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From the Desk of...

Nenad Pacek
Author & Speaker on Global Emerging Markets

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Five Mega-trends facing international businesses through to 2020

Nenad Pacek, business strategist and author of "*Emerging Markets: Lessons for Business Success*", highlights some top issues facing global businesses.

The dust is slowly settling after the biggest economic earthquake in 80 years. However, rebuilding and aftershocks will be with us for years to come. The future landscape in which firms will look for sales and profit growth will be markedly different than the one we observed in the 1990s and from 2000 to 2007. I think the following five mega trends will have a huge influence on how companies approach international business over the next decade:

- Age of economic moderation
- Rise of emerging markets (and relative decline of the developed world)
- Sales growth largely from emerging markets
- A competitive landscape tighter than ever
- Age of relentless innovation

Trend 1: Age of economic moderation

We have had more economic crises in the last 35 years than in the previous 350 years. The age of massive deregulation, "securitization" of risk, free flows of speculative capital to and from emerging markets without capital controls, as well as the most recent age of leverage built on easy money, easy liquidity and financial fraud, all culminated in the current mega crisis. The good news is that another Great Depression was avoided, despite the fact that this crisis is about four times larger than the Great Depression as a percentage of global GDP. It was avoided because the policy response was broadly good. Monetary stimulus, fiscal stimulus, recapitalizations of banks, injections of liquidity into the banks, rescuing banks from collapse, buying up toxic assets and even printing money (these days popularly called "quantitative easing") all played a role in preventing total collapse. Many of these measures will still be around for a while, coupled with changes in the regulatory landscape.

The unprecedented complexity, globality and speed of the crisis surprised authorities and the policy response, although good, came too late. These delays spooked corporate and private confidence. This is why we ended up in a Great Recession. Economic history tells us that once confidence is shattered, it always takes a long time to rebuild. This is particularly the case in crises that have financial and banking problems as their root cause. History also tells us we are at the bottom globally, but there are large differences from region to region and from country to country (note: see my other slide presentations and papers on regional and market outlooks). Some markets will take longer to recover and some are already recovering reasonably well.

But all markets have one thing in common. Their growth will be slower than in the high growth years and we are now entering an age of economic moderation. Why?

- The massive age of leverage which was enjoyable for business will not return for decades, even if regulators do a half-hearted job. Although the financial industry is known for its creativity, it will be hard to hide, package or sell liabilities to third parties as long as memories do not fade away. And without

hiding, packaging and selling liabilities, it will be hard to build another massive credit bubble. Therefore, growth will not reach the super cycle peak it reached in 2006 and 2007 for decades. Current extra liquidity pumped by central banks will soon be withdrawn too.

- The need to restore balance sheets at government, household and private levels will continue, particularly in the developed world.
- Unemployment historically rises for over 4 years from the beginning of any financially induced crisis. This means that in most markets, unemployment will continue to rise during 2010 and in many markets also in 2011. The gradual recovery will be largely jobless for several years. This means that the consumer will remain psychologically fragile, keeping its purchases at a reduced level.
- Lending will remain tight and subdued for many years, particularly for smaller and medium sized firms. There are a number of reasons why banks will continue to operate in the so called “reduced risk mode” over the next few years: upcoming regulations will force them to increase their capital ratios and more cash hoarding is likely, non-performing loans are high and rising, and some of them still need to clean toxic waste (previously known as Triple A rated securities) from their balance sheets. Banks do not like to lend into a recessionary environment anyway and will be looking for easier returns by buying an unprecedented supply of government bonds and treasuries.
- Previous crises show that memories of the crisis linger on for years in customers’ minds. Exuberant confidence is unlikely to return for years.
- High and rising government debt in the developed world and pressures on government budgets in other regions (due to falling tax revenues and stimulus measures) mean that governments will be seeking to live much closer to their means. This might include tax rises and/or various spending cuts.
- Even emerging markets will grow more slowly than in the past as developed world buyers only reluctantly purchase emerging market exports.

Trend 2: Rise of emerging markets and relative decline of the developed world

Next year we will arrive at a symbolic moment. After more than 150 years, emerging markets will again be as large as the developed world (at purchasing power parity). We have been living in a historic anomaly in which today’s developed world has been bigger than today’s emerging markets. This was never the case before 1850 and it will never be the case again. Emerging markets already buy half of the world’s exports and half of the world’s oil. They have accumulated more than 70% of global foreign exchange reserves, more than ever in their recorded history. This is a major buffer for future stability for many regions and countries. They have more than 80% of world’s population and this is rising by 6m people every month (vs. 300,000 per month in the developed world).

For the last 15 years, emerging markets outperformed the developed world in terms of growth by a margin of 3 to 1. This margin is likely to gradually expand over the next decade. This crisis has actually clearly exposed something that close observers already knew was happening. Economic fundamentals show that emerging markets are in a good position compared to the developed world. Emerging Asia, Middle East, key markets in Latin America and key markets in CEE, all have better fundamentals (reserves, public debt, external debt) than West European markets, USA or Japan. In addition, the impact of this crisis is actually accelerating the shift of economic power to emerging markets because the developed world (particularly the US and WE) will have to go through a longer post-crisis hangover period.

Trend 3: Sales growth will be largely in emerging markets

This mega trend is based on two points. First, underlying economic trends point to better performance in emerging markets than in the developed world. Second, based on my interactions with numerous regional and global executives at multinational firms, the corporate consensus is clear. It will be hard to find growth in the developed world in the next years. But it should be easier to find it in a number of emerging markets.

Multinationals are not wasting time in addressing this challenge and opportunity. I observe an ongoing reshuffling of internal priorities, structures and approaches. My advice to companies is to treat the developed world and emerging markets with at least similar seriousness, focus, investment and attention. There are two corporate temptations these days and both are wrong. First, in some companies there is the temptation and determination to focus massive resources on emerging markets, clearly at the expense of

developed markets. Second, in some companies there is the temptation and determination to protect what one has (largely in the developed world), at the expense of any systematic expansion in emerging markets. The problem with these approaches is that they risk business in either the developed world or emerging markets. A corporation that will be successful in the future must nurture both with the same care. A company of the future must become a "two-headed monster"; one head must be focused on protecting (and growing if possible) the large volume, low growth markets of the
developed world, the other head must be focused on building medium and long term market positions in emerging markets. And both heads need to talk to each other and exchange experiences more than ever.

Over the years, many companies have fallen into the trap of being too opportunistic in emerging markets. Too much management focus ended up on the developed world and emerging market operations were run without deep enough local presence and execution, brand building, decentralized decision making, speed, flexibility and commitment (note: please contact me for a full list of corporate success factors in emerging markets). As corporate boards increasingly realize the importance of emerging markets in the next 5-10 years and beyond, the modus operandi is shifting clearly and decisively to a more systematic approach. My advice for starting to implement a "two-headed monster approach" is to appoint the head of emerging markets so that the newly found focus is not lost as time goes by.

In the aftermath of the crisis, many companies will find it financially difficult to deeply engage in the "two headed monster approach". But it is time to look at financing international operations in a more creative way. Many firms are issuing or thinking about issuing new shares and corporate bonds in emerging markets. How many readers know that Nestle is listed not only in Switzerland but also in India, Malaysia, Nigeria, Pakistan, Sri Lanka and Serbia?

Trend 4: The competitive landscape will be tighter than ever

At least two major forces are shaping the international competitive landscape. First, traditional multinationals from the developed world are becoming more focused and systematic regarding emerging markets. Second, there is a growing number of emerging market companies that have regional and global ambitions. There are reportedly close to 3,000 Chinese firms that have serious regional and even global ambitions (about 700 of those are reported to have very concrete global ambitions). Neither of these forces should be underestimated, especially not the rise of emerging market firms. Multinational firms have an ongoing tendency to underestimate domestic competitors and newly rising emerging market multinationals. (By the way, emerging market multinationals already represent 10% of Fortune 500 firms). Business history is full of skeletons of US and European firms which underestimated Japanese, Taiwanese or Korean competition in the past.

These new competitors are coming up with competitively priced products of increasingly acceptable quality. Their margin objectives are different from those of large multinationals. They operate fast and steal market share, especially during crises when customers trade downwards anyway. So the next decade will be marked by growing competitive pressures in a global economy that will grow only moderately compared to the boom years of 2004-2007. This means that multinational firms will face sales, margin and market share pressures on an unprecedented level. A number of actions will be needed to succeed in the new landscape (one of them is the next mega trend below).

Trend 5. The age of relentless innovation – with external and internal focus

International business battles and wars will be won by companies that compete in multiple market segments. Why is it important to have a systematic and sustainable innovation strategy that looks beyond the traditional premium segment?

a) Growth potential. Companies that compete in second, third or lower market segments will find that most growth will come from that space in the next decade. Taken as a whole, the biggest sales growth potential ultimately will be in emerging markets and within them in all segments below premium.

b) Competitive pressures from multinationals. Even multinationals that refused to move below the traditional premium segment are now at least discussing the issue seriously. Goods and services from all sectors are now in this game or will be very soon.

c) Competitive pressures from emerging market multinationals. They usually start at the low end of the segmentation pyramid but in recent years they have been moving upwards attacking many segments.

d) Developing products and services for multiple segments is not just a strategic issue for emerging markets. It is also relevant for the developed world where companies of all sizes and households will all be more price sensitive in the new age of moderation.

e) In the new age of moderation, more consumers will be trading downwards (just as many have done during the last two crisis years). Historical case studies show that once a customer moves down and is reasonably satisfied with a "good enough" product, it is hard to move him up again. Why would you want to surrender those sales to your old and new competitors?

Competing in multiple market segments is a necessity but it is not easy to implement. The approach to R&D, marketing, sales, manufacturing and sourcing will change significantly. To make it work, there has to be full support from the very top of the corporate hierarchy. It is a big strategic leap but the one that will ensure success and survival. Needless to say, innovating upwards remains as important as ever. Companies should be aware that there is a great opportunity for selling super premium goods and services in emerging markets to the narrow segment of the very wealthy (or those wanting to appear wealthy). In addition to externally motivated innovation, companies should be looking at internal innovation focus. This is all about making your employees more innovative and creative. Most of them are using the left, logical side of the brain in day-to-day work. Companies should train their staff and leaders on how to engage the right side of the brain more. In these challenging times for international business, all grey cells should be running full speed. Companies with ideas, out-of-the-box approaches and flexible minds are likely to navigate the next decade with more success than others.

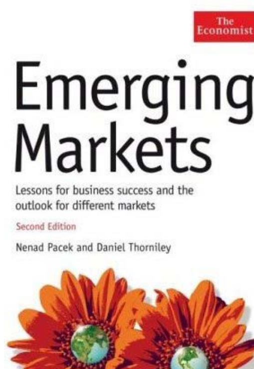
Companies that focus on market share during the tough times usually end up being post-crisis winners.

About Nenad Pacek and The Insight Bureau

Nenad Pacek, based in Vienna and a frequent visitor to Asia, North America and the Middle East, is a leading business economist and strategist, focused primarily on the challenges and opportunities of doing business in Emerging Markets. He is the Founder and Head of Global Success Advisors and was formerly a Director for 16 years with the Economist Intelligent Unit leading corporate programmes, business advisory services and facilitating business-to-government dialogues. He is the author of a book "*Emerging Markets: Lessons for Business Success and Outlook for Different Markets*". His depth of analysis and insights has made him a keenly sought-after presenter at events and in planning & strategy meetings and at board advisory meetings.

The Insight Bureau offers a global resource network, which includes Nenad Pacek, which provides confidential briefings to senior executives, a service that helps achieve a better understanding of the world in which we do business and ultimately strives to enable companies to make better business decisions

www.insightbureau.com +65-6300-2495 engage_us@insightbureau.com



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