



# Transacting in emerging markets

Critical success factors for consumer  
products companies

## Six steps to transacting successfully in emerging markets

1. Market presence alone is not enough; a clearly defined strategy for each targeted emerging market is crucial
2. Think laterally about partner and target selection; there are many routes into emerging markets
3. Develop a strategy to overcome the lack of reliable information
4. Shift your mindset to a different pricing paradigm
5. Allow for lengthy negotiation with a wide group of shareholders
6. Preserve and nurture value in the integration process; motivate key people

The aftermath of the global financial crisis has brought into sharper focus the long-term shift in economic power toward the developing world. The economic outlook for the foreseeable future is for sluggish expansion in the mature markets of the Western developed economies, with emerging market economies providing the best opportunities for growth.

Consumer products companies are embracing this broad underlying economic trend, and the mantra of reaching the next one billion customers in emerging markets has been widely adopted. Global consumer products companies, which may already derive a third or more of their income from emerging markets, have stated objectives of increasing this share to a half or more over a relatively short time frame. Other smaller and less well-established players are also considering – or are already pursuing – diversification into the developing world.

It will not be possible to achieve these objectives through organic growth alone. Emerging market M&A is very much on the consumer products corporate agenda. In the fourth quarter of 2010, for example, Ernst & Young's analysis of the M&A market revealed that a developing country featured as the destination in 6 of the 10 largest deals, while emerging market companies featured as buyers in 4 of the top 10 transactions.<sup>1</sup>

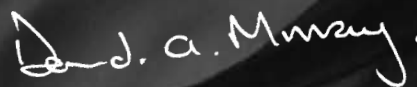
A growing number of transactions involve developed world consumer products companies acquiring emerging market businesses to access the faster growth opportunities they offer. In December 2010, for example, PepsiCo announced the acquisition of 66% of leading Russian dairy and juice producer Wimm-Bill-Dann for US\$3.8b – a transaction that will make the US company the largest food and drink business in Russia and increase its market presence in Central Asia and other Eastern European markets.

Established emerging market consumer products players are equally aware of the opportunity to strengthen their market position, both through acquisitions in other developing countries and through consolidation in their domestic markets. For example, in the fourth quarter of 2010, Noble Group, the Hong Kong-headquartered agribusiness group, acquired two sugar mills from Brazilian ethanol producer Grupo Cerradinho for an enterprise value of US\$950m to increase its presence in Brazil and to diversify its revenue streams.

Meanwhile, in Thailand, SS National Logistics in October 2010 acquired a one-third stake in Thai non-alcoholic beverage group Serm Suk, the local bottler for Pepsi for the past 53 years. The US\$373m deal was widely seen as a response to an earlier failed hostile tender by minority shareholder PepsiCo as part of its strategy to take its bottling operations in-house.

Turning ambition into reality in emerging markets, however, is not always straightforward. Successfully concluding a transaction requires overcoming a greater number of obstacles than will be encountered in the developed world – from a basic lack of quality information to the need to accommodate wide cultural differences. Simply put, it is not always possible to find the right company at the right price. Patience is a necessity. Walmart's long-held, but as yet unfulfilled, ambitions to expand through acquisitions in Russia clearly illustrates the point.

Drawing on Ernst & Young's experience gained on the ground, this report analyzes the six steps to successful transaction in emerging markets, assesses the risks and suggests some strategies companies can adopt to mitigate those risks. We would welcome your comments and questions and are happy to provide further insight on request.



**David Murray**

Global Consumer Products Transactions Leader

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<sup>1</sup> Consumer Products Deals Quarterly Q4 2010, Ernst & Young.

# 1

Market presence alone is not enough; a clearly defined strategy for each targeted emerging market is crucial

“Even a thousand-mile journey starts with the first step.”

Chinese proverb

**Acquisitions in emerging markets should always correspond to a clear strategy and a vision – simply “to be in emerging markets” is not a strategy.**

Emerging markets are no longer a niche play. In fact, many consumer products companies are relying on emerging markets for growth and are focusing their investment strategy on these countries. The drivers behind this investment imperative can be clearly seen in the demographic and economic statistics. GDP growth is currently 4% to 5% higher in emerging markets than in developed markets, and continuing population growth means they will be good markets in years to come: 82% of the world’s population lives in emerging markets, and 92% of births are there.

Meanwhile, sustained improvements in quality of life and income levels are making consumer products affordable to larger numbers. While 10 years ago there were only 1.25 billion people earning US\$3,000 per capita in these markets – the point at which consumer goods start to become affordable – this is expected to grow to 2.75 billion in the next 10 years.

High-level statistics, however, can sometimes be misleading. Before defining your strategy, you first need to define the basic concept of a developing or emerging market. While this may appear self-evident, too often there is a temptation to draw an oversimplified distinction between slow-growing Western developed economies and the rest of the world, which is assumed to offer growth opportunities. But it is also important to distinguish between those developing countries that are

truly emerging economically and those that are essentially non-developed and non-developing. An equally misleading simplification is to assume emerging markets are synonymous with the BRIC nations of Brazil, Russia, India and China, which risks overlooking a range of developing countries from Thailand to Colombia.

## Establishing a hierarchy using local market criteria

We believe the first step should be to establish a hierarchy of countries where you want to have a market presence and decide which customers should be targeted with which products. Merely following the herd to China and India, for example, is not a well-defined strategy and risks overlooking smaller markets with significant potential.

Your hierarchy may need to be based on completely different criteria from those applied in developed markets. A successful product in the US or the UK may not succeed in certain developing markets, particularly when you consider the logistics of how a product is sold – assessing the quality of the required infrastructure is an important element of the strategy decision. In Africa, for example, selling frozen foods outside major cities runs into the obstacle of insufficient chiller capacity as goods may be sold in open markets rather than in refrigerated stores. Even in the cities, continuity of electricity supply can be an issue. For example, Checkers, the South African supermarket chain, is expanding into Nigeria and is building its own shopping mall to ensure both physical security of the premises and continuity of electricity supply through back-up diesel generators.

**“A successful product in the US or the UK may not succeed in certain developing markets, particularly when you consider the logistics of how a product is sold – assessing the quality of the required infrastructure is an important element of the strategy decision.”**

## Ensuring business objectives are reflected in acquisition strategy

Your investment strategy must also be assessed according to whether your company is looking to gain a cost base or a market penetration advantage. For example, investment into India tended to be dominated by companies looking to gain a cost base advantage by outsourcing production and administration functions to take advantage of lower labor costs. In recent years, attention has shifted to the market growth opportunity that India provides, and this is the strategic objective that most consumer product companies are focused on.

The key questions you should ask are: do you already know the market and have local management? Are you looking for brand know-how, manufacturing capacity or distribution and sales capabilities? The latter is critical in the early stages of entry into a new territory.

Emerging markets require a different focus and recognition so a one-size-fits-all strategy is not appropriate. Many companies have adapted their products and packaging to target a much lower price point. In India, for example, Unilever successfully markets Lux and Sunsilk shampoo sachets sold in units costing just a few US cents, and Procter & Gamble markets its high-end Pantene brand in a single-serve sachet.

## Rating the strength of local competition

It is unwise to underestimate the power of local brand competition when going head to head with developed world household name brands. For example, multinationals such as Nestlé have been present in Turkey for many decades, but Ulker, a Turkish family-owned business, remains the market leader in the chocolate and cakes segments, with a market share of about 65%. Local competitors may also have low-cost supply chains that are hard to match, so understanding the local conditions and ways of doing business is important.

As a potential buyer, you should be aware that strong local operators, far from providing easy acquisition targets, might in fact provide strong competition for other local assets that you want to acquire. Entrenched bias against foreign entrants on the part of some regulators can tilt the scales in favor of local competition.

An investment in emerging markets that is predicated on organic growth may be a less successful strategy than acquiring existing regional players, although you may need to pay what looks like a high entry premium.

## Ensuring buy-in from the top

A successful emerging market strategy involves far more than taking a successful developed-world product and transplanting it into the developing world. Your strategy should also look beyond the initial transaction – having a second-stage plan is vital. There is a substantial difference between merely getting deals done and having the foresight and knowledge of how to deploy your company's brand. Factors that may not be relevant in the developed world, such as political risk, corruption, trade constraints and duties, need to be carefully considered. The complexities involved mean that it is vital that there is commitment to the process from the top of your company and that enough resources and investment are devoted to formulating your strategy. It is also important to estimate your cost of exit, since given the range of potential risks, success is not guaranteed. Local emerging market regulators, for example, often try to ensure that foreign companies cannot exit with a lot of money. If long-term control is the ultimate objective but initial entry is through a minority or joint venture, it is also critical that there is a route to achieving that control.

It is no longer an option merely to dabble in emerging markets. Instead, as a prospective entrant, you need to identify the potential significance of an emerging market operation to your core business, as well as decide the extent to which you are prepared to make a long-term commitment to achieve it. An emerging market investment can still be strategically sound, even if it is slow to show profitable results.

## Weighing the attractiveness of emerging markets

Any global consumer products company considering entry into emerging markets, or further expansion, needs to weigh the following as part of its attractiveness analysis:

- ▶ **Political stability** – emerging markets suffer more wars, civil commotion, corruption and economic and political instability than developed markets. How do we assess the likely economic and political stability of the markets we are targeting? What is the level of ongoing civil unrest, and is there much evidence of government intervention or contract frustration?
- ▶ **Infrastructure status** – what is the quality, connectivity and reliability of roads, trains and ports? How reliable are power and water supplies?
- ▶ **Quality and reliability of local manufacturing** – is there a local supply and manufacturing base of sufficient quality that we can leverage?
- ▶ **Legislative and regulatory environment** – what are the legal constraints in terms of import vs. local manufacture, or buy vs. build?
- ▶ **Consumer understanding** – do we have sufficient insight into local consumers across all target segments of the population? Do we understand more than where they live and how much they earn? Do we know how they like to live and how they spend?
- ▶ **Variety and complexity of routes to market** – do we know and understand how to get goods to market? Can we leverage an existing distribution network, or will we need to innovate and build our own?
- ▶ **Local talent** – are there local staff available with appropriate experience and language skills? To what extent will we need to deploy local staff from day one to comply with local requirements?
- ▶ **Regulatory, tax and legislative change** – the pace and scale of change in emerging markets can blindside businesses that are not well networked and can complicate understanding and recognition of local accounting and tax issues.
- ▶ **Corporate social responsibility (CSR) considerations** – working effectively with local partners and local government is essential for success and sustainability in many emerging markets, where rules can change unpredictably, and investment strategy may need frequent and radical revision.
- ▶ **Cash and profit** – do you know whether you will be able to repatriate cash and profit and how?

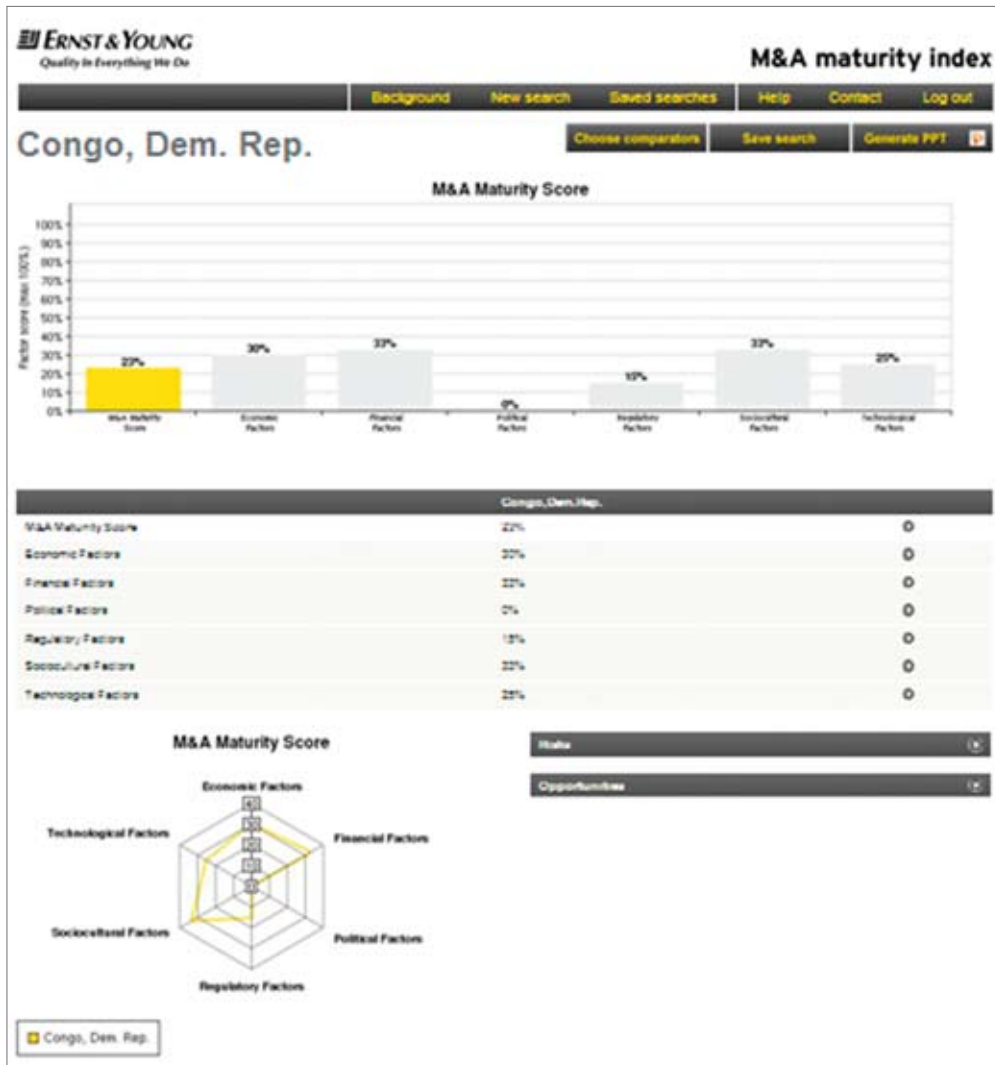
# M&A maturity

Ernst & Young's new tool, the M&A maturity index, provides a high-level summary of risks and opportunities for M&A transactions in 175 countries around the world. It has been developed by MARC, the M&A Research Centre at Cass Business School, City University, London, of which Ernst & Young is a senior sponsor.

The concept behind the index is that the more mature a country, the greater propensity for, or ease of doing, M&A deals. Where there are risks, however, there are opportunities.

Using 36 publicly available data sets from governmental and supra-national organizations, the index rates a total of 175 countries to create an overall M&A maturity score. These 36 equally weighted subfactors are aligned to six groups – economic, financial, political, regulatory, socio-cultural and technological – and the average of these six groups is itself averaged to create the overall score, with 100% being most mature and 0% being least mature.

To gain the insight offered by this new tool, register now at [www.mandamaturity.com](http://www.mandamaturity.com)



# 2

Think laterally about partner and target selection; there are many routes into emerging markets

"Beauty in things exists merely in the mind which contemplates them."

David Hume  
*Essays: Moral and Political*, 1742

The crux of the selection challenge in emerging markets is twofold: are there any companies worth buying, and are they up for sale? Compared with the developed world, there are often fewer potential targets or partners, and they can be more difficult to find and secure at a reasonable price.

## Are they ready to sell?

At a basic level, the number of suitable acquisition targets is a function of the degree of development of local markets: consumer products markets may be relatively underdeveloped in many emerging markets. While the underdeveloped nature of emerging markets is a large part of their attraction because they provide the potential for rapid growth, the number of well-established consumer products companies that would make suitable acquisition targets will be lower than in a more developed country.

The second issue is that, from a potentially smaller universe of targets, transferring power away from existing owners can be a greater challenge than in the developed world. Family ownership is a dominant feature not just in developing markets, but also in the developed world. In the mid-1990s, for example, family businesses still made up 80% to 90% of all business enterprises in North America, according to the 1996 Family Business Review. There is evidence, however, that in some developing countries, there has been less dilution of family ownership on succession.



# Case study

For example, a recent study by Credit Suisse based on data for between 2000 and 2009 concluded that transfer of ownership is far lower in Indian family businesses when compared with their US or European counterparts. Credit Suisse found that generational transfer is managed more effectively within the family than in the Western world. Irrespective of family feuds, succession usually takes place within the same family and thereby supports the creation of family wealth.

## Be wary of how much value resides with the current owner

But succession can also be a source of destruction of family wealth, as well as its creation. A recent study conducted by Joseph Fan, a professor at the Chinese University of Hong Kong, studied the performance of 250 companies in Hong Kong, Taiwan and Singapore that were publicly listed, but controlled by Chinese families.<sup>2</sup> The study found that successions tended to coincide with tremendous destruction of value. Over the five-year period preceding and the four-year period after succession, accumulated stock market returns for this group of companies declined by close to 80%.

Professor Fan suggests that patriarchal businesses benefit from personal relationships that cannot always be passed on to a new generation or to new owners. For example, the long-standing reputation of local business patriarchs can ensure that banks will lend money to their companies, and their relationships with government are often lucrative. Where possible, potential buyers should structure contracts with “key man” clauses to facilitate the transition of business relationships as well as ownership.

## Will they enhance our brand and help us distribute more effectively?

Your choice of target is also closely linked to your brand strategy and distribution capability. In many emerging market countries, access to a distribution network is a critical success factor. For example, when L’Oréal first entered China, it followed a strategy of buying Chinese brands to leverage the good relationships those brands enjoyed with local retailers. This provided a platform for L’Oréal’s Paris brand to penetrate the market.

## Heinz in Indonesia

At a September 2010 conference organized by Barclays, Heinz shared some lessons it had learned on the importance of distribution and the extent of the brand-building challenge in emerging markets.

**“As you know, we have a very good business in Indonesia. But ABC, which we acquired in 1999, wasn’t our first acquisition in Indonesia. Earlier in the 1990s, we acquired a noodles business based in Surabaya that didn’t work. I think there were two main reasons: the first was that there was no strong brand, and I think the intent was that we would create the brand. That is quite a big challenge. And the second is that there was no infrastructure. Again, I think the idea was that we would create the infrastructure. I think that’s very hard to do in a market where you’re making your first entry. I think if we’d bought Suprama after we’d bought ABC, we would already have had the infrastructure.”**

Chris Warmoth  
Executive Vice President  
Heinz Asia Pacific

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<sup>2</sup> Referenced in *The Economist*, 3 February 2011.

More advanced developing economies may offer opportunities for your company to buy local businesses that have built a market-leading position and the necessary distribution capability through organic growth. In 2006, for example, Nestlé Waters acquired Erikli, a Turkish family-owned business founded in 1965, which in 1993 decided to invest in a new plant to bottle its water in PET as opposed to glass. Through this switch, Erikli built a strong presence in the home and office markets in Turkey, eventually becoming a leader in the Turkish PET-bottled water market with approximately 15% share of sales.

## Does size matter?

Frequently, however, large overseas acquirers may come up against the challenge of finding partners of a suitable size – companies may need to consider a number of transactions to gain a meaningful market share.

Intra-country regional variations may also be a factor in selecting targets. Part of the reason for a lack of suitable national-scale acquisition targets can be that in geographically large markets with poor distribution, local players may dominate the market. In these circumstances, a regional strategy, or trying to find strong local niche players in categories similar to your existing portfolio, may be the appropriate way to gain market share.

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Carlsberg's strategy in Asia Pacific, for example, has been to pick up smaller stakes in leading brewers, partly as a way of getting around government reluctance to allow foreign ownership. In China, Carlsberg has built a leading position in the country's western provinces. Although less beer is currently consumed there than in the more prosperous eastern provinces, they offer growth potential. In 2010, Carlsberg increased its minority holding in Chongqing Brewery, which enjoys an almost monopoly position in some areas. Carlsberg claims to have a 59% volume share of western China's beer market.

## How strong is local management?

Joint ventures can provide an attractive option – acting both as a way of sharing risk, and as a means to bridge the gap between buyers' valuations and sellers' price expectations, as well as between their respective views of the local target operation's revenue growth potential. A further consideration is that some countries make a joint venture with a local party a regulatory requirement for entering the marketplace. Against these advantages, however, the added complexity of a joint venture and the lower level of control it entails should be considered.

If you are pursuing a joint venture, you will need to assess the capability and integrity of local management – as well as their M&A experience. Your assessment should include consideration of the potential risk of damage to your company's image and reputation through corrupt or non-ethical business practices. You should try to ensure that the target or the local partner is as attractive as it appears.

## Are the target's business practices ethical?

Corruption is far more than just a reputational issue. Developed world market entrants need to ensure that any acquired emerging market businesses meet the legal requirements of their home country legislation, such as the US Foreign Corrupt Practices Act or the UK Bribery Act. This is a significant issue for developed world buyers, and the trend is for legislation to get tougher. The UK Bribery Act, introduced in 2010, includes a very broad offense of companies failing to prevent bribery on their behalf. A company could be guilty of the offense if a subsidiary, an employee or an agent carries out bribery.

A joint venture strategy also raises the issue of whether you are seeking majority control. For some companies, a joint venture is one stage on the journey toward full ownership, but others are comfortable with a minority position in a joint venture to benefit from the risk sharing and regulatory advantages it can offer.

Heinz, for example, made a profitable exit from a joint venture in the Philippines, but it has admitted that the experience taught the company lessons about its approach to joint ventures. “We had no route to majority control, and I think one thing we've learned is as an American multinational doing business in these markets, we can't operate very successfully unless we can actually run the business, sometimes with partners, but we need to have management control,” said Chris Warmoth, Executive Vice President, Heinz Asia Pacific.

In contrast, Diageo recently demonstrated its willingness in certain circumstances to take a minority position with its purchase in January 2011 of a 24% stake in Vietnam's leading branded spirits producer, Hanoi Liquor Joint Stock Co (Halico), for US\$52m. The small bolt-on acquisition offers Diageo the opportunity for greater local cooperation, particularly in distribution, as well as exposure to local brands in a fast-growing market where local brands dominate.

## What's the equity story?

As a potential buyer, you need to understand the equity story of the company, with a clear understanding of its shareholding structure, but you should also take a forward-looking approach to estimating the complexity of future restructuring tasks. And you may have to carry out all of this against a backdrop of often incomplete or unreliable information.



# Case study

## Diageo: seeking value from joint ventures in Africa

Africa is a key part of Diageo's emerging markets strategy. The beverage group is proactively allocating human and capital resources to the region for inorganic development. Phil Jenkins, Business Development Director at Diageo, outlines the critical success factors for transacting on the African continent:

**“Diageo has a long history of investing in Africa and has built a diversified position on the continent. While every company has to start somewhere, you need to take an approach that gives you exposure across the continent. Once you have one investment, it is important to ensure you look to diversify to avoid being disproportionately exposed to the range of risks in one country.”**

Phil Jenkins  
Business Development Director  
Diageo

This diversified approach is particularly important in Africa. Given the many countries involved – with their differing political, economic and regulatory environments – the range of prospective outcomes when looking at an investment is greater and the risks, by definition, are higher.

“Once you have one investment, it is important to ensure you look to diversify to avoid being disproportionately exposed to the range of risks in one country.”

The degree of certainty around the legal and regulatory framework varies greatly across the continent, which affects how transactions are best designed to mitigate the inherent risks. “We would have a preference for joint ventures over outright acquisitions, and will also consider deferred consideration,” Jenkins says. “If you can’t fully rely on the legal and regulatory framework, it’s important for both parties’ goals to be aligned. You also need to understand your partner’s goals and motivations, as even with careful structuring, any transaction involves a jump in terms of trust.”

“We would have a preference for joint ventures in new markets.”

Understanding the motivation of local partners also helps an acquiring company make the best use of local people and local knowledge. “One of the critical success factors for transacting in emerging markets is to form local partnerships that fully utilize that knowledge while structuring incentives to ensure alignment of medium-term objectives,” Jenkins says.

The transaction process is more resource-intensive in Africa than in developed markets. Scale entry points are often not available, which means that an acquirer may have to complete a number of transactions to achieve a meaningful market position. “You won’t have investment banks knocking on your door telling you about a business for sale in the Democratic Republic of Congo,” Jenkins says. Networks are less developed, meaning there is a need for more resources on the ground.

“We would have a preference for, and would place a premium on, an inorganic entry if there is a brand involved.”

The availability of information, for example, varies greatly – from dealing with state-owned businesses that have the required data, to entrepreneurs who do not have the level of financial detail normally required. “Joint ventures are useful because they provide visibility on performance beyond acquisition,” Jenkins says. “Also, you might design a transaction to allow confirmatory due diligence prior to closing.”

Diageo does consider organic growth as an alternative to acquisitions, but the viability of this approach depends on the nature of each particular market and the company’s long-term strategic view. “Where we see markets becoming very significant in 15 to 20 years’ time, an organic greenfield manufacturing entry route may be appropriate,” Jenkins says. “But we would have a preference for, and would place a premium on, an inorganic strategy if there is an established brand involved, even if it’s not a fully developed brand.”

In Africa in particular, “the beer space relies on local brands, and a company entering a market needs to be clear that there is a mainstream brand that could work locally. This then forms the base upon which a premium portfolio can then be built” Jenkins says.

# 3

## Develop a strategy to overcome the lack of reliable information

"Life is not a continuum of pleasant choices, but of inevitable problems that call for strength, determination and hard work."

Indian proverb

One of the most significant differences between transacting in emerging markets compared with the developed world is in the quality of available financial information.

### Mind the gap

As a potential acquirer, you need to analyze carefully the gaps between local GAAP and IFRS/US GAAP and perform a full audit of all aspects of the target business: financial, tax, legal and IP rights, manufacturing, environmental and ethical. However, the necessary information to carry out this due diligence may not be readily available – you may have to compile it, with the help of your advisors, from raw data.

In Brazil, for example, regulatory requirements to produce financial information are relatively limited. Only public companies are required to disclose financial statements, and even then, information such as turnover and margins need not be divulged. Comparative data is also hard to come by. Most transactions that take place in Brazil are private or involve a private buyer or seller, and share purchase agreements will often specify non-disclosure of transaction values.

"Information, which in the developed world would be considered completely standard, can be difficult to obtain."

## Plan for information underload

Information, which in the developed world would be considered completely standard, can be difficult to obtain. In early 2011, for example, Ernst & Young worked alongside a client in Ghana to obtain board and risk committee meeting minutes from a potential target company. The data existed, but the target was sensitive about releasing it for fear of a breach of confidentiality. Ernst & Young's South African practice has also received requests from clients for local staff not to be involved in transactions to address fears over leaked information, requiring a team to be brought in from outside.

## Be ready for regulatory change

The tax and regulatory environment of the destination country may also be evolving and subject to significant change. In India, for example, while the regulatory process is clearly defined with respect to which sectors permit foreign direct investment, the tax environment is undergoing change with the planned roll-out of a goods and services tax across the country, which could have a significant impact on consumer products companies. But even when companies are aware of such changes, uncertainty remains. The implementation of India's GST, for example, which had already been deferred until April 2011, has recently been postponed once again.

As a potential buyer, you should be aware, not only of impending regulatory change, but also the inconsistent application of existing legislation. In China, for example, the interpretation and the rigor with which laws are implemented can vary somewhat between first-tier cities such as Beijing and second- and third-tier cities.

Similarly, in recent years, Vietnam has made positive legislative changes to improve its attractiveness as an investment destination, bringing its laws closer to international standards. These changes have improved legal certainty and regulatory transparency, while largely removing restrictions on levels of foreign ownership in domestic private companies. Potential buyers, however, must still contend with inconsistent application of regulations and a legal environment that is prone to rapid change.

## Watch for local or onerous requirements

You should also take local ownership and participation laws into consideration. Black Economic Empowerment (BEE) legislation in South Africa, for example, is often poorly understood and applies not just to the structure of an acquisition with respect to local shareholders, but also to how a company is run post-acquisition. For a company to maintain its BEE credentials, its procurement must also be from companies with those credentials. Local ownership rules are not confined to South Africa. They are part of a wider trend, either under way in countries such as Zimbabwe or under consideration, as in Namibia.

Given the large number of different jurisdictions on the African continent, all with differing legislative regimes, it is relatively easy for multinationals to fall foul of local tax laws.

**“Structuring transactions with deferred consideration to allow for further due diligence is one means of mitigating the potential risks of poor-quality information.”**

## Timing is critical

Faced with a potentially long list of obstacles, it can prove difficult to complete the due diligence process in the time available to agree an acquisition, particularly in cases where there is competition for the asset. A conflict of interest can arise between the desire for visibility and the pressure to do the deal. In such circumstances, structuring transactions with deferred consideration to allow for further due diligence is one means of mitigating the potential risks.

Placing funds in escrow is another available means of risk mitigation, but again, understanding local custom is important. In Russia, for example, deferred payment and escrow are perceived as unlikely to be paid out, as issues often arise post-closing.



# Case study

## Ranking African nations on bureaucracy criteria

When dealing with a continent as diverse as Africa, it is easy for multinational companies to underestimate the bureaucratic requirements in different jurisdictions. Ernst & Young provides clients with a ranking system that assesses different African nations according to the extent of bureaucracy involved in forming a business. Each ranking is based on the number of procedures that must be followed and the expected number of days required to complete them and gain approval. Shown in the table, for example, are the 21 African countries where it takes the most time to form a business.

Country	Days required to start a business (2011 data)
Guinea-Bissau	216
Congo	160
São Tomé and Príncipe	144
Equatorial Guinea	136
Zimbabwe	90
Democratic Republic of Congo	84
Eritrea	84
Togo	75
Chad	75
Angola	68
Namibia	66
Botswana	61
Gabon	58
Swaziland	56
Guinea-Conakry	41
Lesotho	40
Côte d'Ivoire	40
Malawi	39
Seychelles	39
Djibouti	37
Sudan	36

# 4

## Shift your mindset to a different pricing paradigm

**“One who does not look ahead remains behind.”**

Brazilian proverb

The most striking feature of emerging market transaction multiples is how much higher they can be than for developed world businesses. Part of the valuation challenge for strategic entrants is to make the mental adjustment from considering the potential of a business in a low-growth mature market to valuing a company operating in a completely different, and far more dynamic, growth environment.

Given the lower number of potential targets, competition for the best assets can be fierce, adding further upward pressure to valuation multiples, which are exceptionally high by developed world standards.

### Prices are often “eye-popping”

Based on data from Capital IQ, Ernst & Young analysis of price/earnings multiples in developing compared with developed markets suggests that emerging market transaction multiples for consumer products are more than 50% higher than in developed markets.

In December 2010, for example, Reckitt Benckiser announced it had agreed to buy Indian-branded personal care and over-the-counter (OTC) drugs group Paras from its private equity owners for US\$722m. Reckitt fought off competition from a number of other potential buyers, including GlaxoSmithKline, Sanofi-Aventis, Novartis and Johnson & Johnson as well as Indian personal care products maker Emami. Reckitt paid a multiple of 8x sales (30x EV/EBITDA), which one US equity analyst described as “eye-popping”.

## Look at more than numbers

When valuing an emerging market business, it is important to look beyond current performance to evaluate both future growth prospects and the potential to leverage the acquired distribution capabilities to create a platform for the acquirer's existing product portfolio. Paras, for example, is a top five player in India's booming US\$1.8b OTC segment, which is growing at 15% to 18% per annum – a rate of growth that Paras has achieved or exceeded over the past four years. Reckitt also would be able to use Paras' distribution network to create significant cost and turnover synergies with its product portfolio. An apparently high price today may simply reflect the justifiable premium to be paid for gaining a solid foothold in a high-growth market.

### Five factors that can result in undervaluing a potential acquisition

- ▶ Assessment of cost structures too high
- ▶ Assessment of revenue growth too low
- ▶ Failure to take potential revenue synergies into account
- ▶ Weighted average cost of capital (WACC) adjusted to too high a level because of aversion to country and market risks
- ▶ Short-term view of value from the acquisition

There are also pragmatic as well as conceptual reasons for focusing less on deal multiples. One of the consequences of the poor quality of emerging market companies' financial data is that less reliance can be placed on available historical numbers when valuing a business.

## Build several growth scenarios

You should consider building several growth scenarios, favoring discounted cash flow (DCF) approaches to value the expected revenue streams, as well as factoring in the risks to those cash flows, including expected inflation. Both economic and political uncertainties should be taken into account, as well as the volatility attached to these variables. Foreign exchange risks should be considered, especially when paying with hard currency, and it is important to understand local remittance rules and what royalty and service fees are chargeable. It is of course impossible to predict everything accurately, particularly future demand.

A triangulation approach to valuing emerging market companies is recommended, comparing the results of three different methods. The recommended approach is first to conduct a DCF analysis using probability-weighted scenarios of the risks the business faces. The value obtained is then compared with a DCF approach using a country risk premium built into the cost of capital and a valuation based on comparable trading and transaction multiples.

## Know what buttons to push

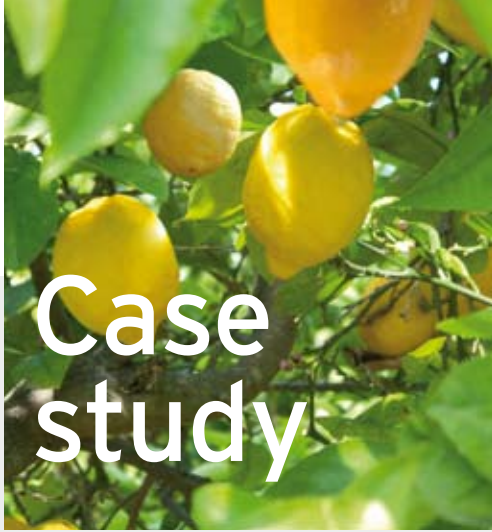
When in competition for assets with local buyers, overseas acquirers face both advantages and disadvantages. Sellers in emerging market countries with depreciating currencies may often have a preference to receive dollars when selling their business. This can give an edge to an overseas acquirer, which may have better access to foreign currency markets. Local buyers, however, often have the advantage of better understanding the idiosyncrasies of the local market and may be prepared to place a higher valuation on a company than a foreign buyer, using information that may be incomplete or unreliable.

### Five questions to ask in assessing growth potential

- ▶ How will local GDP growth feed through to sales growth in the product set?
- ▶ How long will growth continue at these levels?
- ▶ What shocks might emerge to throw it off track?
- ▶ How positive are long-term demographic trends?
- ▶ How will the competitive environment evolve to affect the outlook for growth?

## Be prepared to step back

Often the acquisition decision may require the board to justify the gap between the stand-alone value and the potential price required to secure the asset. It is equally easy either to overestimate the growth opportunity or underestimate the market potential. Faced with pressure to conclude a deal, senior management's role is to take a step back from the process and assess the risks in the valuation – willingness to acquire should not obscure the growth rate implied in the acquisition price.



# Case study

## **Actis – building financial and non-financial value based on local, long-term, collaborative relationships**

With experience stretching back 60 years and an exclusive focus on emerging markets, private equity group Actis has a unique legacy. The company focuses on investments in Africa, Latin America, South Asia and Southeast Asia, but it does not invest purely through a geographic prism.

“We look for distinctive opportunities driven by the changing nature of emerging markets societies across a number of sectors,” says Rick Phillips, Partner and Head of Consumer, at Actis. “We pursue two broad themes. The first is the build-out of domestic infrastructure, which ranges from power generation – keeping the lights on in places like Uganda – to financial payments systems, enabling customers to pay easily and efficiently by plastic. The second important theme for us is the growth in consumer spending and, within that trend, increasingly the consumer’s quest for quality.”

As they develop, many emerging markets pass through three distinct phases. Initially, economic activity is centered primarily on manufacturing, which is followed in the second stage by industries that produce added-value goods. In the third phase, as consumers acquire more spending power as a result of economic development, they begin to demand higher-quality branded goods and services.

Actis’ portfolio reflects this pattern of development. “Our first fund contained many mining and commodity businesses, whereas the most recent fund has a greater emphasis on branded consumer products and financial services,” Phillips says. “More and more, it is the knowledge-led and higher value-added investments that are of most interest. For example, in our portfolio we have Anthelio, a global business processes service with operations in India, and Integreon, a provider of research and legal professional services to law firms and multinationals. In the consumer space, our investment in luxury brands like Vlisco, a leading West African fashion company, reflects the trend-conscious aspirations of our customers.”

Actis is very clear about the critical success factors that underpin its diverse range of investments. “It is vital for us to be “of our markets”,” Phillips says. “That’s incredibly relevant to how we invest because we are the antithesis of the “fly-in/fly-out” model. Our approach, which has proven to be highly successful, is one of being committed to these countries for the long term. We come to the table as trusted local business partners with global capability.”

Being on the ground is an important factor in assessing valuation, given the frequent deficiencies in the quality of financial information available in emerging markets. “Our people on the ground know exactly what’s going on and are harder to fool with numbers that superficially might look all right,” Phillips says. “Also, our sector experience means that we can benchmark valuations against similar deals in other markets.” Actis bolsters this approach to valuation by conducting extensive due diligence using consultants and subjecting every deal to a rigorous assessment by its global Investment Committee.

In addition to having the right team on the ground, the way those people conduct business is also vital. "Very often we sit down with family-owned businesses, which have not worked with outsiders before. We refer to our approach as the "positive power of capital"." Obviously, we are bringing money to the table, but it's about much more than that," Phillips says. "We bring an attitude of partnership, as well as deep sector experience gained not just in developed markets but in other emerging markets. Businesses find it attractive to deal with people with similar insights, and we bring "south to south" experience to the table."

Trust, however, is not built overnight. "It's a slow-burn process," Phillips says. "We often build relationships for five years before concluding a deal. Two of our transactions in the last year resulted from multi-year relationships." This collaborative approach also helps Actis manage the cultural differences that often present a major challenge in emerging markets. "It's a qualitative distinction – an unheated, constructive approach that places value on doing the "right" thing," Phillips says.

Actis' business model is not based on heavy financial engineering or the "strip and flip" model. "We see ourselves as the stewards of the business," Phillips says. "We look to build value by putting in the right management team, right training, right health and safety standards and the correct emphasis on brand equity and development. We act as an economic catalyst so that when we exit, our companies can become, or already are, market leaders in their country. We improve businesses and make them world-class, which makes them very attractive to overseas corporate buyers."

Actis emphasizes the need to build both financial and non-financial value. The investment manager is the primary point of contact – on a daily basis – with the portfolio company, but is supported by Actis' environmental and social governance (ESG) and value-addition teams. "The value-addition team is like a SWAT team," Phillips says. "They look for new ways to add value, be it through supply chain efficiencies or brand equity investment, that will benefit both the co-owners and the local community."

The company pioneered ESG in emerging markets and seeks to raise standards to global rather than local levels, in addition to looking beyond compliance to instigate change that is beneficial to local society. For example, Halonix, an Actis portfolio company in India, manufactures energy-efficient compact fluorescent lamps (CFLs). When the Indian Government introduced a new standard requiring the use of CFLs, Halonix set up a mercury recycling program to help manage the contamination risk in landfill sites from the disposal of non-CFL bulbs.

The recent sale of Paras, the Indian-branded personal care and OTC drugs group, to Reckitt Benckiser provides a good illustration of the Actis approach. Under Actis' ownership, Paras invested significantly in promoting its brands, resulting in a product range with a high level of emotional equity with its customers, leaving the company well placed to expand further into the OTC drug sector. Actis helped the family owners professionalize the management team and improve the efficiency of the supply chain. Reckitt was also attracted by Paras' share of mind and market across MENA (where their pain relief balm Moov is popular) as well as by the state-of-the-art manufacturing plants. "Plants being run to these standards are hard to find," Phillips says. "This illustrates that ESG is more than compliance; it helps build value."

# 5

## Allow for lengthy negotiation with a wide group of shareholders

**"You have to be networking all around, with all the key players and all the time."**

A Coca-Cola manager

**Acquisitions in developing markets often take longer and require time, money, resources and patience to conclude successfully. Foreign buyers should be aware that the pace is generally slower, especially when dealing with local partners and authorities.**

In Brazil, for example, the regulatory work required regarding tax and labor as part of a deal takes a long time to conclude, and it is not unusual for a transaction to take 6, 8 or 10 months, even after a memorandum of intent has been signed. Sellers' lack of experience of the M&A process can also hinder the speedy completion of a deal.

In China, transaction times can be longer. One comparatively small recent deal, which was designed to give the buyer entry into a strategically important subsector in the Chinese market while also opening up access to distribution channels in second- and third-tier Chinese cities, took four years to complete, with the time between signing and completion taking almost two years. The buyer faced difficulties buying out numerous small shareholders, as well as local staffing issues requiring tricky negotiation that it chose to leave to its Chinese managers. Ministry of Commerce approval was also a key issue, as it is difficult to reverse transactions after this step.

Long delays between signing and completion require buyers to focus on having the right protections in place and managing the business in the interim period. Creative financing structures can help mitigate some of the risks, such as by splitting payment into an upfront tranche with the balance as deferred performance-related bonuses.

## It's not what you know

Relationships are of vital importance, and overseas acquirers should consider the value in taking the time to build them. Negotiations need to include all stakeholders, including owners, managers, union leaders, local regulators and government. Compared with doing a deal in the developed world, negotiations in emerging markets will tend to involve a wider number of stakeholders.

It is also important, as a buyer, for you to recognize that the people you would normally wish to negotiate with might not be the people who ultimately make the decisions. In the Middle East, for example, a lot of businesses are family owned but with a CEO or CFO brought in from overseas to run the business. Potential acquirers should look beyond the official management titles and negotiate with the family in ultimate control.

**Negotiations need to include all stakeholders, including managers, union leaders, local regulators and government. But also remember that the people you would normally wish to negotiate with – CEOs or CFOs – might not be the people who ultimately make the decisions.**

## Gain the support of local communities

When considering the interests of all stakeholders, it is important to consider the needs of local communities as well as those with a direct financial involvement in the transaction. In 2004, for example, Coca-Cola had to close down its Plachimada plant in Kerala, India, after local villagers and environmental activists staged protests against the company's use of groundwater. Coca-Cola faced accusations that its bottling plant made local wells run dry and polluted water supplies. Coca-Cola has subsequently addressed these issues with several water stewardship initiatives following a 3R policy – reduce, recycle and replenish.

Coca-Cola India has focused on the creation of rainwater harvesting structures, the construction of check dams, the restoration of ponds and traditional water bodies and interventions toward improving the efficiency of water use in agriculture. For the construction of rooftop rainwater harvesting structures and recharge shafts, Coca-Cola works with NGOs and local communities, which help identify priority areas. The company

then collaborates with local resident welfare associations and communities to establish rainwater-harvesting partnerships. The company's image has improved and its brand-building exercise has been strengthened, while local communities have gained better access to drinking water and farmers have benefited from better irrigation facilities.

Investment in the local environment, infrastructure and welfare is an important means of differentiating the buyer's offer from the competition. In emerging markets, this ancillary investment can often be as important a consideration as the headline price.

## Check cultural assumptions

Buyers should be aware of cultural differences during negotiation. Popular conceptions of European cultures often exaggerate the differences between countries, but business cultures are more similar across Europe. When negotiating with Chinese or Indian business people, however, the cultural differences will be far greater. Often hierarchy is of greater importance in emerging market relationships than in the developed world. A clear understanding is also required of the inter-relationships between local and national government in the target country. Buyers should be aware that the local judiciary might not be as independent as in a developed country.

## Remember the power of the unions

Efforts should be made to avoid negative publicity when news of the deal enters the public domain, raising concerns among the wider stakeholder group. Buyers should also take into account the fact that the future treatment of management and employees often plays a critical role. In January 2011, for example, shareholders in Massmart, South Africa's third-largest retailer, approved a US\$2.4b offer by Walmart to purchase a 51% stake in the business. The deal, however, has faced opposition from South Africa's trade unions, which have accused the US retailer of not respecting workers' rights in some of the countries where it operates. Walmart and Massmart have responded by clearly stating that they will honor all existing union agreements as well as South Africa's labor laws.

## Watch the detail to avoid disputes later

Share purchase agreements and legal documentation should be prepared with even greater attention to detail than normal. If disputes occur, they can be very costly and time-consuming to resolve, with potential for damage to a company's reputation.

### Five success factors in making joint ventures work

- ▶ Knowing the partner well, working together on other projects
- ▶ Full and detailed in-market commercial and cultural due diligence, especially if the relationship is new
- ▶ Clear division of respective contributions
- ▶ Clear and agreed exit route to majority ownership or withdrawal
- ▶ Independent, politically astute managing director

At the end of 2009, Danone and Wahaha, China's leading domestic beverage company, settled a long-running dispute over their joint venture, which was established in 1996. Danone claimed that Wahaha's president had set up parallel companies in direct competition with the joint venture, while Wahaha claimed that the original agreement between the two companies was never approved by China's trademark office and so was never in effect. After several years of public wrangling and legal action in dozens of jurisdictions, the two companies agreed to settle out of court, with Danone selling back its share of the joint venture. Danone did achieve a partial legal victory with a Swedish arbitration court finding that Zong Qinghou, the founder of Wahaha, breached confidentiality and non-competition agreements with Danone.<sup>3</sup>

More recently, in December 2010, a court in Chongqing ordered PepsiCo Greater China to hand back a cola recipe to Tianfu Cola Group Corp. PepsiCo set up a joint venture with Tianfu in 1994, but because of its debts, in 2006, Tianfu had to sell its 40% stake in the joint venture to PepsiCo, while the brand of Tianfu Coke was left in the joint venture. The court rejected all the allegations of infringement or claims for compensation against PepsiCo made by Tianfu, but PepsiCo has stated that it will act on the court ruling and hand over the recipe.<sup>4</sup>

As Danone and PepsiCo have discovered, achieving a partial legal victory does not ensure continued rights over local trademarks and brands. The right commercial option, where mutual trust in a joint venture has been lost, may be to exit. Therefore, an important component of a successful joint venture is a clear "exit" route to majority ownership interest – or, alternatively, a clear route to pull out of the venture entirely if things go badly.

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<sup>3</sup> "Danone/Wahaha – China Business Lessons To Be Learned," *China Law Blog*, [www.chinalawblog.com](http://www.chinalawblog.com), accessed 19 April 2011.

<sup>4</sup> "Tianfu Group Wins the Lawsuit against Pepsi Cola Regarding Intellectual Property Right Dispute," *UB & Co*, [www.ub-co.com](http://www.ub-co.com), accessed 19 April 2011.

# 6

**Preserve and nurture value in the integration process; motivate key people**

**"Arrogance diminishes wisdom."**

Arabic proverb

**The multinational companies that have been successful in transacting in emerging markets are those that have formed strong partnerships with local players, both in joint venture arrangements and acquisitions.**

Clinching the deal is the start of the process, not the finish, because poor integration is an important source of M&A failure. Two years after an acquisition, the majority of acquisitions fail to meet pre-acquisition objectives. Often it is the inability to merge two different corporate cultures successfully that is to blame.

When a foreign buyer is purchasing a company that has performed well in its local market, perhaps for 10 to 15 years or more, it is important to remember that there are sound reasons for that solid performance. And it is those reasons that made the business attractive as an acquisition target. In such circumstances, railroading the company into doing business the same way as in other countries where the new owners operate may not be an appropriate strategy. Equally, operating a different business model in every country is not a viable proposition for a multinational pursuing synergies and economies of scale. Care, therefore, should be taken with the implementation of a new buyer's business model, taking into consideration the right use of available local resources.

In the early 2000s, for example, a North American alcoholic beverage company expanded into Brazil but staffed its office predominantly with people from its home country, including the marketing staff. Attempts by these North American employees to design advertising campaigns for the Brazilian market proved ineffective, leading to a loss of market share.

But successful M&A involves far more than just avoiding making mistakes at newly acquired companies. As an acquirer, you should ask what the target company can teach you and how those lessons might be applied across the entire business. The key is to strike a balance between retaining the best, learning from it and leveraging it further within the business while bringing the new company into the fold. An important tool in achieving this goal is to recognize integration as a full-time function rather than something that is added to a senior executive's existing workload.

## Try to empower local management

It is crucial to keep the target company's key people on board, with their motivation and incentives aligned to the needs of the business, although employee retention in a takeover situation can be tough. Due to competition for talent, it may be harder to replace lost personnel in emerging markets than in the developed world. You need to understand how easily the new location can support expatriate staff, in the event that reinforcements have to be sent from the home country.

**“As an acquirer, you should ask what the target company can teach you and how those lessons might be applied across the entire business.”**

A tougher economic environment has given even greater importance to the achievement of cost synergies, but a focus on reducing costs may risk losing key talent as one corporate culture is absorbed by another.

Empowering local managers and engaging local staff with the change effort are important steps in adapting to the local market and achieving the desired staff retention. New owners should be prepared to spend more time on business planning, but perhaps less on the details of reporting and budgeting, as the available information may not be of the same quality or granularity compared with a developed world market.

## Recognize the importance of governance

Acquirers would do well to resist the temptation to manage exclusively on the basis of cost, even though part of the attraction of the target may be its lower cost base. From the acquirer's perspective, as important as cost is the need to align the governance and employment conditions of the target to the buyer's standards. For example, an Ernst & Young client, which purchased a company in China with 3,000 employees, only discovered after acquisition that a small number of those employees worked in a subsidiary with very poor working conditions, raising a potentially serious risk of damage to the company's reputation.

**“From the acquirer's perspective, as important as cost is the need to align the governance and employment conditions of the target to the buyer's standards.”**

Differing ethical standards are one reason why joint ventures can be unstable. Ensuring both partners in a joint venture share similar business ethics is therefore critical. For example, manufacturing processes as well as behavior may have to be adapted to remove the reputational risk associated with using contaminated or harmful ingredients. An ingredient that is not banned in the target country but is on a dangerous list in the home country can lead to disagreements regarding profitability, but it is important that multinationals stick to their ethical standards. To mitigate these risks, all major multinationals require formulations to be approved centrally and will also normally follow factory health and safety procedures on a global basis.

## Allow for a slower pace of integration **Show respect and empathize**

It is important to execute productivity improvement programs rapidly and to retain existing client portfolios, but this needs to be achieved within the requirements of potentially higher governance standards as well as the need to honor commitments to the target's employees.

The general tendency in developed markets is to integrate quickly, given a focus on realizing cost synergies in a mature and relatively slow-growing marketplace. This will often involve integrating back-office activities. By contrast, seizing revenue synergy opportunities – which is generally the aim in emerging markets – requires more thoughtful front-office integration. This is a more complex task and tends to be implemented more slowly. It can be further complicated by the incentives offered to local management as part of the deal.

Some of the lessons to be learned in running an acquired company are the same as those encountered in the transaction negotiations – such as the need to build relationships with all stakeholders and understand cultural differences. Foreign investors and owners should strive to show personal involvement, respect and understanding.

## Plan for change

The final lesson is that rapid economic growth is accompanied by rapid change. The wider political and economic backdrop to the local market may change more rapidly in emerging market countries than in more mature economies. Political and economic risks therefore require constant monitoring, as acquiring a company is the start of the journey, not the end.

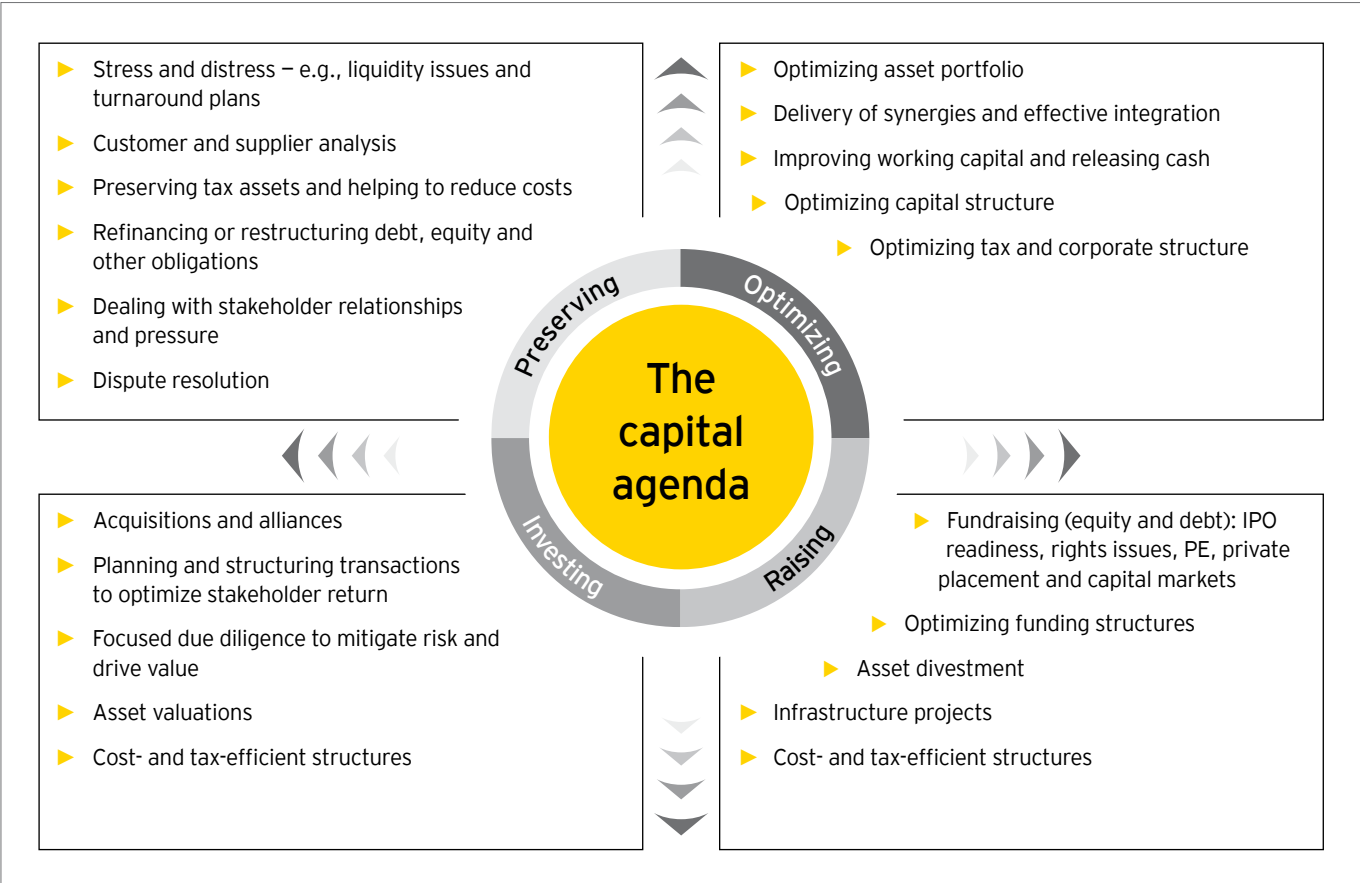


## Six recommendations in conclusion

1. Acquisitions in developing markets should always correspond to a clear strategy and a vision (just “to be in developing markets” is not a strategy!).
2. Acquisitions in developing markets take longer and require time, money, resources and patience. Each developing country is different and needs individual understanding.
3. It is critical to get and keep the target's key people on board.
4. Available historical financial data is not always reliable, and acquirers will need to spend more time on business planning.
5. Acquirers have to multiply contacts with stakeholders, including managers, union leaders, local regulators and government.
6. Acquirers must show personal involvement, respect and understanding of cultural differences.

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If you are looking to raise or invest capital in developed or emerging markets, our Transaction Advisory Services team can help you evaluate opportunities, make your transactions more efficient and help achieve your growth goals.



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