GT BRIEFING: October 2012

Global Trends

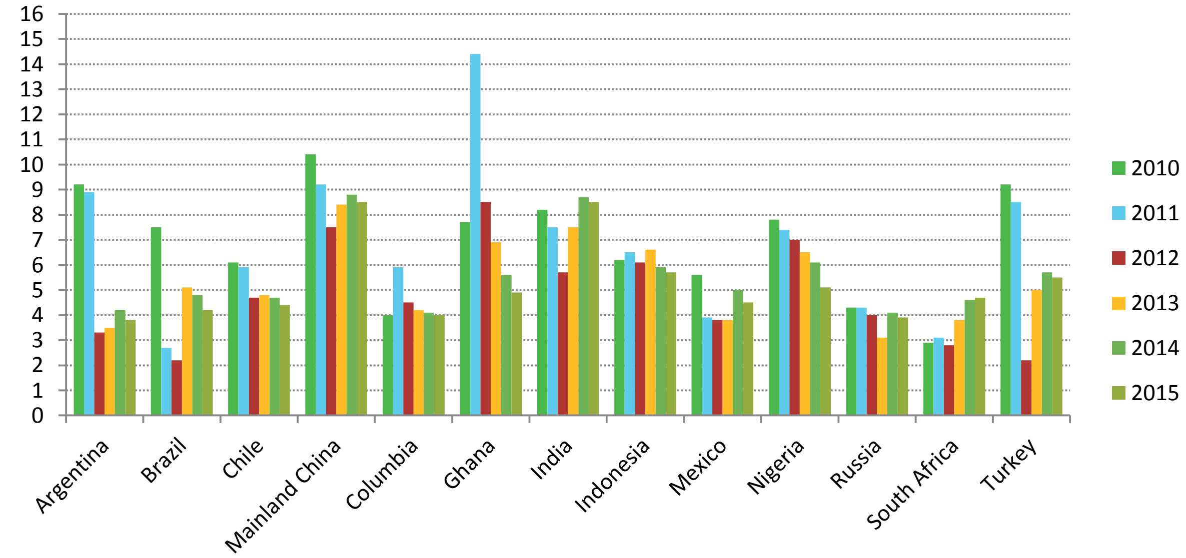
The Rise of the BRICS & Beyond

October 2012:

Open a newspaper, read a report, or listen to an executive interview and chances are that the focus will be the tremendous growth of the BRICS & beyond markets. Economists enthuse over the exploding middle class and long term economic prospects, in contrast with the stagnating growth of the developed markets. Executives talk about their companies' strategies for growth in the BRICS & Beyond. Investors want to buy ever more "emerging market" stocks. Why? Because this is where the growth is, today and in future – and financial markets demand growth. In this briefing, we take a look at the potential of some of these markets, their impact on growth and innovation, and the challenges of competing in the B&B.

EXTRACT OF ERNST &YOUNG' S 25 RAPID-GROWTH MARKETS

Estimated Real GDP growth (% per year)



(Source: Ernst &Young – Rapid Growth Markets)

The world's growth machines

The shift in economic power toward the BRICS and beyond markets continues. The high growth rates and increasing size of these economies continues to attract competitors from around the world. But these markets are playing an expanding role. Home market competitors from BRIC markets are also extending their presence on the global stage, particularly into other high growth markets, leveraging strong bases in their domestic markets. The mindset of many of these players is focused on aggressive expansion and investment, in contrast to the consolidation and risk management mindsets of many traditional Western players. Beyond these players themselves, the economic and political systems across BRICS markets continue to challenge assumptions that there is a single model of capitalism.

While the most highly developed countries will continue to be the world's largest consumers for the next two or more decades, they offer little potential for growth – which is why the BRICS and beyond markets have seen such interest from investors and businesses alike in the last decade and will most likely continue to do so in future. The resulting challenge is how to balance the demands of serving diverse markets, which can exhibit very different profiles in terms of purchasing power per capita, lifestyles, needs, distribution systems and rules of engagement. Further, with competition intensifying in these markets between international and local players, the big question is: Where next for growth? What markets of the future are attractive beyond BRIC? Our GlobalTrends analysis suggests that beyond the BRICS themselves, the next tier of markets that should be on companies' radar screens, based on market size, population and economic growth, income per capita, global focus/influence and resource strength, include: Indonesia, Mexico, Turkey, Iran, South Korea, Egypt, Nigeria, Thailand, Vietnam, Pakistan, Bangladesh, the Philippines and Argentina. Let's have a look at some of these economic power machines.

In Action!

BRIC: From sprinters to runners? The BRIC countries are among the largest and most influential economies of the 21st century. Together they are home to 40% of the world's population and produce more than 25% of global GDP. To date they have survived the financial crisis better than any developed economy. However, there are clear signs that their growth is slowing. With manufacturing output and exports suffering from reduced global demand, in June 2012 China announced that it would reduce its one-year lending rate to 6.31% from 6.56%; then, in early July it reduced it further to 6% in an attempt to prop up output. Brazil's economy boomed in 2010, growing by 7.5%, but in 2011 GDP growth fell back to 2.7% and the EIU recently trimmed its forecast for Brazil's real GDP growth rate to 1.5 %. Russian growth is also expected to slow down from 4.3% in 2010 to 3.8% in 2012 and 3.9% in 2013 remaining below pre-crisis levels. In India growth is also slowing but inflation remains high, with the Indian government proposing reforms to control it. (Source: EIU). As the BRIC countries finally feel the global economic slowdown, expect the sprint to become a steady run,

Introducing MIST: The Goldman Sachs economist Jim O'Neill who came up with the now popular term "BRIC" to describe the emerging economic powers of Brazil, Russia, India and China, has now coined the acronym MIST (Mexico, Indonesia, South Korea and Turkey) for the next tier of large emerging economies. These four countries are not (yet) as strong as the BRIC countries: Although they have outperformed the BRIC in pace of growth, their economic output still can't approach that of the BRIC. Total GDP for the MIST nations was US$3.9 trillion in 2011, compared to US$13.5 trillion for BRIC combined and US$7.3 trillion for China alone. However, all four have: A large population and potential market, a substantial economic base at about 1% of global GDP each, and all are members of the G20. (Source: Institutional Investor, RT) How attractive will these markets be for your company in future?

Latin America calling: Mexico's GDP is projected to grow 3.9% by the IMF. While Mexico's manufacturing could not compete with China' s cheaper manufacturing exports earlier in the decade, according to Barclays the sector is back on track with both countries' manufacturing exports now growing at rate of 9.5 % (Source: FT) as wage increases in China reduce its advantage. However, Latin

America has more opportunities than Mexico. GDP growth in Argentina was almost 9% in 2011, although this year it is expected to slow down to just 3.3% as demand from Brazil weakens and the global outlook remains bleak. Take a look too at Chile, another of Latin America growth markets, which is expected to slow down as a result of lower copper prices and, slow Chinese growth and Eurozone challenges. (Source: Ernst &Young – Rapid Growth Markets) The question for these markets is how and when they will overcome the short-term effects of global economic issues and return to high growth. And when should your company consider the opportunities there?

Look Out For...

Exploding Indonesia: Today Indonesia is the 16th largest economy in the world with 45 million members of the consuming class and a US$0.5 trillion market opportunity. It is forecast by McKinsey Global Institute to be the 7th largest economy in 2030 with 135 million members of the consuming class, offering a US$1.8 trillion market opportunity. Over the past decade its government debt as a share of GDP has fallen by 70% which means that it is in a better financial position than 85% of OECD countries. The country has also managed to control inflation reducing it from 20% to 8%. According to the WEF Global Competitiveness Index Indonesia remains one of the best performing countries within the developing Asia region, still behind Malaysia and China but ahead of India, Vietnam, and the Philippines. (Source: McKinsey Global Institute – The archipelago economy: Unleashing Indonesia's potential & WEF's Global Competitiveness report 2011-2012)

The African awakening: Africa, a continent of hope and opportunity, despair, and contradictions. The world's second-fastest growing continent after emerging Asia, it seems to be almost immune to the on-going crisis everywhere else. Africa has abundant natural resources – and the rest of the world wants them! South Africa has been blooming, changing the acronym BRIC to BRIC**S** when asked to join the BRICS summit as a full member in 2011 (Source: South Africa.info). Six African countries – Angola, Nigeria, Ethiopia, Chad, Mozambique and Rwanda – have been among the 10 fastest-growing economies in the world over the past decade; and seven African countries are forecast to be among the 10 fastest in future: Ethiopia, Mozambique, Tanzania, Congo, Ghana, Zambia and Nigeria. The 54 countries that make up the continent account for 3% of global GDP, which is about the same as Russia or Brazil, with the average African economy expected to grow faster than its Asian counterpart in the future. (Source: Ernst &Young – a Rapid Growth Markets, The Economist – The hopeful continent) The challenge however is that Africa represents a huge diversity of markets – a one size fits all approach will not work – and choices are needed about the best opportunities to pursue.

Turkey's future growth? Turkey was flying high in 2010 and 2011 recording GDP growth of 9.2% and 8.5 % respectively. But 2012 shows quite a different picture with Turkey only expected to show a growth rate of about 2.2% (Source: Ernst &Young – Building Bridges). Exports are expected to drive this growth as domestic demand slows down. The question is whether this slowdown in growth means the Turkish economy is heading for a crash-landing. However, analysts suggest it is not, with Capital Economic research suggesting: *"While growth in Turkey over the next year is likely to be disappointing, the recent improvement in global risk appetite following central bank action in the developed world means that – for now at least – a hard landing seems unlikely."* (Source: FT) Looking forward Turkey's position at the crossroads of Asia and Europe should offer renewed opportunities.

So what? Why does the rise of the BRICS and beyond matter?

Silly question, you may say. Obviously these are the growth markets of the future. The BRICS certainly, and some of the beyond markets, have already moved from being the world's production engines to being the engines of future consumption as growing numbers of people join the global middle class. But we are entering the next phase of the development of these countries. It's not all about new outlets to sell products and services; it is equally about the emergence of a host of new competitors leveraging the growth in their domestic markets to expand globally. Whereas in mature developed markets, leaders are typically focused on consolidation and efficiency to prepare to compete in low growth environments, the mindset of leaders in high-growth markets is focused on expansion and investment. How can I double my business every 3-4 years? How can I hire and train the large number of employees I need to hire every year?

Emerging global competitors typically bring new business models and innovations developed to win in the low cost environments of their home markets. Many are also actively moving up-market at home, while simultaneously expanding to other high-growth (low-income) markets leveraging their BOP (bottom-of-the pyramid) business models. Thus global competition increasingly reflects expensive developed market business models facing BOP models – often in BOP market environments. But not exclusively – as austerity bites in the West, the mindset of the consumer in these markets is increasingly embracing "cheap is chic." Business models, products and services developed for the B&B markets are being exported to the West, from cars to healthcare models. These markets are not just production and consumption engines, but increasingly innovation engines. Which competitors, mindsets and business models will hold the leading position in the markets of the future? How will your organization succeed?

In Action!

Urban economic power: More than 20 of the world's top 50 cities ranked by GDP will be located in Asia by the year 2025, up from 8 in 2007. More than half of Europe's top 50 cities will drop off the list, as will 3 in North America. In this new landscape of urban economic power, Shanghai and Beijing will outrank Los Angeles and London, while Mumbai and Doha will surpass Munich and Denver. (Source: McKinsey Quarterly) And don't forget that already more than half the world's population lives in urban areas – by 2050, this will be around 70% of the global population or 6.3 billion people. Will cities become more important than states?

Rising middle class: Approximately 85% of the world's population lives in developing countries and a decade ago they accounted for only 18% of global consumption – today it is close to 30% and has been rising at about three times the rate of developed countries (Source: Carnegie Endowment). The urban world in emerging countries is driving consumption as increasing income levels push up the demand for necessities as well as big-ticket consumer items. A recent report Urban World: Cities and the rise of the consuming class from McKinsey Global Institute reveals that the Emerging 440 cities will contribute US$23 trillion or 47% of global growth from 2010-2025. 60% of the new urban consumers will be in the Emerging 440 cities.

Energetic emerging market competitors: Contributing to this growing economic power is an emerging cadre of energetic competitors from the BRICS and beyond; companies that expect to own the future, whatever it takes, and are prepared to invest aggressively to achieve this. Take the Godrej Group, whose consumer products unit competes with Unilever. Founded in 1897 with revenues of about US$3.9 billion, Chairman Adi Godrej outlined their "10x10" strategy: to grow by a factor of 10 times in 10 years. Between FY 2010 and FY 2012, it is on track: the company has grown revenue 25% per annum and net profits 20% each year. Another Asian CEO recently told us: *"In our world if we don't double our size every two to three years, we will soon become irrelevant."* Contrast these ambitions with many leading developed market competitors who struggle with growth ambitions in the low to mid-single digits, often relying on M&A and consolidation for significant growth.

Look Out For...

Made better and cheaper in China: Read a label that says made in China, made in Bangladesh or made somewhere else in Asia and most people tend to think "bad quality," but Chinese brands that are already loved by the Chinese are now going abroad. The sneaker brand Warrior ('Hui Li' in Mandarin), originally created for Chinese athletes, has been a household name in the country since the 1950s. The brand keeps its designs simple and unpretentious, maintaining its status as 'the everyman's shoe'. While the footwear retails for EUR 50-120 overseas (and features in publications such as GQ and Vogue), it is still affordable in the domestic market. In December 2011, China Unicom announced that they would distribute Xiaomi's MI-ONE smartphone. Designed to capitalize on the growing domestic demand for reasonably priced smartphones, the MI-ONE costs CNY 1,999, less than half what comparable smartphones from Apple or Samsung usually cost. (Source: Trendwatching)

Leaders in learning: Driven by the desire to improve poor living standards, many people from emerging societies are driven by a different mindset than Western people. Striving for success often leads very young children, students and professionals to work 80 to 90 hours a week to achieve their goals, whether it is learning to play the violin, getting a PHD or running a business. This mindset permeates how businesses are created and operated in B&B markets. And as, for example, Indian and Chinese corporates go global they bring this very different mindset with them into Western markets. They are ambitious, audacious, adaptive, aggressive when necessary – these business leaders have what Boston Consulting Group calls an *accelerator mindset* and BCG think it could be the emerging markets most enduring export. (Source: Boston Consulting Group)

Reverse innovation: In case you missed our May GT Briefing on Creative Destruction, here's just one of the examples of reverse innovation from rapidly developed to developed markets: Mahindra and Mahindra (M&M) began manufacturing tractors for the Indian market in the early 1960s. They were very affordable, fuel-efficient, and sized appropriately for small Indian farms. Then they looked more broadly and identified that the little red 35-horsepower tractor would be perfect for hobby farmers, landscapers and building contractors in the US. To enter the market, Mahindra partnered with International Harvester to manufacture a line under the Mahindra name. With a few modifications for the US market — such as brake pedals and super-sized seats to for larger American bodies — Mahindra arrived in the US in 1994 – and has successfully created the American hobby farming market (Source: An interview with Professor Vijay Govindarajan *via* DNA).

Competing in the BRICS and Beyond

The size and high growth rates of the B&B economies continue to attract competitors from around the world, as well as to incubate the next generation of global companies. These are crowded, competitive markets. So how do you compete in them?

For some, often developed market players, the opportunity is to leverage existing portfolios of products and services – often adapted (lower price), sometimes not (e.g. luxury goods). This is typically an "export" model, even if production happens in the B&B, and aims to extend existing capabilities and portfolios. The other approach, which we see among many B&B competitors and an increasing number of forward-thinking developed market companies, is to see the B&B markets as catalysts for building long-term growth platforms. This involves local R&D and design for customer needs, deep understanding of the economic systems, and innovative business models. There is a recognition that B&B markets in future will actively drive future trends, technologies and innovations. A key challenge with this approach is not only to develop the B&B focus and strategies, but to build an organization and mindset that is flexible enough to manage multiple business models at the same time – as one size does not fit all – and to operate in markets with radically different environments: Overcoming infrastructure deficiencies and bureaucracy, navigating sprawling retail and distribution channels, and addressing the cultural challenges of being a global company.

Looking forward, there are three underlying levels of competition, with important long-term implications for the positions of both individual firms and their home economies. First, there is strong competition **in the BRICS (or B&B)** markets to capture today's growth. This competition pits developed market players, often with their developed market products, business models, and mind sets, against strong, increasingly capable and aggressive home market players. Whereas developed market players often seek to exploit existing strengths and ways of working, BRICS players are investing to build their positions today in order to own the future. This battle is for today's growth markets, but is one with asymmetric expectations. Some developed market companies are seeking to counter this challenge by combining their expertise with local players, e.g. in June 2012, Walgreens (US) bought a 45% stake in UK-based Alliance Boots creating the world's largest pharma chain. One of the attractions: In September, Alliance Boots revealed plans to buy a 12% stake in China's fifth-largest pharmaceutical wholesaler Nanjing Pharmaceutical (Source: EIU).

The second level of competition is **with BRICS (or B&B)** players on the global stage. Growth is happening in a vast array of markets across Asia, Africa, Latin America and the Middle East (the "beyond" markets). Competition in these "neutral" territories again reflects fundamentally different mind sets, business models, strategies, and home economic systems between developed and B&B firms. While they offer important short-term growth opportunities for developed players, they often are the central focus of international expansion for the B&B players, leveraging their home business models. According to one CEO, "Why would I want to invest in the crowded, stagnant markets in Europe when there are much bigger opportunities closer to home." However some B&B companies also see potential in competing more aggressively for developed markets, particularly as some including the US are becoming more attractive as manufacturing centers again as costs come down in the wake of economic slowdown. Some of these B&B corporates are buying their way into developed markets, e.g. Chinese Sany Heavy Industry (the largest Chinese construction equipment group), bought 90% of German firm Putzmeister in January 2012, while China's Geely Holding Group's acquired Volvo. In the next five years Chinese acquisitions of foreign companies are set to double, and by 2020 they could quadruple.(Source: BBC) This second battle is about positioning for the next generation of growth markets – and for the consumption potential of developed markets.

The third level of competition is **among the BRICS (or B&B)** players – together with their home political and economic systems – for leadership in and control of future growth technologies and industries. It is no secret that much of the investment in key future technologies, e.g. clean energy, is taking place in the cash-rich BRICS, most notably China and India. On the other hand, the cash-strapped developed markets are often trying to protect old industries and players to prevent further disruption to weakened economies. The role of the state, politically and economically, in both instances is important. Competition between state control (China and Russia), chaotic democracy (India), social democracy (Brazil) and regulated democracy (Europe, U.S.), will create the seeds and environment for control of key future technologies and markets. This battle is ultimately for control of the engines of future economic growth.

How will B&B Wars impact you?

As an executive – wherever you are located – how do these B&B wars impact your organization's playing field today—and in the future? Consider:

1. What role do activities in B&B markets play in your overall strategy, both to meet short-term growth targets and to reinvent the company based on the long-term shifts underway?
2. What are the primary barriers you face, in terms of products, business models and mind sets, in successfully preparing your organization to compete in an economic future led—or at least co-led—by B&B markets?
3. What would be the implications of moving your headquarters to China, India or Brazil to prepare your leaders and your businesses for the future?

Answering the first question requires exploring how much your organization perceives B&B markets as add-on, short-term growth opportunities for current business models and products versus using these opportunities to fundamentally rethink the business for the future. The second requires considering what specific elements of your current operations are focused on holding onto the past as opposed to preparing for the future. Answering the third question challenges leadership to consider how its base impacts its world view as it prepares to lead the organization to the future.

In November: Look out for a Review of the Year in action!