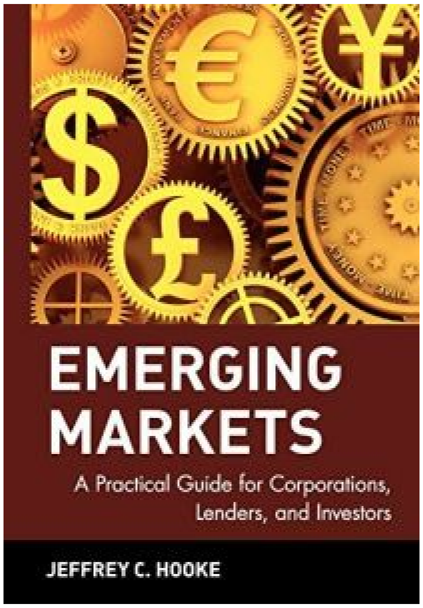

Book Emerging Markets

A Practical Guide for Corporations, Lenders, and Investors

Jeffrey C. Hooke
Wiley, 2001

Recommendation

Former investment banker Jeffrey C. Hooke now carries out financial deals in the developing world. He describes the potential for doing business or investing in the world's 156 emerging markets. Hooke is realistic about the great risks – such as unstable governments in impoverished countries – but he highlights future potential. His book is a solidly researched and clearly written guide to assessing the business climate and deciding what types of products make the most sense in different developing countries. After an overview of the nature of emerging markets, why companies want to participate in or avoid these markets, and how to invest and make loans there, he looks at particular markets in Latin America, Asia, Eastern Europe and Africa. *BooksInShort* recommends this worthy book to those considering working or investing in emerging markets, but academics or readers interested in how business is conducted in foreign places may also be intrigued.

Take-Aways

- Emerging markets - sometimes called developing nations or the Third World - are poor countries in various stages of development.
- The 156 emerging markets represent 84% of the world's population.
- Doing business in emerging markets isn't easy, but they generally have good natural resources and a low-cost labor supply.
- Typically, emerging countries have many poor and a few elite, wealthy families.
- The 12 largest emerging markets have some foreign business infrastructure.
- These markets are Argentina, Brazil, China, India, Indonesia, Mexico, Poland, Russia, South Africa, South Korea, Thailand and Turkey.
- Many multinationals first enter these markets with exports, and then marketing alliances, joint ventures, small acquisitions and, finally, larger deals.
- The major risks in an emerging market are political, macroeconomic, currency and information risks.
- Most stocks in these markets are speculative and the markets are very volatile.

Summary

The Nature of Emerging Markets

Emerging markets, poor countries in various stages of development, are sometimes called developing nations, low-income countries and the Third World. Currently, 156 developing nations represent 84% of the world's population and live on 76% of its landmass. Generally, in these countries, per capita income is lower than $3,000 and household income is around $4,000. Most Third World residents don't own the things taken for granted in developed countries, such as a phone, a home or a car. Well-paying jobs are rare and so is education or training. These countries have little technology and a very small industrial base. Their economies depend largely on agriculture, with most people outside the cities barely subsisting on small farms. A small, wealthy elite holds most of the developing world's wealth, and maintains its rank through a rigid class structure and repressive, authoritarian government.

> "Emerging markets are poor countries with per capita incomes of less than $9,000. 156 nations fit this definition, encompassing 84% of the world's population and 75% of sovereign states."

Though emerging nations are difficult places for Westerners to do business, their natural resources and low-cost labor supplies make them important to the dominant economies of the U.S., Japan and Western Europe. Increasingly, multinational corporations, investors and financial institutions have become interested in these markets. However, they are fraught with difficulties. For instance, they lack a good legal infrastructure for working out problems when things go wrong with a deal, and the local courts heavily favor local companies. In their eagerness, inexperienced Western firms may accept one-sided terms from a local company, rather than bargaining for a better deal. Thus, while these countries can be good opportunities, you need to be especially cautious and prepared.

> "From a business point of view, emerging markets supply the materials necessary to keep the industrialized economies running."

The 12 largest markets, representing 73% of the Third World's gross national product, might be a good place to start, because other Western firms are already there and the countries have already developed some infrastructure. These markets are Argentina, Brazil, China, India, Indonesia, Mexico, Poland, Russia, South Africa, South Korea, Thailand and Turkey.

Emerging Markets Pros and Cons

Emerging markets can be good export platforms for multinational companies, since the wage and benefit packages paid to workers are much less than for workers doing similar work in developed nations. Additionally, employers face fewer health, safety and environmental protection regulations (or the regulations aren't well enforced). Emerging markets also have good natural resources, in such areas as oil, gas, timber and mining. These can be expensive to extract, but few environmental laws are in effect. On a long-term basis, these countries can be expected to develop and become large consumers of Western goods. Additionally, Western multinationals may be interested in these countries' strategic importance.

> "Looking to the future, the supplier role of the developing countries will expand, since the exploitation of natural resources in many of the wealthy countries has reached its limit."

The risks are as great as the opportunities. Frequent political instability is one source of uncertainty. You also have to know the political landscape to get contracts, since you may have to go through certain intermediaries, and you may have to pay referral fees, which are sometimes like bribes, to these intermediaries and government officials. One consultant who opened up an office in Brazil for his company found he had to pay 10% to 15% of the contract value to an American intermediary who had been in the country for 20 years. He also paid a portion of his fee in commissions to various officials to get the contract's green light.

> <"The underground economy can amount to as much as 50% of the GDP in an emerging market."/QUOTE>

To be successful, learn the culture. Although not knowing the language can put you at a disadvantage, there are dozens of primary languages and hundreds of dialects. However, most senior executives know some English. Every culture is different and every business environment is unique. Generally, though, avoid political discussions, since local executives usually fear getting in trouble with the government if they speak frankly or critically. Also, be prepared for poor public service and government corruption. Since public employees and elected officials typically are poorly paid, they seek bribes and insider deals. Demands for payment for business licenses, permits and concessions are typical. In most of these places, the vibrant underground economy can represent as much as 50% of the country's GDP.

> "In natural-resource industries, like oil, gas, timber and mining, emerging markets represent new areas of exploration."

Other common problems in emerging countries are weak currencies due to short-term fiscal policies and poor monetary discipline. Investors fear long-term investments because the economies are unpredictable, so most trading involves short-term treasury bills, certificates of deposit and commercial paper. The stock markets are volatile and speculative. Since these countries lack functioning bond markets, their businesses depend too much on short-term commercial bank loans, which are also based on short-term deposits. Little venture capital is available because commercial banks and a small group of wealthy families dominate these markets.

Assessing the Business Climate

The best way to enter an emerging market, once you have a general understanding of the country, is through a respected local partner. This person can help open doors, which is especially necessary in countries characterized by oligopolies and high trade barriers. Generally, these countries erect high barriers to foreign entry because they are afraid of being overrun by multinational corporations. They protect their local companies at the cost of economic development and technological advances. While they are generally open to joint-venture licensing agreements, they become receptive to giving up local ownership only when these half-measures prove unsuccessful. Then, they generally become more flexible to gain access to western technology, managerial skills and products, for which demand is growing. Often, the initial steps involve a local firm handling import sales, which then develop into joint ventures or more extensive investments.

> "By and large, these 12 larger economies (Argentina, China, Indonesia, Poland, South Africa, Thailand, Brazil, India, Mexico, Russia, South Korea, Turkey) are good places of entry for the newcomer. Other Western firms have paved the way, and a certain infrastructure is established for foreigners to do business."

Typically, you need to ally your company with the participation of a wealthy family in these countries, since few major projects proceed without them. Although you can usually expect to write contracts in English, generally they are shorter and simpler than in a developed country. If problems develop, local courts cannot usually help. Court calendars are very crowded, judges are likely to be influenced by local enterprises and attorneys, and even if you win, it's hard to enforce a judgment. Most markets have laws on intellectual property rights, but the laws are loosely enforced, and the markets provide little research or statistical information. Thus, you have to make decisions with less than complete or accurate information. You'll find that local bank officials have little credit training and usually want loans secured by hard assets and personal guarantees. Tariffs are typically high, and usually there are import licensing regimes and quotas. Personal relationships are more important than in the west, especially when legal systems are weak, so business people look to personal trust as a way to settle disputes in a friendly manner. For all these reasons, teaming up with a local, well-connected partner will help to smooth the way.

Entering an Emerging Market

Multinational firms are attracted to emerging markets by the opportunity for growth. They often use these countries for low-cost production of goods sold to customers in the First World. Developing countries are also attractive secondary markets, particularly if your company has a classic growth product that has gained acceptance in the developing world and could be expanded into emerging markets. For instance, AOL made a big push into Latin America after achieving success in the U.S. and Europe. You might be able to provide a better quality product, and foreign companies enjoy an advantage in coordinating the consolidations of smaller companies, since local business people lack relevant experience. Whatever you do, seek an effective local player. For recommendations, contact multinational firms already in the country. Avoid government development groups and the local chambers of commerce, since they generally don't have much knowledge and are understaffed.

> "Things most of us take for granted in the United States - a telephone, a decent home, and a family car - are not within the means of the average breadwinner in developing nations."

Joint ventures are a good way to enter an emerging market, especially as a second-stage entry - after you already are selling your products through local distribution networks. In one type of joint venture, both parties contribute cash for the start-up. In other cases, one contributes technology and cash, while the other provides operating assets and local expertise. A third possibility is acquiring newly issued stock in a local firm, although this can be risky.

> "Well-paying jobs are scarce and economic advancement opportunities are limited, as wealth is concentrated in the hands of a small elite who promote a rigid class structure."

Another approach is buying a business in an emerging market. Four factors make this a better alternative than a joint venture, passive investment or marketing alliance. 1) There is less risk, since the business already has a customer base and a track record. 2) The local company already has a plant, technology, reputation and employee base. 3) You can realize an immediate income and positive cash flow. 4) You have more control, though the other alternatives require less capital. However, you must do careful due diligence to make sure the purchase price isn't too high or there aren't hidden liabilities.

> "By and large, it's best for a foreign businessman to steer clear of political discussions when traveling to an emerging market. In the authoritarian countries, local executives are afraid to discuss current affairs, because frankness or criticism regarding the existing regime might get back to those in power, and invite reprisal."

A high percentage of multinationals start in a new market with exports and then enter into marketing alliances, joint ventures and small acquisitions. After these efforts succeed, they move to the next step - larger deals to culminate a long-term entry approach.

Emerging Market Risks

The best approach for participating in an emerging market depends on your company. If you are a manufacturing firm, a developing country might be a good source of low-cost labor to reduce your production costs. If you are a natural resource firm, you may find untapped natural resources. If you want to invest in them, you can reduce your local currency problems by using an offshore bank.

> "The desire for U.S. money rather than the local currency is the product of common sense."

Take steps to reduce emerging markets' major types of risks - political, macroeconomic, currency and information. The most widely known political risk is expropriation, where a government takes over a foreign firm. Other dangers include having political instability turn into armed conflict or being subjected to crime and corruption.

- To limit your political risks - Have a prominent local company as a partner. Invite the government to own part of your company. Buy political risk insurance and borrow money from First World export-import banks and multinational banks.
- To limit the macroeconomic risk that occurs from a downturn in the GDP - Make sure your venture gains a reasonable rate of return, even under difficult economic conditions.
- To reduce currency risks reflected during devaluation - Engage in exporting or natural-resource projects. Finance part of the business with local institutions using short-term loans and leases, since there are fewer financial penalties should devaluation occur.
- To reduce information risk - Always remember that the information you get isn't as good as in the west. Do extra due diligence, such as spending more through your local advisors to learn about production costs, real estate titles, factory operating permits and equipment leases. Be prepared to make decisions based on less information than usual.

Investing in volatile emerging markets is speculative. Problems include lack of information, poor regulatory environments, inefficient pricing and illiquidity. Avoid these markets, unless you have a high tolerance for risk. If you choose to invest in them, study the markets thoroughly. Start with a regional profile to learn about the economic and business environment, including regional export bases, stock exchanges and recent developments. Then, look more closely at the particular country where you are thinking of doing business.

About the Author

Jeffrey C. Hooke had been an investor banker for 10 years when he began doing deals in the developing world in 1991. He initially worked with the International Finance Corporation, the World Bank's $8 billion private sector affiliate, where he investigated and closed large transactions in Latin America. In 1998, he began working with the $1.8 billion AIG-Asian Infrastructure Fund, the largest private equity partnership devoted to emerging markets. He arranged large equity financings in China, Thailand and Korea. These experiences led to the book.