Prof. Dr. Thomas Hofmann | June 2014

SETTING UP IN EMERGING MARKETS.

The risks and opportunities hiding in uncharted territory.

In times of enormous worldwide competition, producing local-for-local – and in best-cost countries wherever possible, too – has become an absolute necessity in order to keep pace with the continuously increasing pressure on costs. Our local analyses over the last three years specify economic perspectives in four target countries with reference to their cultural particularities. This follows on from our concept of "growth off the beaten track" in our last newsletter: while the regions we present in what follows offer alternatives for future investment, we are careful not to ignore the risks that come with the territory.

1| INITIAL SITUATION

Brazil, Russia, India, China and South Africa – also known as the BRICS-states – have long been held up as the global growth regions; and the economic data confirm this impression beyond all doubt. At the same time, the overall conditions and support offered by these states are not optimal for every business looking to invest. Furthermore, some BRICS locations have lost their advantage, such as China, whose wage costs are no longer South-East Asia's cheapest and whose urban infrastructure is reaching its limits. It was for these reasons, for instance, that we examined neighbouring Vietnam and Cambodia (the new insiders' tip in the region) as alternatives to China.

Furthermore, the distance between the place of production and the sales market can often be more of a disadvantage than a plus-point, both for the products and for the people involved. In view of this, we also studied the risks and opportunities of North Africa as an alternative to South Africa; in this region, the abrupt change in political frameworks in recent years has opened up new perspectives – both positive and negative – for investment. Our comparison between Morocco and Egypt will give you an idea of just how broad the spectrum in the region is.

The central questions are: which resources do these countries have at their disposal? How qualified is the population? And what do their cultural backgrounds allow us to expect in terms of levels of dedication among potential staff?

2| MATURITY IN THE POTENTIAL TARGET REGIONS

As a first step into considering the investment suitability of these regions, macroeconomic evaluative data as in the tables below offers a good basis. This comparison shows the difference between Morocco and Egypt in North Africa and between Vietnam and Cambodia in south-east Asia; to provide an overall benchmark, we have listed figures for Germany, which has a population comparable to that of both Egypt and Vietnam (Morocco and Cambodia have significantly lower populations). In terms of the comparison of surface areas, it is important to bear in mind that despite the extensive territory of the North African states, industrial development is concentrated by and large on the coasts and along the river Nile.

The per capita gross domestic product (GDP) figures for North Africa are, on average, twice those of south-east Asia; then again, the comparison to Germany illustrates the gap between developed economies and emerging countries. Yet while growth in Germany has been stagnant for quite some time, there is clear progress in the regions examined. At 6%, Cambodia's GDP growth is strongest, while in Egypt growth has all but stalled, due mainly to the political turmoil of recent years, showing very clearly the fragility of these systems.

	Germany	Morocco	Egypt	Vietnam	Cambodia
Population	82m	33m	80m	92m	14m
Surface area	357k km²	447k km²	1001k km²	332k km²	181k km²
GIP	3.577bn $	99bn $	236bn $	123bn $	14bn $
GDP per capita	43,700 $	3,200 $	3,100 $	1,900 $	1,000 $
GDP growth	0.7%	+4.0%	-0.2%	+4.2%	+6.0%
Average age	44.9 years	26.9 years	24.3 years	27.8 years	22.9 years
Literacy	98%	56%	72%	93%	78%
Percent. living in poverty (<2 US$/day)	0%	14%	15%	43%	53%
Gini coefficient	28%	41%	31%	36%	38%
GNP per capita (Atlas method)	44,260 US$	2,960 US$	2,980 US$	1,550 US$	880 US$
Cement production	33 Mio. t	16 Mio. t	45 Mio. t	50 Mio. t	2 Mio. t

Table 1: Cross-comparison of characteristic macroeconomic data

Beyond GDP figures, it is interesting to compare average age: Germans are nearly twice as old as Cambodians, almost certainly in no small part due to the horrific actions of the Pol-Pot regime in the 1970s, which systematically murdered the intellectual classes of the population.

In terms of literacy, Vietnam's 93% is a positive figure by comparison with the countries examined and promises rich labour market potential in the form of a young, committed and inquisitive workers.

The poverty figures shown in the table refer to the two-dollar-a-day cut-off defined by the World Bank as moderate poverty; this is used as an indicator for the poverty typical of mid-income countries and shows the percentage of the population who have disposable resources of two dollars a day or less. In South-East Asia, poverty by this measure is almost three times as high as in North Africa, and this ratio is also reflected in terms of overall income; the lowest wage costs – and thus the largest overall cost advantages – are offered by Cambodia.

In accordance with the World Bank definition, the Gini coefficient is used to show to what extent the unequal distribution of household income differs from a completely homogenous distribution in the economies examined. A high Gini coefficient can therefore be used to identify the possibility of social tensions: in Brazil, for example, the coefficient is considerable, at 55%, while Mexico is at 48%, China at 47%, and the USA at 45%; Germany, meanwhile, has a lower Gini of 28%, only marginally higher than that of the Nordic countries, whose social equality is used as a global benchmark. On this scale, the four countries examined are all somewhere between these two extremes, and this can be interpreted as a positive sign for societal stability.

Cement production – in which Vietnam leads – may appear to be a somewhat unusual factor, yet it allows us to draw conclusions about investment in infrastructure. As Germany is a highly developed economy, its cement production is below that of the emerging markets of comparable size and population, proving that this is a stable economic early indicator and shows trends for future growth.

> | NORTH AFRICA

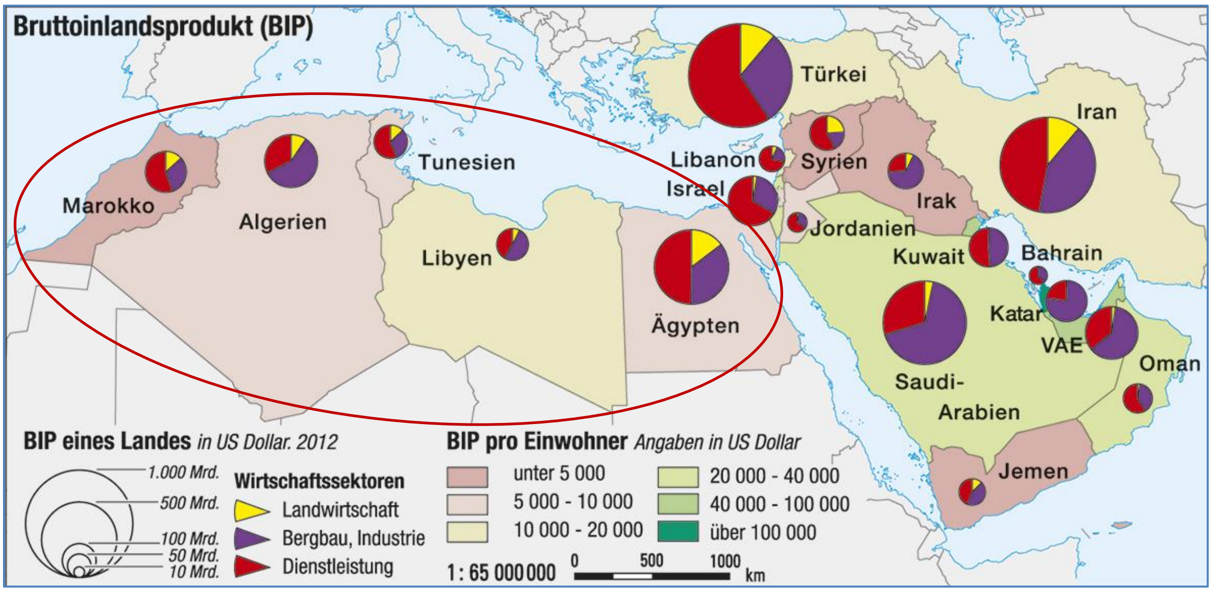
With annual growth rates of almost 6%, Africa has become the world's second most dynamic continent. The increases, however, remain unevenly distributed, with one half of African states showing very good growth while the other half is tackling its problems stuck at three to four percent. Political unrest and natural catastrophes have forced millions of Africans to flee, robbing these countries of a target group with purchasing power.

China has been very quick to identify the regions of the continent with the most potential and to harness their rapid growth for its own needs; seven African countries have become hosts to industrial zones housing hundreds of companies.

Europe, meanwhile, has not profited to any great extent from this growth – despite the fact that it is Africa's largest trading partner. The EU exports goods to the value of 153 billion Euros south to the neighbouring continent, with 22 million of this figure alone coming from Germany.

Currently, gaps in infrastructure and education are the principal obstacles in the market, and in order to counteract these issues and continue to lower barriers to entry, Africa is aiming to set up a free trade zone by 2017; this would at least be sure to alleviate the situation somewhat.

Economic development on the continent shows some noteworthy focus points: besides tourism and solar/wind energy, it is above all industrialisation in the agricultural sector which is drawing in investment capital.



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This diagram shows the size and spread of GDP figures across the countries of North Africa, as well as the distribution across the three sectors of the economy. Egypt and Morocco have a similar structure in that the services sector is, with 50%, the main impetus to economic development (in both countries, services is substantially tourism-related); industry contributes one third.

Looking at the Moroccan economy, it is striking that, while only roughly one sixth of GDP comes from agriculture, around 40% of the work force is employed in farming. Meanwhile, the industrial sector, as well as services (principally tourism), are showing strong growth and promise positive perspectives for this north African kingdom.

One option for Morocco is car production, which already has a long tradition in the country: as early as 1962, the Société Marocaine de Constructions Automobiles (SOMACA) was assembling CKD (completely knocked-down) Fiat and Simca products in an industrial zone to the north east of Casablanca. Since 2006, 80% of this Franco-Moroccan joint-venture has been owned by the Renault Group, and even assembles the Porsche 911 for the African market in order to make full use of its production capacities.

Due to its relatively high level of political stability and state subsidies, Morocco has become an attractive destination in north Africa by comparison to eastern European production sites. The Agence Marocaine de Développement des Investissements (AMDI) offers enticing investment support packages and the Moroccan automotive industry association (Association Marocaine pour l'Industrie et le Commerce de l'Automobile, AMICA) can provide competent contacts.

In 2012, Renault-Nissan opened a new, carbon-neutral works 14km outside of Tanger to produce the Dacia Lodgy, Sandero II and Dokker models; located at Tanger Automotive City, the site is conceived to produce 400,000 units annually, with 6000 workers employed directly. Suppliers are being brought in with the use of tax breaks for the first five years in country, followed by a reduced rate for 25 years.

The close relationship between Morocco and the Renault company means that, for some time into the future, Morocco will not be an easy enterprise for other OEMs; yet suppliers may well find it a promising point of entry offering access both to the African market and to the French automotive industry.

Due to the arrival of the OEM, numerous suppliers have already opened production sites in country: Hirschmann Automotive in Kenitra 200km south of Tanger, for example, which produces plug connections and contacting systems; Leoni, cable producers, is not only producing in the Casablanca conurbation, but has opened an R&D centre there too.

Alongside these positive developments which, up until the Arab Spring, were also taking place similarly across the north African states, the example of Egypt shows the dangers that are nonetheless present for investors. Although Egypt initiated a promising education drive before the rupture in the form of the American and the newly-opened German universities, this kind of activity has now come to a complete standstill. Furthermore, in view of the currently unpredictable situation, most foreign skilled workers have left the country: many of the Peugeot, GM, BMW, Nissan, Hyundai, Daimler, and Suzuki assembly lines are already idle or are being

rapidly ramped down; the sales market, too, has all but collapsed. In essence, this country is now on the brink of civil war.

There is another point that those looking to invest in north Africa would do well to bear in mind: the influence of Islamic fundamentalism on the population is very strong, and one effect of this may be a lessened enthusiasm for new projects and economic progress.

> | SOUTH EAST ASIA

In contrast to north Africa, the population in Vietnam and Cambodia – the two countries we examined – is influenced principally by Buddhism. Due to their rich and varied history, these countries also house Christian, Hindu, and animist currents, leading to a widespread attitude of tolerance; especially following the long-lasting wars and atrocities, the younger generation does not want to be held back the past and is looking to grasp its own fate in its hands and change the future for the better.

While officially socialist, the region is in practice dominated by capitalism and the political frameworks are stable (despite widespread, latent corruption). The international actors in this market are diverse, with China, the USA, Australia, Thailand, and France all playing a role. Germany is comparatively under-engaged in these markets: in recent years, Bosch has greatly expanded its activity near Ho-Chi-Minh-City (HCMC, formerly Saigon), where rigid chain links are produced for Asian motorcycle powertrains.

Measuring over 1600km from north to south, Vietnam stretches across two climate zones. Alongside the two competitors in the form of HCMC on the Mekong delta in the south and the capital Hanoi on the Red River delta in the north, in recent years, a third economic hotspot has sprung up around Da Nang, precisely on the border between the two climate zones. The city is now one of south-east Asia's fastest growing, and its natural harbour is used as a port for Laos and north-eastern Thailand. In the immediate vicinity, the Vietnamese government and the World Bank have established two industrial zones at Chu Lai and Dung Quat; the country's oil refinery is situated here and shipbuilding plays an important economic role. As a result of these location factors, a Taiwanese company is looking to invest in a steel works and Korean companies are planning to produce equipment for heavy industry, such as cranes and electric transformers, here too. As far back as 2001, KIA started a joint venture with Truong Hai Automobile Co. (THACO) to assemble cars in country; THACO itself is to be found all over Vietnam as an own-brand for light and heavy goods vehicles.

As well as the industrial sector, there is already a range of investments in services; since 2002 now, the Metro concern has been active in the three abovementioned areas of Vietnam: in Hanoi and Haiphong in the north, Bien Hoa and Can Tho in the south, and Da Nang in the centre.

While, when compared to Vietnam, Cambodia may appear backward, its pace of development is considerably higher: the International Monetary Fund (IMF) lists the country as the fourteenth fastest growing economy worldwide in terms of percentage of GDP, and this becomes particularly clear in the region around the capital Phnom Penh in the form of numerous construction projects on a gigantic scale; meanwhile, prime real estate on the river banks of the city centre is now going for 3,500 to 4,500 US$ per square meter (land prices have been rising by 12% annually in recent years).

Even though most of the labour force is currently in agriculture, tourism and textiles are increasingly gaining importance, while economic progress is leading to better infrastructure and an improved level of qualifications among the country's youth.

As a connector between the strong economies of Thailand and Vietnam, trade is of crucial importance to the whole ASEAN region. As such, Cambodia has gone up 46 places in just four years in the World Bank's ranking of logistics services; much of this is thanks to the Trade Related Assistance in Cambodia (TRAC) programme, financed by the Cambodian state to simplify the border and customs regimes for importing and exporting goods.

3| PROGNOSIS

Comparing the situation of Vietnam and Cambodia today with that of China and Thailand at the beginning of their economic upswing, we can draw a range of parallels. By the same token, there are lessons to be learned from the mistakes of earlier waves of globalisation by looking at both successful and failed investments. While the time is currently right to engage in south East Asia in both of the countries examined, anyone looking to do so should also consult with expert partners.

Beginning with the macroscopic approach presented in this study, a variety of microscopic factors also need to be analysed and evaluated in a location report specifically tailored to the investment planned.

As we have shown, North Africa also offers some attractive options for European companies looking for investment opportunities in best-cost countries away from the BRICS states – as long as cultural factors and political risks are taken into account in so doing. The proximity to sales markets is greater than in South-East Asia, wage costs are low, the population is young, education is present in the coastal growth centres, and there are investment incentives, meaning that tier 1 and tier 2 suppliers above all should be checking these locations.

As well as economic aspects, investors should of course also rely on their own common sense during scouting visits to potential sites. In this respect, it is important to mention that all four regions are not only economically important, but also of interest to tourists: this means that future expats will also be interested in the attractive landscapes and pleasant climates – and happy expats are the basis for a successful engagement abroad.

If you are the type who is still reluctant to go for growth off the beaten path, then a look in the history books might give your confidence a boost. Robert Bosch left his Ulm home early his life in order to find out about different markets and forms of production across the world; he was given a job abroad and only three years after he founded his own firm, he broadened his activities to include England. 20 years later, he was present on every continent in the world, and the lasting success of the business is testimony to how perceptive his global vision was. Yet successful international expansion is by no means a no-brainer, and more often than not, the first step is not the move abroad, but an analysis of the company situation with regard to its domestic locations.

Based on an accurate estimation of a company's own resources, strengths, and potential as against its peer group, its focus can then successfully be turned abroad to the target region – supported by expert partners. All too frequently, premature decisions are made without a master plan in which the legal, economic, and infrastructural characteristics of the target country are described and from which corresponding to-dos can be derived. An important question at this point is whether these additional challenges can be tackled adequately by the current team as it tries to keep on top of developments in the domestic market at the same time.

If you are unsure about how to answer this question, or are generally looking for advice and/or decisive process support from experienced partners, then please do talk to us.

As the old African proverb says: "If you want to go fast, go alone. If you want to go far, go with other people."

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MANUFACTURING INDUSTRY

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