L.E.K.

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Ensuring Value Creation through International Expansion

Facing highly competitive or near-saturated markets at home, companies instinctively look overseas for expansion. But managers must consciously ask the question, "Is this expansion creating real value for shareholders, or simply adding territory and growing top-line revenues?"

Too often, the value potential in new geographies is misunderstood, while the costs of entering new markets are understated. Adding unfamiliar business practices and cultures to this mix causes many companies to concede value creation to an undetermined time in the future – a shaky proposition for shareholders.

This edition of *Executive Insights* outlines the strategic assessment process for evaluating geographic growth opportunities that enables managers to make economically sound decisions about international expansion. China will be used as the country of focus, but the process is universal.

The Allure of New Markets

There are three common motivators for companies embarking on an expansion strategy:

- Improvement in cost-effectiveness of operations
- Expansion into new markets for new customers
- Following global customers

While companies hope to reap benefits in all three areas, action typically stems from one or two of the motives. For example, Dupont, Carrefour and Nokia are investing in China to capture new customers and new markets. Solectron and Flextronics are building manufacturing facilities in China to take advantage of its lower-cost and increasingly sophisticated production capabilities, while at the same time servicing their global customers.

Serving current customers as they become global may initially motivate firms to evaluate expansion opportunities, but less commonly justify an overseas investment. In a survey of goals for entering China, 63% listed the production of goods or services for the China market as a primary goal, and 32% noted the country's lower labor costs as being a significant factor.

Companies looking for growth through new markets and customers, particularly those with limited international exposure, should begin with a prioritization of countries to determine where resources should be spent. Even if a country has already been identified as a high priority, understanding the relative attractiveness of other countries is valuable for decision making.

Ensuring Value Creation through International Expansion was written by **Carol Wingard**, Director of L.E.K. Consulting's China Practice. Please contact L.E.K. at finance@lek.com for additional information.

Planning for International Expansion

A growing or untapped market holds an understandable attraction. But every country must be scrutinized under the lens of a company's value proposition before expansion is considered. Managers must have their eyes open to the additional difficulties of capital flow, the exposure to inadequately protected intellectual property, and the added costs of working with an unfamiliar government bureaucracy.

Entering large, rapidly emerging markets such as China may seem to be an easy decision, but in fact there may be a market closer to home that provides stronger returns, has less strategic complexity, and requires fewer costly adjustments to business processes.

The focus of the analysis should not be *"Should we expand into China?"* but rather *"Should we expand into another country, and if so, which one?"*

Business planning for international expansion includes three phases:

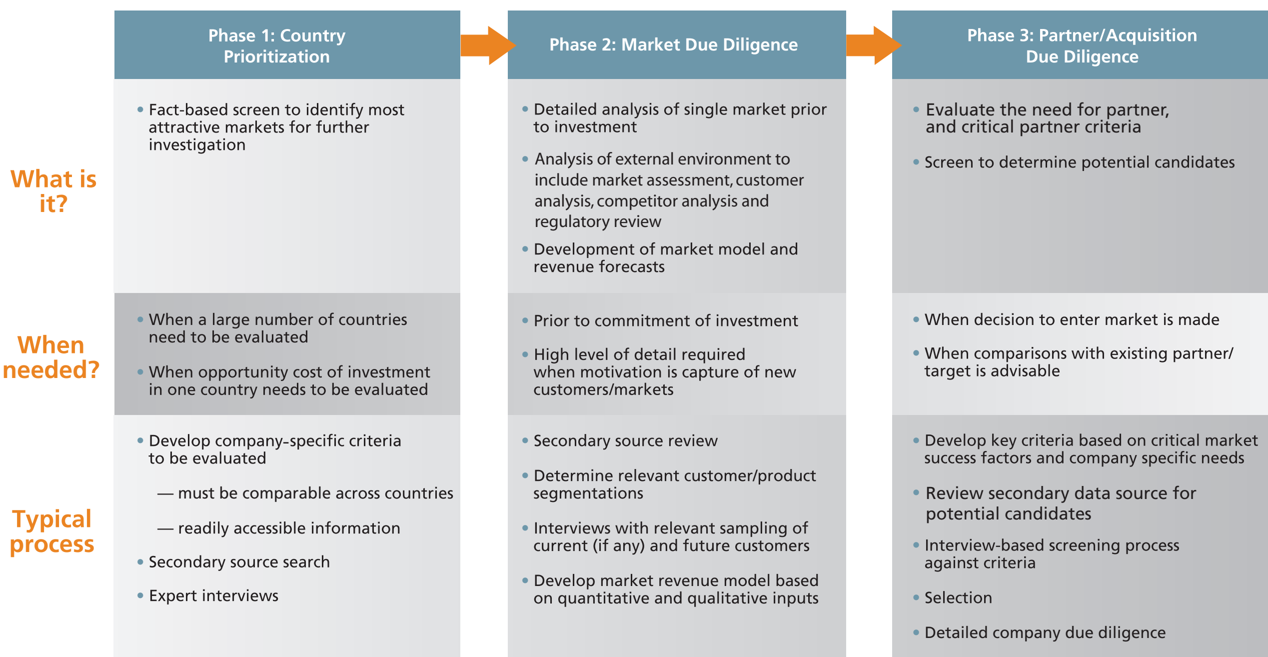
1. Country prioritization, in which basic strategic questions are answered, the environment for doing business in likely markets is studied, and "fit" is assessed, allowing managers to compare entry into one market with entry into another.

2. Market due diligence, in which the most attractive markets are further analyzed for their potential size and accessibility, allowing revenue and profitability forecasts to be made.

3. Acquisition or local country partner selection, in which a preliminary entry plan or feasibility study is conducted to identify the most practical vehicle for entering the market.

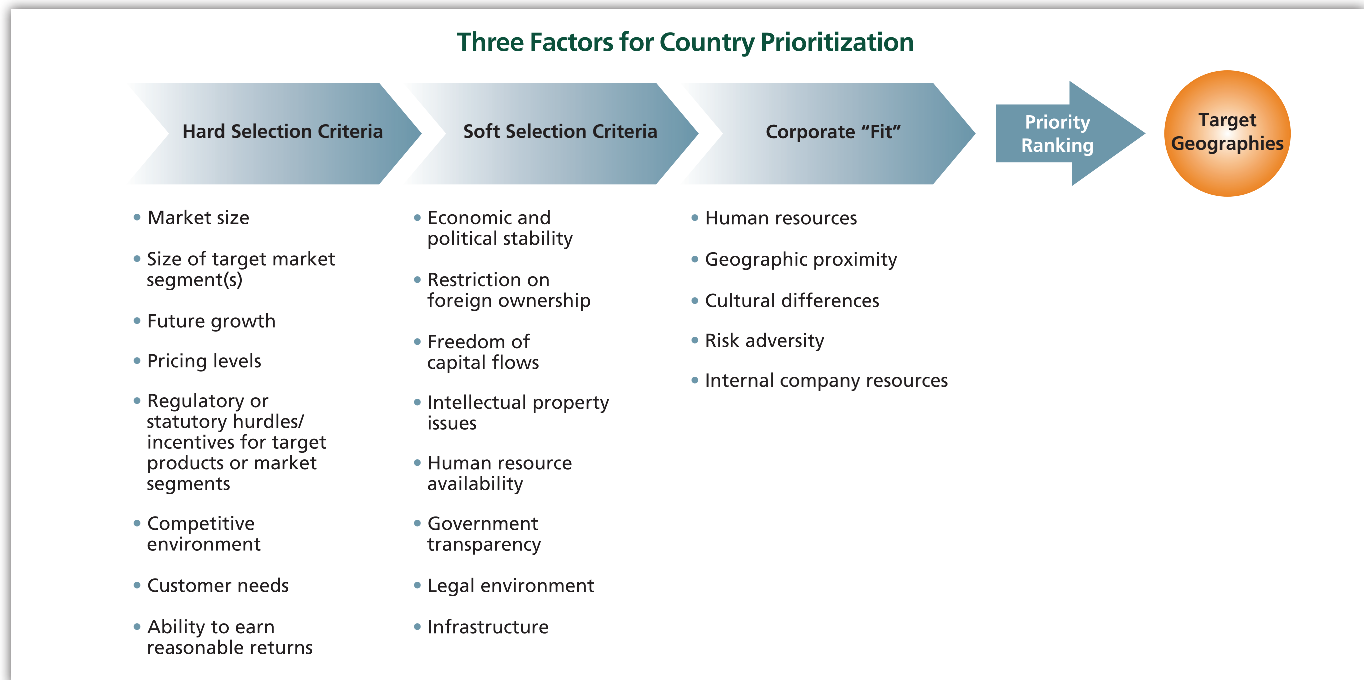
Phase I: Country Prioritization

Relying on typical indicators such as per capita income, total industry market size, or geographic proximity can be misleading. Instead, a systematic screening process will bring the best options to light to be studied further.



Business Planning for Geographic Expansion

	Phase 1: Country Prioritization	Phase 2: Market Due Diligence	Phase 3: Partner/Acquisition Due Diligence
What is it?	• Fact-based screen to identify most attractive markets for further investigation	• Detailed analysis of single market prior to investment • Analysis of external environment to include market assessment, customer analysis, competitor analysis and regulatory review • Development of market model and revenue forecasts	• Evaluate the need for partner, and critical partner criteria • Screen to determine potential candidates
When needed?	• When a large number of countries need to be evaluated • When opportunity cost of investment in one country needs to be evaluated	• Prior to commitment of investment • High level of detail required when motivation is capture of new customers/markets	• When decision to enter market is made • When comparisons with existing partner/target is advisable
Typical process	• Develop company-specific criteria to be evaluated — must be comparable across countries — readily accessible information • Secondary source search • Expert interviews	• Secondary source review • Determine relevant customer/product segmentations • Interviews with relevant sampling of current (if any) and future customers • Develop market revenue model based on quantitative and qualitative inputs	• Develop key criteria based on critical market success factors and company specific needs • Review secondary data source for potential candidates • Interview-based screening process against criteria • Selection • Detailed company due diligence



The screening should cover three factors: hard criteria, soft criteria, and corporate fit.

Hard Selection Criteria

Hard criteria provide a quantifiable gauge of market size and accessibility. For example, a U.S. biopharmaceutical firm launching a new asthma product selected the following factors to gauge relative country attractiveness:

- Total size of the pharmaceutical market and the asthma segment
- Relative pricing levels
- Level of medical insurance reimbursement available
- Difficulty and time required for a foreign product to obtain regulatory approval and to get to market
- Competitive positioning based on customer needs for the product

Typically, hard criteria can be evaluated through existing sources of information. Other criteria can be investigated through interviews with customers, competitors, and industry experts. For the asthma medication project, drug protocol and medication availability varied widely between countries and secondary data sources proved inadequate. L.E.K. conducted select physician interviews in each country, which provided the necessary foundation for a cross-country comparison of "customer need," defined as the drug being sufficiently different from existing alternatives.

Soft Selection Criteria

Soft selection criteria are more challenging to quantify, but it is important to know how difficult it would be to get the product to market given the local infrastructure. Issues to be assessed include the market's economic and political environment, its stability of currency, government efficiency, legal system structure, and corruption levels in its bureaucracy. While there are ways to handle restrictions on profit repatriation and to reduce intellectual property infringements, entering a country with a poor score on these issues guarantees extra challenges.

The figure on the following page shows that in the case of the asthma medication launch, arranging prospective countries along a compilation of soft criteria in two areas of concern – intellectual property protection and healthcare policy environment – highlighted the changes in country attractiveness over time.

Management should weigh the relative importance of all the factors and rank countries on both hard and soft criteria before making final decisions. The criteria should be as company specific as possible and the expected changes over time integrated into the analysis. This is especially important for countries undergoing rapid regulatory and market change.

Corporate Fit

Corporate fit gauges internal competencies needed for expansion. Questions to be answered are:

- How adaptable is company management?
- Does the company have, or can it find, international management talent?
- What is the company's attitude towards risk?

China and Its Unique Challenges

China has a compelling economic story. Over the past two decades, China has shown a seven-fold increase in GDP, has become the world's second-largest economy, and is now a leading trading entity. In 2001,China's exports grew by more than 6%, while globally exports fell 4%.China increasingly serves as a production hub and select foreign products have made broad inroads into their consumer market. For example, China is now the largest market for mobile phones, with 90% of those sales going to non-Chinese companies.

But for all its recent success,China's economic terrain is still rough and littered with the shells of businesses built on "quick and dirty"analysis. While each story may be unique, the majority of failures result from insufficient business planning. Eager investors have been caught up in the sheer size of the market and they have encountered three common strategic hurdles.

Failure to properly size the target market for a company's products and services is the most frequent pitfall. While the market forecast approach is the same in Shanghai and Chicago, collecting and evaluating information for the analysis is not.

Official information about China's economy is issued by the State Statistical Bureau, but economists are skeptical of its accuracy. For example, China's official index of real GDP, which showed impressive gains each year from 1997 – 2001, were not matched by growth in urban employment (slightly up), the consumer price index (slightly down), or energy use (down). "China watchers" believe these figures indicate systematic over-reporting of growth by regional authorities to the central government.

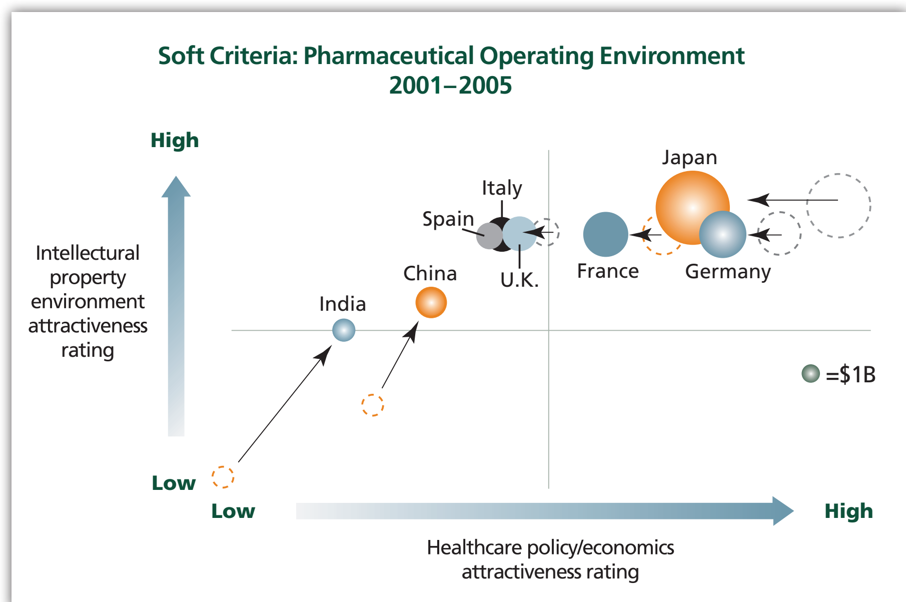
Secondary data sources are often not available or, as the above suggests,the data is inaccurate. When it is available and deemed accurate, it is rarely in sufficient detail or segment specificity. Using primary sources such as interviews with customers, competitors and channels can be the only effective way to evaluate the market.

Corporate resource requirements tend to be underestimated. The requirements are often inversely related to proximity of the target market to corporate headquarters. "Proximity"is defined as both physical distance and business culture differences. For example, a company accustomed to operating within a detailed, unbiased legal environment can find the vagaries of Chinese contract law challenging. Corporate fit does not typically make or break a decision, but it may settle a tie between markets with similar attractiveness.

Phase II: International Market Due Diligence

The result from Phase One is the identification of one or more geographic markets that appear desirable but warrant a more detailed assessment.

In Phase Two, management determines the expected value this expansion might generate. This valuation is based on a forecast of revenues, an evaluation of costs and investments, and the application of a risk-appropriate discount rate. Typically, revenue forecasting is the most challenging component and is usually more complex for a less familiar environment.



Separate regional forecasts are required to capture the wide variations in economic development, customer activity and price sensitivity. Close to 70% of China's population lives in rural areas, with average incomes at least three to four times lower than their urban counterparts. Large segments of the economy operate independently on a regional level due to difficulties in logistics and disincentives for "importing" goods from other provinces. Consumers in north,central,south and western China speak different dialects, have different tastes in foods, and exhibit different purchasing habits.

It takes extra time and resources to create cogent market forecasts given these complexities. L.E.K.'s experience has been that an urban market analysis will take twice as long in China as in Europe or North America.

Failure to prepare for local competition is another problem for foreign companies, because China is, incorrectly, viewed as a virgin market.

Many companies have invested early, only to suffer the entry of ***nimble local players***, operating inside a region on very low cost structures, taking advantage of the market that the first entrant has created. Expansion plans must include the cost of building competitive barriers – brand, technology, operations, quality, price, service – that should be tested to ensure the product is valued by this unfamiliar customer base at appropriate price points, and that the entry barriers protect competitive advantage.

The agreed-upon ***market reforms*** that marked China's entry into the WTO fuel competition by increasing access and reducing costs. While WTO offers well-publicized benefits to foreign firms operating in many sectors of the Chinese economy, this era of rapid regulatory change will pose challenges as well as the apparent rewards.

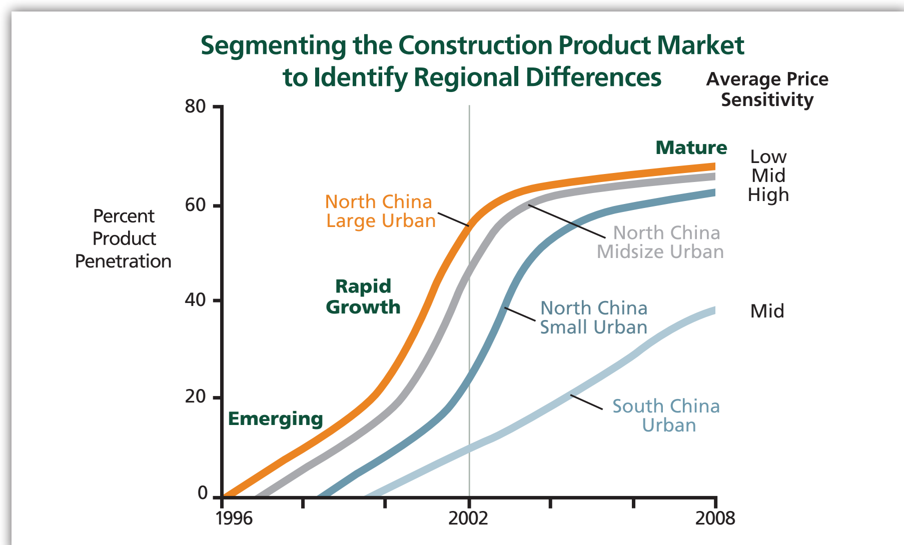
Revenue forecasts based on objective and detailed analysis are the tools for rational investment and expansion decision making. In forecasting product revenues, key steps include:

- Determining the total customer base or market size
- Segmenting the market to identify what portion should be targeted by the product or service
- Defining the expected penetration of the product or service into the market segment
- Setting the expected price per unit

Defining the Addressable Market Size in Complex Markets

A range of factors including geography, price point, technological capability and end-user group can define markets. In a developing economy, the segmentation is typically by price point or income level of potential customers. For a mid-tier retailer looking to enter the China retail sector, L.E.K. analysis revealed that consumers with enough disposable income to be considered customers represented less than 2% of the total population. That is a seemingly disappointing answer, but in a population of 1.2 billion, this translates to 24 million potential retail buyers.

In large and diverse markets it is often necessary to look at discrete subregions as independent economic areas. Recent work conducted by L.E.K. for an Asian construction products conglomerate underscores the importance of regional differences. An extensive interview program was used to develop projected industry sizing in the "base case" of Beijing and Tianjin, two large urban centers with relatively insensitive pricing.



Companies cannot rely on China's bureaucracy to take leadership in sorting out the ramifications of the reforms, and trade disputes will no doubt arise. Pre-WTO players will find they need to restructure their business models, withdraw from undesirable locations, simplify their operations, and rethink manufacturing and sourcing strategies in the absence of tariffs.

Ongoing ***reforms of state-owned enterprises (SOEs) and financial systems*** hold the promise of greater efficiency and penetration as Chinese companies gain access to capital markets and foreign firms are permitted to acquire Chinese state-owned assets.

Failure to choose the right local partner has dampened corporate returns. Foreign participation in real M&A activity in China is gaining steam. However, to date, the most common choice for a partnership structure in China has been to establish joint venture enterprises with SOEs or private corporations.

Mandated partners, imposed on foreign investors by regulatory requirements, bring with them the risks of any commercial partnership. The added problem is that, as privileged position holders, these partners are somewhat insulated from commercial or legal discipline. Mandated partnerships have declined but are still compulsory in telecom services, insurance, retailing, financial services and some large-scale infrastructure projects.

Commercial partners are sought by foreign investors for the commercial advantages they bring, rather than the legal cover they provide. Companies seek benefits such as an existing customer base, industry knowledge or a well-known Chinese brand. Local partners can also bring access to "closed" customer groups and to guanxi, the web of relationships particularly useful in untangling China's byzantine bureaucracy. But not all local partners actually possess these strengths. Companies have found they have to navigate oversubscribed transportation networks and fragmented distribution systems on their own.

Significantly fewer opportunities existed in price-sensitive smaller urban and rural areas. Growth curves in south, central and western China look substantially unalike due to differences in local purchasing patterns, available substitutes and customer needs. Only through a segmented geographic approach could a viable revenue forecast model be developed.

Developing Forecasts in Rapidly Changing Markets

Forecasting new revenues is particularly difficult in unfamiliar markets and those undergoing rapid changes in the competitive landscape and/or regulatory environment:

- ***Competitive landscape –*** Maybelline, now a division of L'Oreal, was the first cosmetics company to enter the China market over a decade ago. Their challenge was to construct forecasts without benchmarks of consumer behavior, because the sale and use of cosmetics had been discouraged.

  This competitor-free situation is a rarity today, with most industries now experiencing entrants from global competitors; state-owned enterprises; and low-cost, well-connected local companies emerging from China's private sector. Entry forecasts need to recognize this dynamic.

- ***Regulatory environment –*** Substantial regulatory reform may make forecasting more challenging, but it can also provide a competitive advantage. "Big Bang" events such as the creation of the European Common Market, NAFTA, or China's accession to the WTO create new opportunities for companies to capture change in newly opened competitive arenas.

Phase III: Acquisition and Partnership Development

International expansion is often combined with acquisition or a strategic partnership as the vehicle for entering a country. This requires the entering firm to quantify the acquisition or partnership value. Companies should ask themselves: *Do we need a local partner?* and *What kind of partner is appropriate? Do we need a local partner?* The answer lies in straightforward business basics, whether an acquisition, partnership or joint venture — *What value does a partner bring? What is the partner worth?* and *What are their customers and their assets worth?*

Partners can be especially valuable if they provide:

- Access to valuable or scarce resources or raw materials
- Privileged market position
- Access to transportation or distribution systems
- Access to specific markets or customers
- Valuable brand recognition or identification

Joint ventures were formerly structured to absorb existing Chinese assets and labor, but overblown asset valuations have steered companies toward greenfield joint ventures or those that incorporate select assets of the Chinese party.

Importantly, foreign investors can skip joint ventures and opt to "go it alone" by establishing a wholly foreign-owned enterprise (WFOE) – currently the most common form of direct investment in China. By some measures, WFOEs are more likely to be profitable, have shorter times to break-even and are more autonomous. In L.E.K.'s experience, an active physical presence is required. There are very few successes with licensing or pure distribution; even in franchising businesses, most principals stay closely involved.

In sum, China remains a vibrant and attractive market and has become the second-largest recipient of foreign investment. Last year, even as foreign direct investment dropped globally, it continued to increase in China by two billion dollars. China will remain a tempting target for expansion for growing companies around the world – but will only add real shareholder value for those who follow a disciplined process.

In China, 80% of its coal is mined from state-owned enterprises (SOEs), and over 90% of China's power is generated from SOE power companies. For a foreign mining concern, the relatively closed nature of this industry, difficulties with distribution and customer access increase the need for a local partner.

At the other end of the spectrum are consumer goods. Access to raw materials is not an issue, but distribution is – it ranks as one of the thorniest operational hurdles in China. Many companies find that local partners are not more efficient or effective in this regard. The best distributors of consumer goods are Coca-Cola, Procter & Gamble and Wrigley. These leaders often serve as the models for locally developing firms, rather than the other way around.

What kind of partner is appropriate?

Many companies still select their local partners reactively, based on deals being brought to them rather than through a systematic screening process, and they end up with a suboptimal partner. L.E.K. recommends first outlining the specific criteria and benefits you are looking for and then identifying a range of companies that could provide those benefits. For the mining example, the likely partners would own coal resources, but holders of the limited number of coal import and export permits could be considered as well. From this, specific companies are evaluated, ranked according to "fit"and approached for a possible partnership. Here "fit" must include alignment between the company's and partner's objectives. The Chinese adage for a partner mismatch – "One bed, two dreams"– sums up many failed joint ventures.

Evaluating a Coal Mining Partnership

Critical Partner Value	Industry Dynamic in China	Partner Rationale
Access to valuable or scarce resources or raw materials	Coal resources controlled by local state-owned mining groups	**High**
Privileged market position		**High**
Access to transportation, distribution systems	Coal relies on rail transport, where capacity exceeds demand, industry "insiders" given preference	**High**
Access to specific markets, customers	Coal-to-power conversion chain controlled by government-owned enterprises, foreign companies may have trouble accessing	**Medium-High**
Valuable brand	Commodity business	**Low**

Conclusion

The principal cause of failures in international expansion has been commercial misjudgment. Occidental's Antaibao mine project, for example, survived many challenges from Chinese partners and regulators, but ultimately failed when coal prices plummeted well below original estimates. A number of high-profile brewing joint ventures failed when they overestimated China's thirst for more expensive internationally branded beer. When entering any new geography, the odds of success can be improved significantly if the company conducts more due diligence,identifies realistic market demand,and tests the waters prior to an aggressive expansion effort. Gathering locally generated information is time consuming, but it is much less costly than changing direction once an investment has been made.

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