Second Quarter, 1997

Strategy & Business ...Booz, Allen & Hamilton

Competing in Emerging Countries

The Case of Latin America

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By Jorge H. Forteza

For the past decade, decision-makers in major banks and multinational companies have been focusing their attention on one of the hottest "growth frontiers": emerging markets, specifically Southeast Asia, the Indian subcontinent and Latin America.

During much of the 1980's, the prospects in most emerging countries were quite bleak: the debt crisis, inflation and domestic political turbulence turned these regions into a planner's nightmare. Then a number of "economic miracles" began to pop up, drawing attention to Asia, Eastern Europe, China, India and, toward the end of the 80's, Latin America.

Why are "emerging countries" now at the top of the decision-makers' agenda? The obvious first answer is sheer mathematics. As Willie Sutton used to say, in explaining his interest in banks, "That's where the money is." Well, when it comes to the world economy, that's where the growth is:

- Emerging countries now represent the clear majority of the world's population.

- Their growth prospects range from 4 to 5 percent per year in Latin America to 6 to 7 percent in East Asia to 10 percent in China. These are typically two to three times the expected growth rates of developed countries.

- In all of these countries, growth will invariably entail the expansion of new middle classes, with outsized needs for consumer durables, housing and mobility. For example, in most of the market-planning exercises in which Booz-Allen & Hamilton is involved, emerging countries represent anywhere from 50 to 80 percent of the growth in consumer durables over the next 10 years.

- This growth will call for unprecedented investments in infrastructure. For the world's leading engineering and construction companies and the major builders of capital goods, long-term survival hinges on the effectiveness with which they capitalize on the growth opportunities offered by emerging countries.

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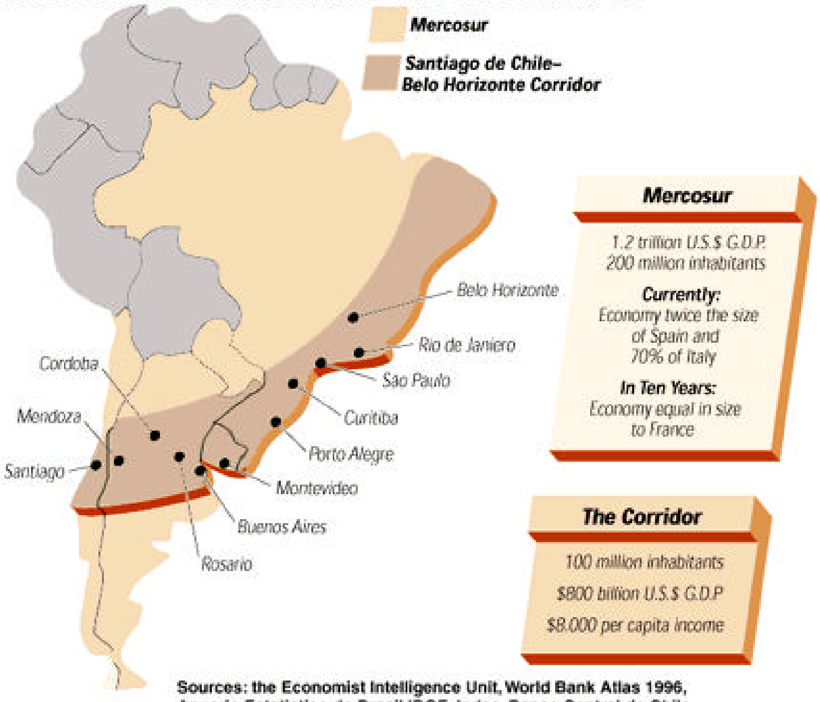
THE HEART OF THE REGION:
THE SANTIAGO DE CHILE-BELO HORIZONTE CORRIDOR



Sources: the Economist Intelligence Unit, World Bank Atlas 1996, Anuario Estatistico do Brasil IBGE, Indec, Banco Central do Chile

This massive shift in the world's "center of gravity of opportunity" is reflected in the way in which leading political analysts are arguing about the foreign policy priorities for the United States and other developed countries. Two examples illustrate the point:

- A Foreign Affairs article, written by a team led by Paul Kennedy, argues that American foreign policy should focus on "a small number of countries whose fate is uncertain and whose future will profoundly affect their surrounding regions."(1) These "pivotal states" are identified as Algeria, Brazil, Egypt, India, Indonesia, Mexico, Pakistan, South Africa and Turkey.

- In an article published in Foreign Policy, international analyst John Stremlou contends that the priorities of American foreign policy should be the "10 big emerging countries," namely Argentina, Brazil, China, India, Indonesia, Mexico, Poland, South Africa, South Korea and Turkey.(2) In the article, Mr. Stremlou estimates that these 10 countries will account for 44 percent of the non-American growth in world imports, and that by 2010, they could be responsible for more trade with the United States than Europe and Japan combined.

This shift in strategic focus has translated into major growth in foreign direct investment and portfolio flows to emerging countries. (F.D.I. represents investments in plants and equipment while portfolio flows are directed at debt and equity positions.) The stock of F.D.I. in emerging countries has soared from about $100 billion in 1980 to more than $700 billion in 1995, and it is not surprising to find the same familiar names among the host nations. By decreasing size of F.D.I. stock, they are China, Mexico, Singapore, Indonesia, Brazil, Malay-sia, Argentina and Hong Kong.(3)

Given this extremely attractive outlook for growth, it is not surprising that Booz-Allen has witnessed the following evolution in the behavior of leading multinationals, local enterprises and local governments with which the firm works in designing and implementing strategic agendas:

- Multinationals are busy concentrating their investment efforts in emerging countries. This requires either entry strategies into new, unfamiliar countries or growth strategies in countries that are opening up or deregulating their markets.

- Local enterprises that are typically dominant in their home countries find themselves facing serious challenges when their governments start dismantling the import-substitution policies that had protected them for so long. Those companies need to decide whether they can adapt to their new environment (by trying to grow internationally or developing alliances with world-class players) or simply exit the business by selling out to a multinational.

➢ National governments are involved in a broad range of efforts to persuade multinationals to bring plants and skilled personnel to their countries. These efforts range from the urge to obtain a favorable rating in the various "competitiveness" or "economic freedom" rankings (4) to very focused campaigns intended to attract major production facilities of automotive, electronics and durable-goods manufacturers.

At Booz-Allen & Hamilton, we are heavily involved in assisting all three segments of actors (multinationals, local players and governments) to enhance their competitiveness in this exciting game in emerging countries. In the course of our work, and in research efforts developed with client organizations, we have been able to distill experience and knowledge about the drivers of success and failure in ventures undertaken in this promising area.

We would like to share some of these learning experiences in a special series of articles, "Competing in Emerging Countries: The Case of Latin America." This initial article focuses on the specific opportunity offered by the rapid transformation of Latin American economies, and how that opportunity is being addressed by major multinational corporations. Regular features written by senior members of the firm's Latin American practice will follow.

[1] "Pivotal States and U.S. Strategy," Robert Chase and Paul Kennedy, Foreign Affairs, January-February 1996.

[2] "Clinton's Dollar Diplomacy," John Stremlou, Foreign Policy, No. 97, Winter 1994.

[3] United Nations Commission for Trade and Development, World Investment Reports, 1994/1995.

[4] For example, the World Economic Forum's "World Competitiveness Report 1996" and "Economic Freedom of the World," the Fraser Institute, Vancouver, Canada.

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TRANSFORMATION IN LATIN AMERICA

During most of the 1980's, Latin America struggled with the heavy burdens of the debt crisis, hyperinflation, recession and the transition from authoritarian to democratic governments. In fact, most analysts call the 80's Latin America's "Lost Decade."

It is striking how a few numbers can capture the extent of the decay suffered by the region: While the gross domestic product of Asian countries grew by almost 7 percent a year (6 percent a year in per-capita terms) from 1986 to 1995, Latin America's G.D.P. advanced at a rate of little more than 2 percent, translating into virtually zero growth in per-capita terms. In similar fashion, Argentina's per-capita G.D.P. dropped to just 29 percent of the per-capita average in O.E.C.D. countries, from 44 percent, between 1970 and 1995.(5)

The only Latin American country that systematically improved its competitive positioning during the Lost Decade was Chile. Chile is the country in the region that can be compared to an "Asian Tiger" in terms of its economic performance, and its institutional transformation during the 80's led the way for the reform processes of the region.

Toward the end of the 80's, most governments in the area came to the realization that they were gradually becoming "irrelevant" to the investment decisions of major international players and that they would slowly but surely lose ground to Asia and Eastern Europe in the competition for capital and employment opportunities. As a result, most of the countries started adopting what some analysts call "democratically led transformation programs," efforts that are widely known as variants of the "Washington consensus."

In our view, the different policy initiatives were all aimed at sharply increasing the attractiveness of the countries to international investors. Mexico in the late 80's, Argentina starting in 1987-89 and Brazil in 1990 all designed transformation policies that targeted the following objectives:

➢ *Attaining economic stabilization and a functioning price mechanism as the fundamental building block of a capitalist economy.* The Salinas, Cavallo and Real plans are all variations of the same programs, which are designed to build the basis for rational economic decision-making.

➢ *Creating the conditions for a massive recovery in domestic demand.* The stabilization efforts, combined with a steady exchange rate, translated quickly into sharp recoveries in real wages, with a resulting surge in demand for packaged goods and consumer durables.

➢ *Launching large-scale privatization programs.* By shifting the ownership of most state-owned utilities, governments were trying to reduce their financing needs. But they were also trying to offer businesses with huge untapped potentials to foreign companies. By doing so, billions of dollars of investments have poured into the region, from such leading players as STET, Telefónica de España, France Telecom, GTE, Lyonnaise des Eaux, EDF, British Gas and several Chilean companies.

➢ *Launching regional integration initiatives.* Most of the countries in the region realized that they would have to join forces to become more interesting to multinationals. At the same time, they saw the need to offer their own domestic corporations a more "tolerant" environment to reorganize and grow. The two major initiatives in this respect are Mercosur and the Andean Pact.

These efforts are slowly combining to form an image of Latin American transformation among decision-makers that is translating into sharply enhanced investment flows into the region. That perception is based on the following favorable determinants:

➢ Countries in Latin America are now democratically led, capitalist societies in which the process of transformation is quite advanced and large-scale violence and upheaval are seen as highly improbable.

➢ Clusters of urban areas in both the "Caracas-Bogotá-Quito corridor" and the "Santiago de Chile-Belo Horizonte corridor" are now significant centers of demand.

Take the "Santiago de Chile-Belo Horizonte" corridor. This grouping of the 10 largest cities in Argentina, Brazil, Chile, Paraguay and Uruguay is the backbone of Mercosur, an economic union with a $1.2 trillion G.D.P., nearing the size of the Italian economy. (See the accompanying exhibit.) These 10 urban centers account for around 60 percent of Mercosur's G.D.P., forming an economy the size of Spain's with an adjusted per-capita purchasing power that is similar to the levels in Portugal and southern Spain.

[5] Inter-American Development Bank, cited in Business Latin America, April 1996, and International Monetary Fund statistics.

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The exciting part of the story is that the region shows a remarkable potential for growth in consumer durables. The level of ownership of cars, computers and other products is so low, relative to European standards, that the untapped market is simply enormous.

For example, to reach the level of car ownership in Greece would mean more than doubling the present stock of cars in this region; to reach the level in Spain would require multiplying that stock by a factor of almost four.(6) And in computers, a gain of 250 percent would be needed to match the penetration level in Portugal. Numbers like these always make corporate planners dreamy.

But the tantalizing market for consumer durables is just for openers. Because of regulatory and socio-demographic changes, most countries in the region are slated to undergo significant "discontinuities" that will create major shifts in demand:

➢ There are enormous shortages of decent housing in the region; estimates of shortfalls range from 3 million dwellings in Argentina to more than 10 times that number in Brazil. The growth potential for quality, low-cost housing is enormous.

➢ The state-owned pension systems are not viable (as is also the case in most developed countries). Chile led the way in establishing a privately run pension fund industry, which now manages $30 billion and has become a major driver of investments in Chile and abroad. Argentina reformed its systems in 1994, Uruguay did so in 1996 and Brazil will be next. The prospect of managing funds reaching $200 billion by 2010 is attracting all leading world players to this market.

➢ The population is steadily getting older, and the growth prospects for services to elderly people are huge. The government supply of these services is nonexistent or of unacceptable quality. For that reason, sharply growing segments of middle-class elderly people will have to pay for such services.

In summary, it should be clear by now that the "emerging clusters" in the north (Caracas-Bogotá-Quito) and in the south (Santiago de Chile to Belo Horizonte) offer enormous growth opportunities for multinationals -- on a scale that can be compared only to the potential of India's middle class -- in the consumer goods, durables and service sectors.

6 See "Latin America, New El Dorado," Financial Times, Jan. 7, 1997.

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OPPORTUNITIES AND CHALLENGES FOR MULTINATIONAL PLAYERS

When we analyze the prospects for multinationals in addressing the growth opportunities in the region, it is useful to differentiate among three very contrasting situations in which they find themselves:

a) The "multidomestic player" that must move to a regional footprint and management model.

b) The multinational player that is starting to expand in the region.

c) The multinational player that is entering, or considering entering, the region.

Let's look at each of these strategic situations in turn.

The multidomestic player. Some multinationals have been household names in Latin America for several decades. Most of these companies grew by creating country-specific positions to take advantage of the import-substitution policies of each country. By the early 90's, however, the compounded effects of the opening up of the import barriers and the formation of regional integration agreements led these multinationals to sharply rethink their strategies, production footprints and management models. In fact, most of the multinationals were facing situations that they had already seen in Europe in the 70's:

- a production footprint made up of too many plants, many of them subscale and with too wide a product range.
- a number of "self-contained" country units, each with its own management and administrative functions.
- limited trade and cooperation among the country units.
- a "multidomestic" culture with little knowledge creation and exchange among the country units.

Booz-Allen has been involved in the redesign of several of these management models, ranging from strategy review to the development of a new organization structure and a number of "regional key management processes." In doing so, the firm has studied the lessons learned in the reorganization of major multinationals in Europe in the period leading up to 1992 as well as similar efforts by multinationals in emerging countries. The models include the following features:

- Rearranging country units into "regional clusters" that each combine several countries.
- Moving toward a matrix in which product and functional expertise starts becoming a partner to geographically focused capabilities.
- Generating interactions between the "country manager" and two new actors: the "regional product or capability manager" and the "regional functional manager."
- Moving toward a new production footprint, which implies greater specialization of production facilities, more intra-regional trade (maybe even plugging the regional plant into the worldwide trading network of the corporation) and, in some cases, capability consolidation.
- Creating regional units for capabilities such as product development, industry-specific expertise and functional areas where cost is important (such as logistics and administrative services) or where uniform quality and common standards are paramount (as in human resources and information technology).

The design and implementation phases are extremely complex and conflict-ridden. But we have found that multinationals that manage to implement the transition from a "multidomestic" perspective to a "regional" perspective wind up creating a powerful platform for future success. In fact, they typically start reaping a number of benefits:

- *Growth in revenues.* By creating a regional product or expertise that each country unit would be incapable of developing, the range of products is streamlined and the marketing focus is tightened. That typically translates into market-share gains.
- *Reduction in costs.* The combination of a reduction in administrative costs (by merging several previously independent country units) and in operating expenses (by streamlining and merging production facilities and functional units) can result in a cost savings of up to 30 percent in overall regional operations.
- *Attractiveness to top-quality human resources.* By adopting a regional approach, the corporation now offers much greater career opportunities to its management. The product line manager in Chile, for example, now has the opportunity to run a Southern Cone unit that is 10 times the size of his or her previous responsibilities.

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The multinational that is starting to expand. In a number of sectors that were originally dominated by local players, such as packaged food stuffs, there has been a remarkable shift in the past five years toward ownership by multinationals. Merger and acquisition activity has increased dramatically in the region, as industry giants such as Procter & Gamble, Nabisco, Parmalat and BSN, among others, have acquired local players. (This is also the case, incidentally, of such leading financial services players as Banco Bilbao Vizcaya and Santander from Spain and ABN AMRO from the Netherlands, which have grown substantially via recent acquisitions.) For these players, the opportunity for growth is substantial, but it entails dealing with a number of challenges:

➢ How to capitalize on well-known local brands with a healthy local franchise, which typically have mediocre product ranges and very ineffective delivery systems.

➢ How to start complementing the local range of products with world "category killers" and how to allocate resources between the "local" and "global" product lines.

➢ How to significantly upgrade the quality of product manufacturing, packaging, distribution and channel relations. In short, how to bring a "sleepy, but successful local player" into a global network.

➢ How to handle human resources. In the typical company that is acquired, a layer of self-taught managers nearing retirement age is coexisting with a very weak middle-management and some bright youngsters, all within a paternalistic and authoritarian culture. How to start injecting new blood while making sure that expatriates do not destroy that culture is the greatest challenge of all.

Here again, there are already a number of success and failure stories that we can analyze across the region. In general, most "disaster stories" in acquisitions and entry strategies have a number of common traits (which, incidentally, parallel the cases we ran across in Europe in the late 80's):

➢ *Extremely high acquisition prices.* There is always a moment in these transformation programs (Spain in the mid-80's, Argentina in 1993-94, Brazil right now), when there is a "stampede" of eager multinationals, all running after the same 10 local companies. The results are superficial evaluations, widely inflated "synergies" and, in general, unrealistic estimates of financial return.

➢ *Investment horizons that are too short.* Having overpaid for the acquisition in the first place, managers are then under pressure to deliver very high returns very soon. The resulting race to produce financial results leads to a number of strategic errors, including milking successful brands and underinvesting in new brands or in infrastructure.

➢ *Limited attention to culture and human resources.* While it is clear that the multinational is normally bringing superior human resources and management practices, the key factor is how these capabilities are planted in the local corporation. Subsidiaries that end up relying heavily on expatriate staff because they have not been able to retain or attract skilled local managers are typically losers over the long run.

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The multinational that is entering the region.
For several multinationals that have woken up only recently to the promise of Latin America, the challenge is how to build a viable regional presence while the "window of opportunity" is still open.

That is the situation for some European players, American firms in the financial services industry and Asian companies that are now trying to
enter the region. Interestingly, this is also the case for leading Chilean corporations, which are finding limits to growth in their domestic markets and are now expanding to Argentina, Brazil and Peru.

Most of these companies are facing the following challenges:

➢ *Confirming market potential.* On paper, the region offers boundless potential for everything from toiletries to software to consumer banking. The key questions are: how much potential, and by when? We have seen several cases of corporations wildly overestimating potentials for product/ service adoption, based on their home country or European experience. Careful segmentation and understanding of consumer dynamics are a must in avoiding costly failures.

➢ *Designing viable entry strategies.* For years, the conventional wisdom has been that it is better to acquire than to start from scratch in a new, unfamiliar market. We believe that deregulation and shifts in consumer attitudes and in human resource markets now argue for a wholesale rethinking of this approach. In our experience, one should always start with a "clean sheet of paper" approach, to be abandoned only in the face of immovable obstacles or if an incredibly attractive acquisition/alliance opportunity crops up.

➢ *Competing for top human resources.* Throughout the region, the pool of human resources is very small. Ask for a top consumer goods marketing manager or a world-class retail financial services marketer and you will seldom find more than 10 to 15 attractive candidates in each country! Coming up with an appealing business proposition, using headhunters effectively and mixing local and international resources adequately are all keys for success.

These are all illustrations of the opportunities and challenges confronting multinationals in one of the world's most attractive regions. Since Booz-Allen is continuously involved in research efforts related to strategies and transformations pursued by major economic actors in the region, the firm would like to report on the results of these efforts in upcoming issues of Strategy & Business.

What follows is a sample of the topics that we will be addressing:

➢ *Local companies.* Local corporations are finding significant opportunities and challenges in this new Latin American playground. They are typically family owned, undercapitalized and with limited human resources. They are also under pressure to design new strategies, create alliances or internationalize.

➢ *The regional multinational.* Forming a very interesting subset of these local corporations are those that are placing brave bets on becoming regional multinationals. Companies like Chile's Lucchetti, Argentina's Alpargatas and Brazil's Sadia are all expanding into neighboring countries, launching brands, creating new country units and starting to deal with the promises and frustrations of internationalization.

➢ *Consumer markets.* In the Latin American consumer markets, the basis for competition is being transformed by the combination of a growing middle class and the internationalization of the higher-income segments of the population. These markets show the simultaneous effects of rapid growth and the emergence of differentiated segments. All of a sudden, it is becoming attractive to segment the markets and specialize the product/ service range accordingly.

➢ *Strategic alliances and acquisitions.* For companies planning to enter this marketplace, or for local competition pondering their future, the issue of strategic alliances and acquisitions is becoming critical. We have analyzed and executed a number of alliances across the region and will present the lessons we have learned.

➢ *Media/entertainment and tele-communications.* A number of "new" industries are emerging in this region. We will focus on the cases of media/entertainment and telecommunications. In both marketplaces, we are witnessing dramatic growth, the entrance of leading multinationals and sharply increasing competitive stakes. Local groups such as Carbajal, Globo, RBS and Clarin are all implementing aggressive strategies for growth. In telecommunications, we are witnessing a major showdown among the likes of GTE, Motorola, Telefónica de España, France Telecom and STET.

This listing of issues, which is still incomplete, is intended to portray to the readers a number of considerations that they should bear in mind when addressing the challenges and opportunities offered by one of the most dynamic regions in the world.

Reprint No. 97202