Local governance and practices**: Inadequate corporate governance, corruption, lack of enforcement of intellectual property rights, and immature dispute resolution mechanisms are common challenges in emerging markets. In particular, U.S. companies (and their potential targets) must avoid running afoul of the Foreign Corrupt Practices Act (FCPA).
- **Unpredictable regulatory and political environments**: Regulatory requirements and political influences in emerging markets can be unpredictable and difficult to maneuver, as in cases where governments nationalize assets.
- **Unclear legal title of seller assets**: Lack of proper legal documentation and related-party transactions may make it difficult to analyze legal ownership of assets related to the target company.
- **Valuation challenges**: Some foreign markets may have a different philosophy regarding deal economics, which can present valuation challenges.

Financial

- **Quality of financial information**: Local private companies may lack sophisticated financial reporting functions; they also may lack information to manage the business, particularly in owner-managed private companies (e.g., basic KPIs may not be consistently or regularly tracked or monitored); and what financial information is available often lacks completeness and reliability.
- **Inadequate reporting of liabilities**: Target companies may lack the appropriate accounting processes and supporting documentation for management’s use of estimates and assumptions to support the amounts reported in the financial statements (e.g., lack of supporting documentation for its bad debt policy and as a result insufficient reserves for bad debts); they could lack proper documentation of supplier agreements, often resulting in understatement of liabilities; also, contingent or actual liabilities related to statutory employee welfare contributions and severance payments are often not recorded accurately.
- **Other obligations and liabilities**: There may be penalties and liability exposures related to social insurance obligations, statutory employee welfare contributions, and severance of redundant staff; other potential issues include lack of booked reserves for labor, legal, and environmental issues.
- **Tax-driven accounting**: The local company’s accounting processes may be driven by tax requirements as opposed to applicable accounting standards; there may be a tendency to report lower earnings to drive lower effective tax rates.
- **Ever-changing tax regimes**: Many emerging markets can have tax regimes that change significantly over time as a result of changes in the local country political landscape. Also, many emerging markets depend heavily on indirect tax collections (e.g., VAT) and consideration of these areas during due diligence should typically play a larger role than may be the case in more developed countries.
- **Intercompany and related company transactions**: Multiple related-party transactions could make it difficult to identify guarantees and transactions completed for the benefit of the “Group” rather than commercial reasons, and to assess transfer pricing; also, financial statements often include family personal expenses.

Operational

- **Lack of infrastructure and substantive controls**: Sophisticated control mechanisms are often absent and/or if present, are sometimes overruled by family owners; also, significant adjustments are often made at year end, creating difficulties when trying to analyze interim financial information.
- **Employment of family members**: Family-owned businesses in emerging markets could have several family members, close relatives, or friends working for the company; this will likely need to undergo due diligence to effectively understand their applicable roles and responsibilities.
To avoid a shipwreck, navigate carefully
Consumer products companies seeking to engage in emerging markets M&A should carefully navigate some unfamiliar — and potentially, treacherous — waters if they hope to avoid a shipwreck. When contemplating a market entrance or expansion, CP companies should consider these strategies:

Keep an eye on the waypoint
Determine how M&A in emerging markets fits into your overall strategic growth plan. Understand what countries you want to enter, why you want to be there, what customer or product segments offer the most potential, what companies fit from a target screening perspective, which targets would likely be prioritized should they come on the market, and how you will compete.

Approach emerging markets from a consumer’s perspective. These markets are not homogeneous; think strategically about which consumers have unmet basic requirements — like safe food and water supplies — and whether consumer demand will justify investing. Similarly, understand which markets have moved beyond meeting basic requirements and may lend themselves to products that meet higher-order requirements such as home and personal care products. You may want to consider creating a niche segment and configuring your products to that segment — employing the same models/products as in developed markets is often not a successful approach.

Monitor your course carefully
Pursue targets that you believe can add value in the medium term while providing long-term positional advantages. View emerging market growth as a portfolio of options value-adjusted for market risk. Classify and selectively pursue targets in BRIC countries but also seek growth options in the “next” wave of emerging markets.

Establish and practice strong M&A governance. Clear decision rights are critical to deploy resources effectively and to make sure priorities are consistent with corporate, unit and local management objectives. In some cases, companies opt to refine their governance model on the fly. This can result in frustration as potential deals are pursued for a variety of reasons; targets are screened with inconsistent sets of criteria; resources are allocated to diligence efforts that are misguided; and sellers become frustrated with the acquirer’s ability to move at a pace that seems “reasonable” outside the process of a multinational company.

Use strategic, economic, and demographic screens to select markets. When you look at your existing geographic, customer, and product mix, does the market help grow or strengthen that? Gaining refined market insights will likely require local knowledge and “feet on the street,” as syndicated data and reliable research is not as well developed as sources routinely consulted for commercial, operational, and financial due diligence in developed markets. Draw upon knowledge that is analyzed carefully by advisors with experience in specific country and market practices in the areas of human resources, accounting, channel dynamics, government relations, etc. Be sure to carefully diligence local agents to help avoid FCPA issues.

“My advice to other organizations that are pursuing an acquisition growth strategy in emerging markets is to hope for the best, plan for the worst. You need to accept the losses that will occur as being fundamental to the process.”

Vice President
Corporate Development, U.S. consumer products company
Set a pace for the journey that is appropriate for the conditions
If you are engaging in M&A in an emerging market for the first time, realize that it often takes longer to close a deal than it does in the United States or another developed country. Be patient and move judiciously; emerging markets can be treacherous due to unstable political environments, unreliable legal systems, and very different accounting practices.

Review and leverage what companies in other industries (e.g., automotive, industrial manufacturing) have done to establish or strengthen their presence in emerging markets. Just as important, learn from their mistakes.

Set sail with a compass and experienced crew
Carefully assess the accounting and tax issues of an M&A transaction. If you are going to acquire a decent-size company in an emerging market, the legal entity structure and tax issues normally come into play, especially in future-state planning.

In a buy-side transaction, make sure you understand the ownership structure of the company you are dealing with. In a family-owned enterprise, for example, the general manager you are dealing with may not be the decision-maker. Work with the right people as soon as you set sail.

Safeguard your intellectual property (IP). Regulations in less mature markets generally aren’t as restrictive and/or enforced in the same manner as in the U.S. There may be dangers of product cannibalization and other IP infringements.

In the United States, the claw-back mechanism in an M&A agreement can protect the acquirer if a deal goes sour. Such a provision may not carry the same weight in emerging markets. In this context, an escrow may be an attractive option to consider.

Don’t overestimate the transferability of U.S. brands and products to local markets; extensive research and testing may be needed prior to a product launch. Also, if you are adding local products to your portfolio, be careful about trying to change their branding strategy too quickly without understanding consumer preferences.

Identify and bridge cultural gaps. Appreciate and respond to cultural differences in executive-level representation, the decision-making process, and monetary philosophies. For example, some foreign markets (e.g., China and Japan) may have a different philosophy regarding deal economics, which can present a valuation challenge. EBDITA is the benchmark for value for U.S. companies; Asian markets generally focus more on asset value, land rights, and other factors. Understand how the counterparties think about value to help bridge gaps between parties.

Safely heed the siren song
While emerging markets can offer significant M&A growth potential, oftentimes the voyage to value-creation for the acquiring entity can be more complicated than expected and can take longer to realize. Also, the short-term end benefits may be smaller than expected. Still, consumer products companies may be able to more safely heed the siren song and realize long-term competitive advantages, by considering:

• Employing a balanced approach to M&A activities and looking for opportunities in both developed and emerging markets;

• Making sure they can maintain the continuity of the local business by actively and consistently engaging with local team members and incentivizing them to grow the business;

• Understanding that bridging cultural differences is critical to the probability of being effective/achieving the desired results;

• Recognizing that while value and price are important considerations in analyzing the worth of a potential acquisition or strategic joint venture, there are other considerations. Each emerging market has different factors that influence current and future business value.
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