

Beyond Asia

Strategies to support the quest for growth





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Introduction

Asian companies are transforming the global business landscape. Gone are the days when traditional multinationals - based almost exclusively in the West - looked to Asia mainly for cheap labor and low-cost manufacturing. Today, Asian companies are major players in international business, forming 87 of the Fortune Global 500 largest firms. Fanning out across the globe in search of new investment opportunities as well as access to natural resources, technology, brands and expertise, Asian companies are investing in a variety of geographic regions and sectors, with telecommunications, banking and electronics joining the more traditional manufacturing and extractive industries. This expansion will continue steadily over the next decade: foreign direct investment outflows from the nine Asian countries we surveyed for this report will reach US\$400 billion by 2020, according to projections by Oxford Economics (see chart).

The impact of this trend should be momentous, creating new spheres of competition, a new generation of global companies, and changing patterns of trade flows and foreign direct investment both within and outside the region. In fact, the three largest economies in East Asia - China, South Korea and Japan - recently signaled their intention to form a regional trading pact to stimulate economic growth. At the same time, the crisis in the Eurozone continues, adding to uncertainty in developed markets.

Global expansion for Asian companies is not, however, without its challenges. For companies used to operating solely within Asia, playing on the global stage is no easy task. It will require major shifts in

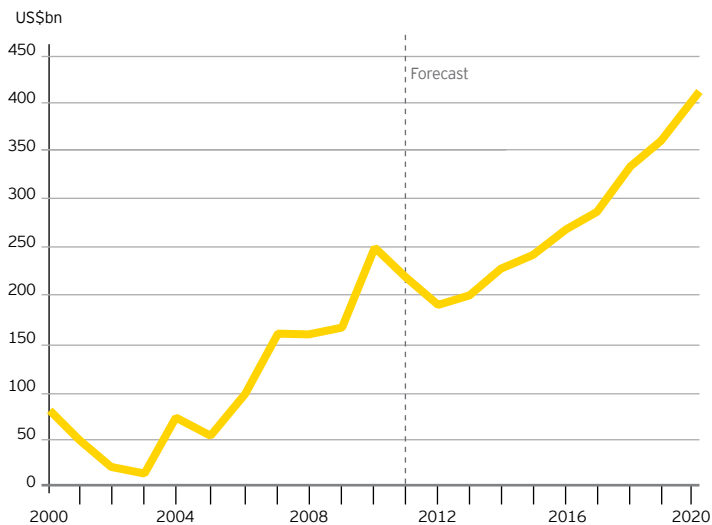
organizational design, talent management and decision-making processes, as well as pose serious execution challenges. For Asian companies already operating globally, gearing up for additional growth will require greater understanding of the nuances of global business to leverage the next big opportunities.



In this report we explore the practical issues - and ways to resolve them - that both regional and global Asian companies will need to consider in order to succeed in the next few years. The report contains challenging and thought-provoking insights for all businesses that are developing strategies for global expansion.

Lou Pagnutti
Asia-Pacific Area Managing Partner
Ernst & Young

Asian outbound foreign direct investment to rise strongly



Source: Oxford Economics/IMF

Fast facts: Asia

- ▶ Rapid-growth markets from Asia represent the fastest-growing economic region in the world, with annual growth forecast at more than 6% a year.
- ▶ The IMF expects advanced economies to grow by just 1.4% in 2012 and 2% in 2013. The corresponding figure for East and Southeast Asia in 2013 is 7.9%.
- ▶ Since 2000, Asia has been the fastest-growing source of foreign direct investment (FDI). Its businesses currently produce a quarter of the world's exports (US\$3.77 trillion in 2010) and form 87 of the Fortune Global 500 largest firms.
- ▶ FDI outflows from East and Southeast Asia recorded a compound annual growth rate of 22.9% in 2005-2011, jumping from US\$70 billion to US\$242 billion.
- ▶ Investors from East and Southeast Asia are major drivers of growth in global foreign direct investment (FDI) outflows, making up 16% of the world's total FDI (up from just 7% in 2005) and driven by increased outflows from mainland China, Hong Kong (SAR), Malaysia, South Korea, Singapore and Taiwan.
- ▶ Intra-regional trade is expanding rapidly, reflecting the shift towards higher consumption in Asia. China leads the way in terms of outflows and destination, with growth for Indonesia, South Korea, Thailand and Vietnam close behind.
- ▶ Trade flows from Asia to the US and Canada, the Middle East, Latin America and Africa are expected to increase by over 10% a year up to 2020.
- ▶ Cross-border M&A purchases are consuming an ever-larger slice of FDI flows, with purchases from Asia reaching a record US\$94 billion in 2010.
- ▶ The China – US trade route is forecast to see the biggest increase in the world, predicted to rise by almost US\$700 billion by 2020.

Sources: UNCTAD, IMF, Oxford Economics

In this report, we use the term “Asia” to refer to the nine rapid-growth markets in East and Southeast Asia that we surveyed. These markets are mainland China, Hong Kong (SAR), Indonesia, Malaysia, Singapore, South Korea, Taiwan, Thailand and Vietnam.

About this report

Beyond Asia: strategies to support the quest for growth is based on a survey of 617 business executives based in East and Southeast Asia, conducted by the Economist Intelligence Unit in March and April 2012. Companies were headquartered in mainland China, Hong Kong (SAR), Indonesia, Malaysia, Singapore, South Korea, Taiwan, Thailand and Vietnam. In addition to the survey results, qualitative interviews were conducted with several Ernst & Young sector and country leaders and senior executives from companies across the region. Oxford Economics provided analysis of current and projected trade and foreign direct investment flows among individual Asian markets and between Asia and the rest of the world.*

All the companies we surveyed had significant operations, revenues or profits outside of their home market. Our objective was to explore the *differences* among companies in their quest for growth. What were the key challenges facing companies in achieving their growth objectives, including strategic planning and operational capabilities? In conducting our analysis, we examined the survey responses by company size, profitability and location. Perhaps surprisingly, the data suggested that the most critical difference between companies was the level of internationalization that each had achieved: those that were already operating at a significant level in two or more

markets outside Asia were addressing growth challenges in a different way from those that were still operating just regionally. Our analysis showed no substantial differences by company size or location.

As a result, throughout this report, we contrast the findings for the two groups that showed the most striking differences (493 companies). The remainder of the sample consisted of companies operating in only one market outside the region.

1) Globally focused (“global”) companies:

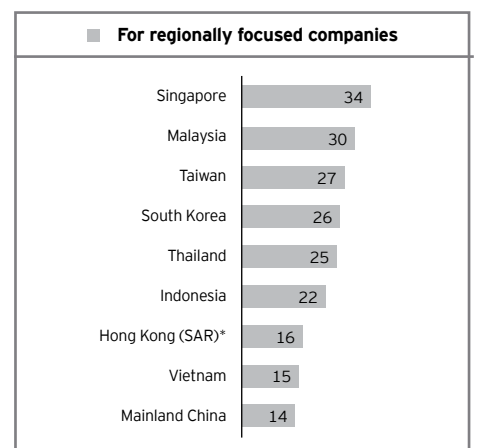
177 companies with operations in two or more of the following markets: Australia and New Zealand, Brazil, Eastern Europe, India, Japan, Latin America, Middle East & North Africa, Russia, Sub-Saharan Africa, US or Canada, Western Europe.

2) Regionally focused (“regional”) companies:

316 companies with operations in only East and Southeast Asia.

In our research, “global” did not necessarily equate to multinational, and “regional” did not necessarily signify small or entrepreneurial companies. Both groups contained companies from all nine countries surveyed; large and small companies by revenue, a mix of public and private ownership, and a spread of industry sectors.

Geographical areas of operations In which of the following countries or regions do you conduct a significant amount of business (excluding your company’s home market)?



Note: Scores shown = percentage of respondents
* Special administrative region



Executive summary

**Beyond Asia: strategies to support
the quest for growth**

Asian companies are on the move. Once viewed by Western multinationals primarily as a source of low-cost labor and manufacturing, Asian players are now international players in their own right. They are expanding into new markets for a variety of reasons: growth, diversification, routes to market, access to resources, access to skills, and access to technology. And they are doing so in a variety of ways: moving into both rapid-growth and developed markets, revising their business models, exploring growth through greater business efficiencies and carrying out mergers and acquisitions.

As Asian companies grow, however, they are running into challenges that could slow or even block their expansion. These challenges - and the responses to them - are not necessarily the same for companies that operate only within Asia (regionally focused) and those with significant operations in at least two markets outside the region (globally focused). This difference between regional and global companies is the highlight of our research, as no significant differences emerged by company size or location.

Asian companies' expansion patterns

Although newly globalizing Asian companies are not restricting themselves geographically, some markets stand out as more attractive than others because of proximity, lower barriers to entry or favorable business conditions. Regional and global companies exhibit differences in their market expansion patterns.

Companies that are already global - and presumably have the capabilities to handle the large Asian markets - expect most of their growth to come from Asia in the next three years, including India, China and rapid-growth markets such as Indonesia and Vietnam.

By contrast, companies operating just within Asia cite Western Europe and the Middle East and North Africa (MENA) as their top destinations for investment, thanks to the attractively priced assets of the former and the cost-effective manufacturing of the latter.

In general, Asian companies are looking to new markets not only to expand their customer base but also acquire new technology and capabilities.

Companies that are still regional recognize that they need to get the basics in place as a first step when expanding outside the region. They are focused on building capabilities and resources - access to skilled workers, raw materials, low-cost labor and intellectual property.

Global companies appear to already have these capabilities in place, and are concentrating instead on acquiring new customers and technology.

Companies typically follow an expansion path that progressively deepens their involvement in new markets, going from direct exporting to local sales and distribution desks and finally to joint ventures or acquisitions.

Both the global and regional companies in our survey still rely heavily on local sales desks, direct exports and franchises or licensing to explore new markets.

The global companies, however, are more likely than their regional counterparts to try mergers and acquisitions, partnerships, alliances and joint ventures as a mode of entry into new markets, given their deeper knowledge of markets outside the region.



Challenges

While Asian companies are on a high growth trajectory, they also face a host of dilemmas. Our research identified four key challenges:

Challenge 1: Moving up the value chain could erode a critical advantage - low cost.

Climbing the value chain is an aspiration that all our respondents share. They highlight leading technology and the quality of their products, services and workforce as their key advantages. Having a low-cost business model - Asian companies' key competitive advantage a decade ago - comes toward the bottom of the list. But while it is essential to climb the value chain to compete, Asian companies face the danger of doing so at the expense of cost competitiveness.

Challenge 2: The nuances of local markets are difficult to understand or control.

Political instability, sudden regulatory shifts, varying consumer preferences, questions of local autonomy versus global control - the complexities of international expansion are many, and are not easy to deal with. They can quickly damage the benefits of scale if not managed effectively.

Challenge 3: Top management teams often lack an international outlook. Asian companies say their leadership teams need a better understanding of global markets and a more strategic approach to international hiring. For most companies, finding high-quality local talent is problematic, but expatriates are not always the answer either.

Challenge 4: Full international expansion requires shoring up infrastructure and capabilities. That means spending considerable time and resources on building such functions as strategic planning, financial management, tax planning, and risk and control frameworks, as well as collaborative relationships with partners.

There is no doubt that Asian companies are on a highly successful expansion path. But they are already encountering challenges and risks that even established multinationals would find hard to handle. The strategic moves Asian companies must make to counter these obstacles are tricky and difficult, but they are essential steps in the path toward globalization. In this report, we recommend some winning strategies for both regional and global companies.

Regional companies seeking to build a global footprint must ensure that they get the basic capabilities in place before making bold moves.

Recommendations

Globally focused and regionally focused companies in Asia have different priorities. Below we offer recommendations for these two groups in our survey:

Recommendations for globally focused companies

Put in place robust risk management. A more diverse international footprint and the need for greater autonomy at the local level emphasize the need for a robust risk management framework. Our research has shown that companies with more mature risk management frameworks can outperform their peers financially.

Make the transition from investment to profitability. For many globally focused Asian companies, the priority remains investment and growth. But as these investments mature, they will require a greater focus on process, a consideration of where economies of scale can be derived, detailed tax planning and more sophisticated finance functions.

Take steps to make the corporate culture more international. To succeed in global markets, companies need a management team and corporate culture that reflects the diversity of their customer base and

operations. By recruiting managers with experience of different markets, reducing reliance on expatriate workers, and putting in place global talent management programs that enable the flow of key talent around the world, companies can disseminate best practice and create a more international workforce.

Choose which functions should be global or local. Autonomy for local managers helps to ensure that products and services are relevant to the local customer base, but not everything needs to be decentralized. Companies need to think about where they can derive economies of scale without compromising local relevance.

Recommendations for regionally focused companies


Prepare for greater competition. Over the next few years, Asia will remain a dominant recipient of inbound foreign direct investment. This will increase competition - for assets, talent, resources and customers. Regional companies need to consider whether they need to join other regional companies in looking outside Asia for new opportunities.

Build the capabilities for international expansion. Regional companies seeking to build a global footprint must ensure that they get the basic capabilities in place before making bold moves. They need managers who have an understanding of international markets, and core functions, like finance, HR and IT, that can support multiple markets.

Rethink organizational design to enable greater local autonomy. Greater geographic scale makes it more difficult to control from the center. Regional companies should therefore consider devolving greater autonomy to regions, but do so within a set of parameters and risk frameworks. This devolution, with its consequent upswing in local empowerment, is particularly crucial for the establishment of an effective and optimized supply chain.

Leverage global resources. Increased competition means that regional companies will be under greater pressure to ramp up their innovation, product and service mix and talent pipelines. By building partnerships with companies outside Asia, or acquiring companies with the right resources and expertise, regional companies can leverage global resources to ensure that they remain globally competitive.

Asian companies face an upward climb in their quest to globalize. Without careful planning and well-thought-out strategies, they could encounter major roadblocks to expansion. Our report explores these obstacles and their business implications, and discusses some effective tactics that these companies can adopt to sustain their impressive growth.



**Setting the scene:
Asian companies' expansion quest**

The history of Asian business is entering a new phase. Key economies in the region, including China and South Korea, have become export powerhouses and home to some of the world's largest companies. Three of the top ten companies on the Fortune Global 500 are Chinese, while Korea's Samsung, Hyundai and SK Holdings all make the top 100.

Many Asian companies are following what Peter Williamson, Professor of International Management at the Judge Business School, terms an "inside out" strategy, whereby they focus initially on smaller, adjacent economies, then larger rapid-growth markets and finally developed markets. "By starting from these adjacent markets, which fit their knowledge and business model better, they can learn from experience and then move on to larger rapid-growth markets, before being ready to tackle Europe and, finally, the United States." These companies are using a variety of strategies to move into both rapid-growth and developed markets: revising their business models and exploring growth through greater business efficiencies.¹

That growth path isn't necessarily a smooth or linear one. In the April 2012 Asia-Pacific edition of Ernst & Young's *Global Capital Confidence Barometer*, 48% of the respondents said they were focused on growth (vs 52% globally), while 46% were focused on maintaining stability, consolidating gains made over recent years.² Of course, the picture is not uniform across Asia: the *Global Capital Confidence Barometer* shows companies in China with a relatively greater focus on maintaining stability, with those in Southeast Asia and Korea more focused on growth.

In this report, we see that Asian companies are increasingly coming up against new challenges to growth, outside their home country, whether just within Asia, or outside the region.

Footnotes

1. *Winning in volatile times: a roadmap for surviving and succeeding in the current uncertainty*, Ernst & Young, April 2012
2. *Capital Confidence Barometer*, Asia-Pacific edition, Ernst & Young, April 2012

Where are Asian companies expanding?

Asian companies are not restricting themselves geographically, but some markets stand out as more attractive than others because of proximity, lower barriers to entry or favorable business conditions. Our survey shows a significant difference between globally and regionally focused companies with regard to their market preferences.

Globally focused companies

Companies that already have a global footprint still expect their greatest growth to come from Asia in the next three years

(see Figure 1). In particular, India and China, the growth powerhouses of Asia, are the main priorities for globally focused companies, which are also targeting second-tier rapid-growth markets in Asia, particularly Indonesia and Vietnam. According to Ernst & Young's *Rapid-Growth Markets Forecast* (Spring edition, April 2012), these markets will be star performers in 2013: projected GDP growth is 8.6% for mainland China and Hong Kong (SAR), 8.5% for India, 7.1% for Vietnam and 6.7% for Indonesia.³ Globally focused companies are primarily targeting these markets because:

New and existing market segments within China still hold great promise.

Eastern China has attracted significant investment and interest from East Asian firms, but in the longer term, Central and Western China may offer good growth opportunities as well. In addition, growing affluence in China and changing consumer tastes and preferences offer significant opportunities for market expansion. Intense competition and a slowing economy, however, are leading Asian companies to look to other economies within the region.

India and other South Asian markets offer long-term growth potential. Despite India's fiercely competitive business environment and bureaucratic restrictions, globally focused Asian companies view it as the second best country for expansion opportunities. Elsewhere in the region, Indonesia, Malaysia and Vietnam have been gaining favor for their markets' medium- to long-term growth potential as platforms from which to export to Asia and beyond, and as economies for sourcing manufactured inputs. These countries also offer rapidly growing middle-class consumer populations.

Regionally focused companies

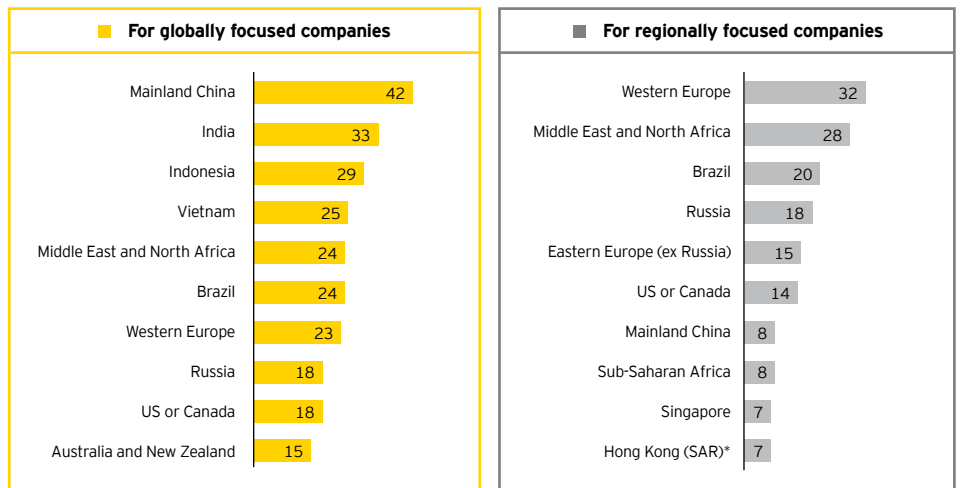
By contrast, respondents from regional companies expect their best growth opportunities to come from outside Asia.

India and China barely make the list for these companies, many of which may simply not

have the resources and capabilities to succeed in these huge but challenging markets. Instead, regional companies pick Western Europe as their top investment destination, followed by the Middle East and North Africa (MENA). Key reasons for this include:

Western Europe offers cheap assets and open economies. For cash-rich Asian companies seeking access to growth, technology and resources, Europe may be the opportunity of a lifetime. Banks across Europe are being forced to sell assets at knock-down prices to meet capital requirements, governments are privatizing assets to shore up balance sheets, and struggling companies are offloading non-core subsidiaries. "We have seen lots of Chinese companies paying careful attention to assets in Europe because of the valuation opportunities," says Eleanor Wu of Ernst & Young's Transaction Advisory Services.

Figure 1: Excluding your company's home market, which countries or regions do you expect will hold the best growth opportunities for your company over the next three years?



Note: Scores shown = percentage of respondents
 * Special administrative region

“Asian investors are looking for new manufacturing hubs, and among these are certain markets in the Middle East and North Africa region because of its proximity to Europe.”

Alexis Karklins-Marchay, Co-leader, Emerging Markets Center, Ernst & Young

Europe is also a relatively open business environment that, with only a handful of exceptions, tends to be more welcoming of overseas investment than some other developed economies, including the US. “Asian companies feel few restrictions to acquire in Western Europe,” says Wu. “For companies targeting the US there may be a perception of a greater risk of protectionism preventing deals, though such a perception may not be well justified.”

MENA is a cost-effective manufacturing and resources play. Due to rising labor costs across Asia, compounded by higher oil prices³ and shipping costs, a growing number of Asian companies are seeking to relocate manufacturing and assembly to regions that are closer to their key export markets. The tax benefits of this move are significant, according to an Ernst & Young tax expert. By carrying out final assembly closer to the market, rather than in the source country, Asian companies can reduce their tax liabilities because components will be charged at a different rate. Asian companies may also be able to benefit from tax incentives in markets like Eastern Europe from hiring local people and carrying out manufacturing in these economies.

Even non-manufacturing activities could move offshore. As the domestic population in China becomes wealthier and consumes more, policy-makers will need to decide whether it makes sense to retain highly energy-intensive sectors, such as aluminum smelting, within China or move them to other parts of the world. “These activities could still be Chinese-owned, but there may be a view that they would be better located in places like the Middle East where energy is a lot cheaper,” says Mike Elliott, Global Mining and Metals Leader at Ernst & Young. “When you talk about 50% of the world’s aluminum smelting capacity potentially being subject to relocation, that’s a big deal.”

The US and Australia are less attractive investment targets. Despite being the world’s largest economy, the US is low on the list of growth opportunities for Asian companies, whether globally or regionally focused. A key reason for this is simply distance. “We only have so much capital and we need to allocate it properly, so our preference is to focus on markets that we think we can manage well,” says one senior executive. “America is a distant market, and we think we can do a better job of managing opportunities that are closer in Asia.”

Australia is also notable for its absence from the list of growth markets for Asian companies. Although a mature and stable economy, Australia has a small population when compared with most countries in the Asia-Pacific region, and so the opportunities for market penetration are average to low. Foreign direct investment continues to be strong, however: Australia is consistently part of the United Nations Conference on Trade and Development (UNCTAD) top 20 host economies in terms of FDI inflows, ranking eleventh in 2010.⁴ The top five sources of FDI are still the US, the UK, Japan, the Netherlands and Switzerland, although significant growth is coming from mainland China, South Korea, Singapore and Hong Kong (SAR).

Footnote

3. *Rapid-Growth Markets Forecast*, Spring 2012, Ernst & Young

4. *World Investment Report 2011*, UNCTAD

What are Asian companies looking to achieve by international expansion?

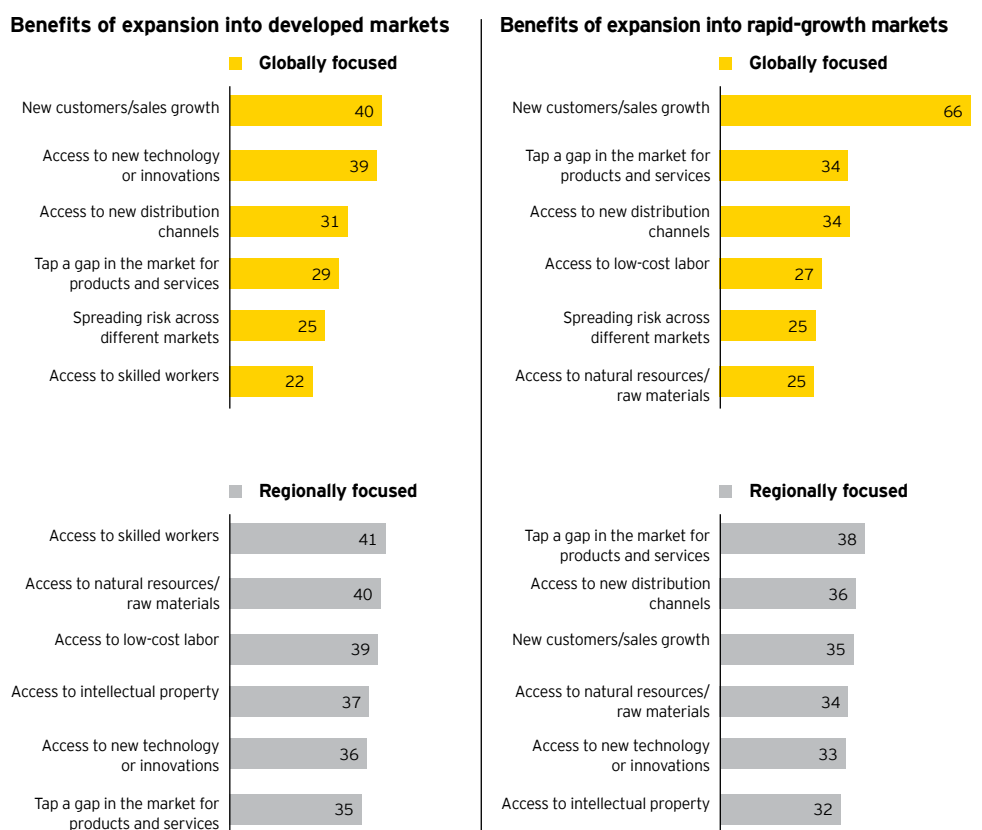
Companies expand outside their home markets for a variety of reasons, but these can essentially be grouped into six main areas: growth, diversification, routes to market, access to resources, access to skills, and access to technology. In general, Asian companies are looking not only to expand their customer base but also acquire new technology and capabilities.

While the priorities of global and regional companies are similar in many respects, some noteworthy differences are apparent. Companies that are still regional recognize that they need to get the basics in place as a first step when expanding outside the region. They are focused on building capabilities and resources – access to skilled workers, raw materials, low-cost labor and intellectual property. Global companies appear to already have these capabilities in place, and are focused instead on new customers and technology.

Acquiring new customers

For globally focused Asian companies, acquiring new customers is the top reason for expansion across both rapid-growth and developed markets, but is particularly pronounced in the former (see Figure 2). Rapid-growth markets offer greater opportunities to capture sales and gain market share. ZTE, for example, a telecommunications company based in China, finds overseas expansion critical once a certain domestic market share is reached. “It is hard for ZTE to gain market share in China, where major local players ZTE and Huawei are each restricted to one-third of the total domestic market,” says Lin Jianyi, ZTE’s Overseas Investor Relationship Manager. “So overseas markets are very important for ZTE’s future growth.”

Figure 2: What are the most important benefits you would be looking to achieve through international expansion in developed markets and rapid-growth markets?



Note: Scores shown = percentage of respondents

“In many different sectors, Chinese companies need access to people, processes, and IT that will enable them to bring those products back to China and distribute them to the domestic population.”

Keith Pogson, Asia-Pacific Leader, Financial Services Organization,
Ernst & Young

Gaining access to resources and technology

When targeting developed markets, the rationale for investment is more complex and multi-faceted for both regional and global companies. Factors such as access to new technology and distribution channels figure prominently. As Bing Xiang, Dean of the Cheung Kong Graduate School of Business in Beijing, points out, even companies that conduct the majority of their business within China will still need to access resources outside the region. “Many of the top companies in China see little reason to look beyond their domestic market, but that does not mean that globalization will stop,” he explains. “These companies will still need to leverage global resources in order to compete effectively.”

Between 2010 and 2020, the number of Chinese households with a disposable income of between US\$30,000 and US\$50,000 is forecast to grow from 1.5 million to 26 million.⁵ This creates unparalleled opportunities for Chinese companies, which will seek technology and expertise to serve the domestic market first and foremost.⁶

Keith Pogson, Asia-Pacific Leader for Financial Services Organization, Ernst & Young, gives the example of a Chinese bank seeking expertise in private banking. “Buying a private bank in Europe enables the acquirer to gain a better understanding of wealth management so that it can apply this knowledge to a high-net-worth customer base in China,” he explains. “In many different sectors, Chinese companies need access to people, processes and IT that will enable them to bring those products back to China and distribute them to the domestic population.”

Strengthening capabilities such as supply chain

Expansion into overseas markets (whether by organic growth or through acquisitions) provides an ideal opportunity for a company to review its supply chain and restructure it from a country-centric to a truly regional operation. Through a holistic review of business operations and alignment of the tax

planning, the supply chain can be optimized to deliver improved shareholder value. That optimization needs to include speed and flexibility to respond to new opportunities or changes rapidly. Increasing flexibility involves making processes more agile, and this often means challenging traditional organizational structures to fit the new business realities. By acquiring companies with strong processes or a well-designed supply chain, investors can extend their reach and apply these capabilities across their business.

Footnotes

5. *Rapid-Growth Markets Forecast*, Spring 2012, Ernst & Young
6. *Innovating for the next three billion*, Ernst & Young, 2011

How are Asian companies expanding?

Overseas expansion typically follows three stages. The first is direct exporting, as domestic companies seek new markets for their products and services overseas. Local sales and distribution desks follow, to help deepen the presence in overseas markets and build stronger relationships with customers, partners and suppliers. Finally, companies form joint ventures with local companies, or carry out acquisitions as they make the transition to becoming fully multinational.

In recent years, Asian companies have become more flexible about the deal structures that they are prepared to consider. In the past, Asian companies have been looking for a controlling stake instead of some other investment arrangement, but now they are

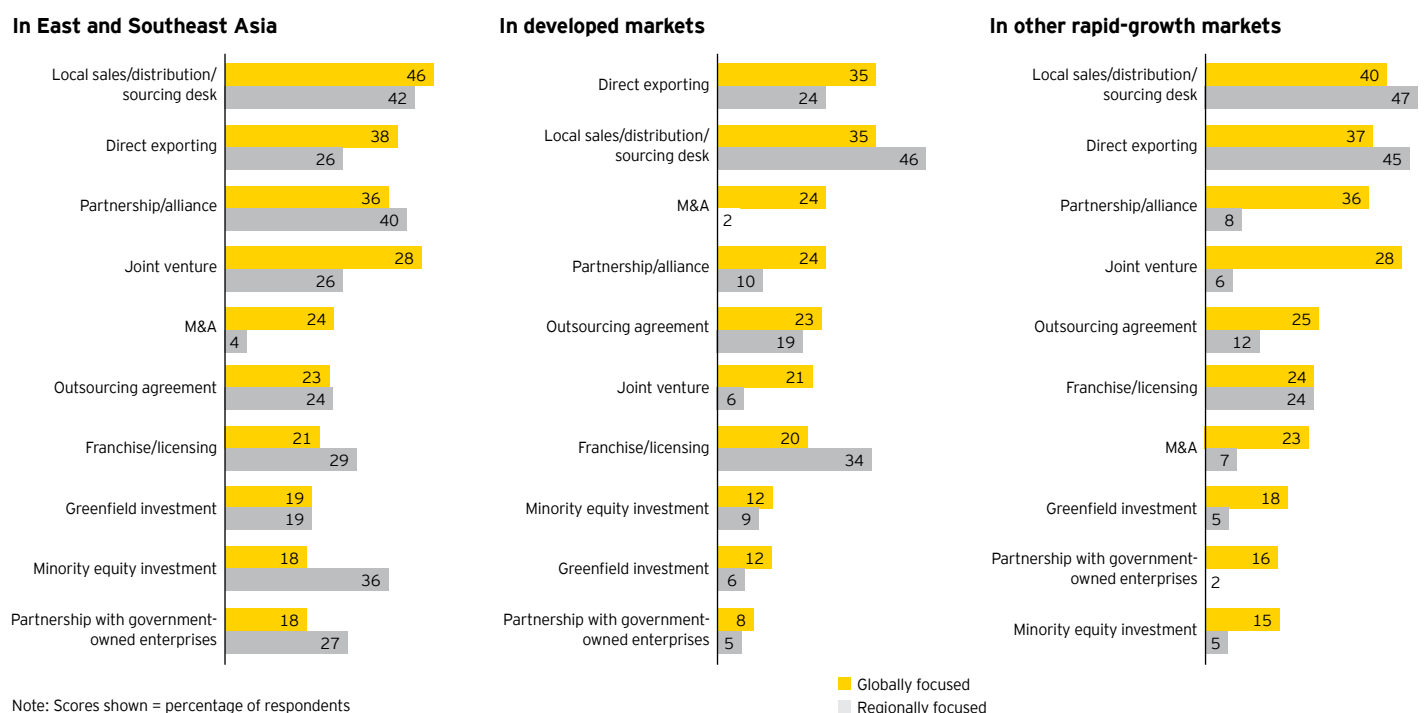
willing to reduce their investment stake and enter into a joint venture or minority stake.

Local sales desks, direct exports or franchises/licensing

Both the globally focused and regionally focused companies in our survey still rely largely on these methods to explore new markets, which is consistent with their desire to acquire new customers and tap gaps in the market for their products and services. In the past several years, many Asian economies have been focusing on export-oriented growth and development. Oxford Economics estimates that trade flows from Asia to the US and Canada, the Middle East, Latin America and Africa will increase by over 10% a year

up to 2020. Given this surge in trade, direct exports and setting up local sales desks continue to be perceived as the most efficient expansion methods in the next three years for both global and regional companies. Less than 10% of the regionally focused companies think that mergers and acquisitions, joint ventures or minority equity investments will become more important for them in the next three years (see Figure 3).

Figure 3: As you consider strategies for expansion, which methods will become more important in the next three years?



“The first phase is to go after the low-hanging fruit. It’s important to start small and choose something manageable at first. Then you can start to build up your workforce and expand into other sectors of the market. A lot of companies make the mistake of investing too quickly.”

Seah Moon Ming, Deputy CEO and President of Defence Business,
Singapore Technologies Engineering

Partnerships and alliances

In general, Asian companies are cautious about partnerships in developed markets, because the cultural differences can be too great, and these transactions can be more difficult to manage than outright mergers and acquisitions (M&A). “Partnerships can be more agile than an M&A, but in practice they are riskier because you need so much trust,” says Ernst & Young’s Raymond Woo. “There are a lot of cultural and management differences between Chinese companies and those in the West, which makes partnerships difficult.”

M&A is a much more viable option for the globally focused companies, which have deeper resources and knowledge of markets outside the region. Just under a fourth say that M&A will become more important as a mode of entry when targeting both developed markets and those in East or Southeast Asia. Four in ten regional companies say that

partnerships and alliances will become more important for them, and 36% think the same about minority equity investments.

Mergers and acquisitions

According to Ernst & Young’s April 2012 *Global Capital Confidence Barometer*, 48% of the companies surveyed in Southeast Asia said that they expect to pursue acquisitions in the next 12 months, which is a 5% reduction compared with October 2011. But among respondents from China, the corresponding finding is just 22%. This may be because there are not sufficient numbers of attractive deals available, or potential difficulties in closing deals.⁷

A far more common phenomenon has been for Asian companies to carry out small, bolt-on acquisitions designed to gain access to specific technology, expertise or routes to market. In some cases, the acquisition of smaller companies can be used as “practice” to prepare for bigger deals at some point in the future, as M&As can be a highly effective way to grow abroad and acquire new overseas operations quickly. They are the “quickest way to access a new growth platform for your business,” says Seah Moon Ming of Singapore Technologies Engineering. “For example, in the US, we acquired the satellite communications company iDirect. They had their own customer base, which we acquired overnight. This enabled us to hit the ground running when we entered the US market.”

Many Asian investors have strong balance sheets that will allow them to fund deals with 100% cash or equity. Ernst & Young’s April 2012 *Global Capital Confidence Barometer* finds, for example, that just 16% of Chinese companies plan to refinance loan or debt obligations in the next six months. Most expect their already low debt-to-capital ratios to decline even further. This strong cash position gives companies a major advantage over cash-strapped competitors in other markets that must rely on raising funds in a more constrained funding environment.

Footnote

7. *Global Capital Confidence Barometer, Southeast Asia edition and China edition*, Ernst & Young, April 2012

Playing for high stakes

The strategic challenges of global growth

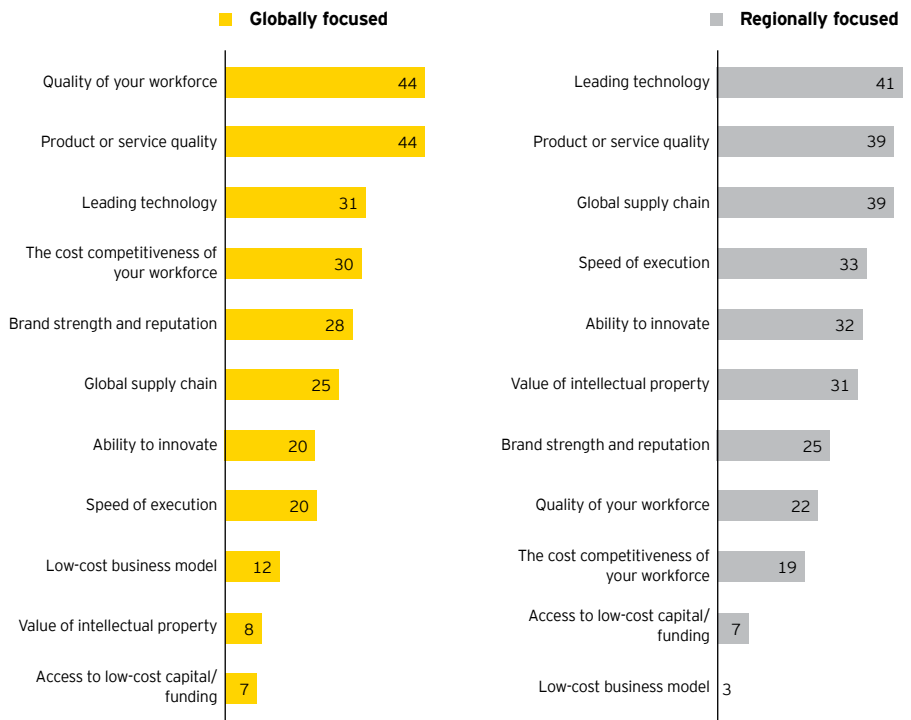
Asian companies' new market expansion will transform global business. But it also brings an urgent need for these companies to build competencies and skills that they have not developed previously, as well as enhance several functional areas. These strategic challenges have business implications that are relevant for all businesses as they seek new opportunities across the globe. In this section are some key challenges that we identified in our research.

Challenge 1: moving up the value chain could erode a critical advantage – low cost

Climbing the value chain is an aspiration that all our respondents share. They highlight leading technology and the quality of their products, services and workforce as their key advantages. Having a low-cost business model - Asian companies' key competitive advantage a decade ago - comes toward the bottom of the list (see Figure 4).

For example, China's status as the low-cost manufacturer of choice is facing stiff opposition from other rapidly growing Asian countries, including Vietnam and Bangladesh. Wage inflation is eroding the labor cost advantage. And the appreciation of the renminbi, while still fairly gradual, is further stoking export prices.

Figure 4: What are your company's most relevant strengths and advantages as it targets international markets for sales or investment?



Note: Scores shown = percentage of respondents

It is important to balance the aspiration to climb the value chain – essential for Asian economies to compete on a level footing with Europe and North America – with a continuing focus on cost competitiveness.

Tan Kian Seng, President of Venture Corporation Ltd, a Singapore-based provider of technology services, products and solutions, says that rising costs in China have affected the company's growth plans. "China is an important market for us, but we have to be very cautious when expanding there because of the significant cost escalation," he says. "This is a measure that we look at closely and it has made us rethink our expansion strategy in China."

Still, it is important to balance the aspiration to climb the value chain - essential for Asian economies to compete on a level footing with Europe and North America - with a continuing focus on cost competitiveness. "Chinese companies are among the best in the world at cost control," says Eleanor Wu of Ernst & Young's Transaction Advisory Services. "Their scale, speed and ability to move from prototype to finished product at low cost are in some cases second to none."

The erosion of the cost advantage is encouraging a rethink in policy circles about the region's comparative advantages. In China, the 12th five-year plan has a strong emphasis on innovation. It includes a pledge to increase R&D funding for emerging technologies by 159%, to US\$18 billion, as the global manufacturing powerhouse bids to transform itself into an innovator. Over the next decade, China will account for half of the growth in IT trade.⁸

Footnote

8. *Rapid-growth markets forecast*, Ernst & Young, Spring 2012

Spotlight

Hankook Tire's path to premium

South Korea's Hankook Tire is the seventh-largest tire maker in the world and has a strong position in rapid-growth markets. It is the biggest car tire manufacturer by market share in China, the world's largest car market, and also has almost 50% of the market share in South Korea. The company has two factories in China and will invest US\$1 billion in a third, as well as building a US\$350 million factory in Indonesia that is due to start production in 2014.

Brand development and a shift to the premium end of the market are essential to the company's future development. Hankook Tire recently took over from Dunlop as the official tire supplier to Deutsche Tourenwagen Masters, a Europe-wide tour of 10 races. "Although we are in the second tier group when it comes to tire brands - the first tier group being Michelin, Bridgestone and Goodyear - we are targeting the medium to high range of the product segment," says Jong-Ho Park, Senior Vice President for Strategy and Finance at Hankook Tire.

Park believes that the company's "capability to secure personnel in the local market is crucial" if it is to broaden its footprint. Execution is another key skill that he highlights. "It's very important that we further enhance our capacity for effective, fast execution," he says. "We think that we are already pretty good, but in order for us to compete in markets like Russia, India or Brazil, we need to further enhance our capabilities in that area."



Challenge 2: the nuances of local markets are difficult to understand or control

Spanning multiple markets creates powerful growth opportunities, but it also means managing across different regulatory environments, political systems and customer preferences. Dealing with this complexity can quickly erode the benefits of scale if it is not managed effectively. Our survey demonstrates some of the challenges that global expansion brings. The further from home they travel, the more likely Asian companies are to encounter difficulties with understanding the nuances of the local market. Among our respondents, the globally focused companies in the survey consider themselves to be far less effective at dealing with key aspects of running an international business than their regional peers (see Figure 5). Our respondents' challenges are many:

Tailoring strategy to specific markets.

"Sometimes there is an assumption that if you've got a great product it will fit all markets," says Koh Boon Hwe, Chairman of Yeo Hiap Seng, a Singaporean food and beverage company. "But it doesn't work that way. The way people respond to our products differs across Asia, and we have to tweak the formulation for each country."

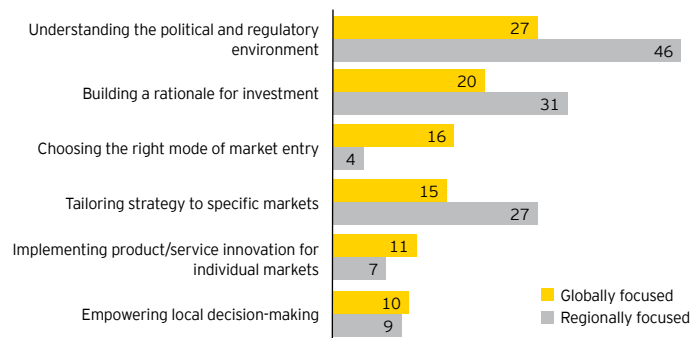
Understanding the political environment.

Almost half of regional companies consider themselves to be very effective at this aspect of running an international business, but

among the globally focused companies, this proportion falls to just 27%. Many Asian companies express a need for familiarity with the political environment before being willing to invest. "Political stability is very important," says Venture Corp's Tan Kian Seng. "We will only expand into countries that we know well, and where we understand the government policy and political landscape."

Sudden political change can be very disconcerting for executives from a market like mainland China, where there has been continuity of power since the late 1940s. "Many of these companies are not accustomed to operating in jurisdictions where the power base may change every three years, or may even be unstable from month to month," says Mike Elliott, Global Mining & Metals Leader at Ernst & Young. "They need to learn how to create a sustainable model for dealing with all the potential power players in the market."

Figure 5: How effective do you consider your company to be at the following aspect of international business?



Note: Scores shown = percentage of respondents

“In some cases, companies have overpaid for assets or not structured deals properly. We are certainly seeing that clients are putting more focus on valuation of the assets and realize the importance of conducting relevant financial and legal due diligence.”

Loletta Chow, Global Leader, China Overseas Investment Network, Ernst & Young

Dealing with unexpected regulatory change.

An abrupt shift in regulations can quickly undermine the viability of an overseas investment. To manage the associated risks, companies must make sure they have an effective risk management framework in place to implement the changes. They will also need to maintain a “risk radar” that looks ahead to spot the early warning signs.

Conducting due diligence and valuation.

Building a rationale for investment also becomes more difficult when Asian companies move beyond the region. Among the regionally focused companies, 31% say that they are very effective at this, compared with just 20% among the regionally focused firms. Choosing the right assets is essential to success, but is an area when some Asian companies have struggled in the past.

This highlights the importance of conducting rigorous financial, legal and integrity due diligence when planning deals. “I think there has been a tendency in the past to think only about acquiring the asset and perhaps not enough about due diligence,” says Loletta Chow, Global Leader of the China Overseas Investment Network at Ernst & Young. “This means that, in some cases, companies have overpaid for assets or not structured deals properly. We are certainly seeing that clients are putting more focus on valuation of the assets and realize the importance of conducting relevant financial and legal due diligence.”

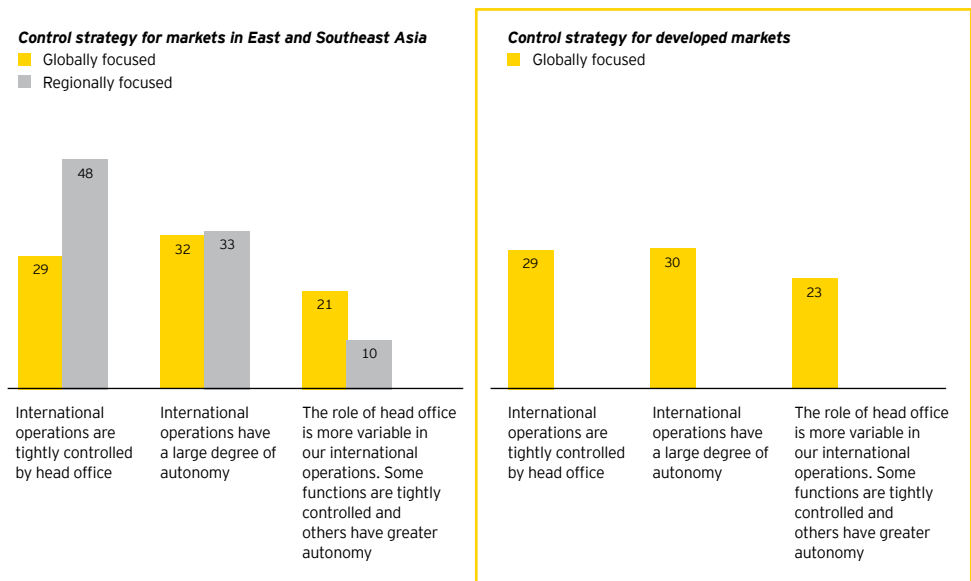
Instituting greater autonomy. When companies expand overseas, they often need to rethink their organizational structures. With operations in multiple markets, it may no longer make sense for all key decisions to be taken at the headquarters. Companies may decide to decentralize some degree of decision-making authority to local markets, or put in place a regional structure so that country managers report into a regional, rather than global, headquarters.

The transition from regional to global seems to be a trigger point at which greater decentralization gets under way. Among the regional companies, just under half say that their international operations in East and Southeast Asia are tightly controlled by head

office. Among the globally focused companies, this proportion falls to 29% and is the same for operations in developed markets.

Also important is the need to consider which functions and activities require local autonomy, and which can benefit from scale advantages. For example, companies may decide that marketing and talent are functions that require local execution, while finance and IT can be managed centrally - either at headquarters or through shared service centers. Among the globally focused respondents, 23% say that the role of head office is more variable in developed markets, and 21% for markets in East and Southeast Asia.

Figure 6: Which description best represents your company's international strategy in Asian and developed markets?



Note: Scores shown = percentage of respondents.



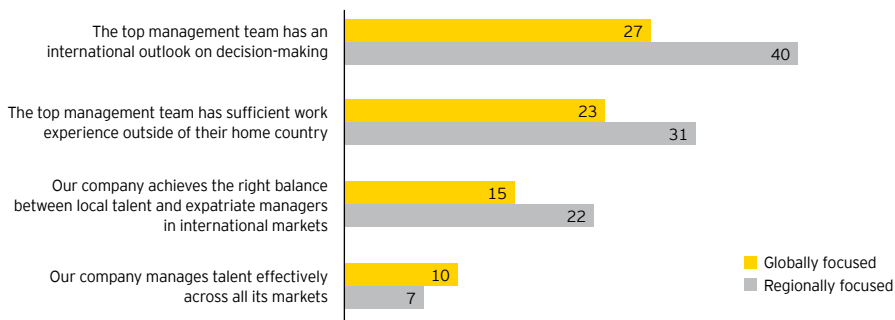
Challenge 3: top management teams often lack an international outlook

The complexities of international business mean that management capabilities must evolve as companies broaden their geographical footprint. Asian companies say their leadership teams need a better understanding of global markets and a more strategic approach to international hiring (see Figure 7). Those that are globally focused are less likely than their regionally focused peers to agree that their top management team has an international outlook on decision-making. They are also less likely to agree that their top management team has sufficient work experience outside the home country (see Figure 8). This may be because globally focused companies have learned the hard way - as they become more international, they realize how difficult the challenges of expansion are and the high level of preparation required to deal with them.

Ways that Asian companies are coping with the talent challenge include:

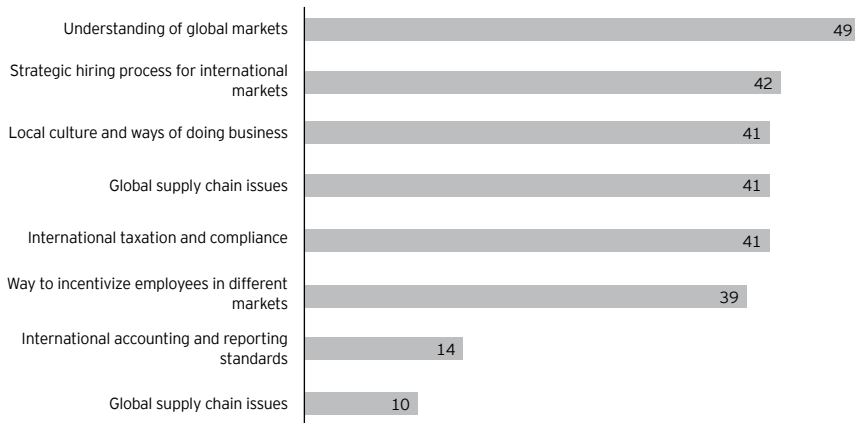
Focusing strongly on local talent. Thirty-eight percent of our global respondents say that they will recruit locally in new international markets (see Figure 9). An international outlook becomes particularly important when Asian companies enter developed markets because of differences in the management style.

Figure 7: Do you agree or disagree that...?



Note: Scores shown = percentage of respondents who agree

Figure 8: Where does your organization's top management team need more knowledge or insight to be successful in today's global marketplace?



Note: Scores shown = percentage of respondents

“You have to make sure you have an infrastructure that is well set up for global expansion. Without the right structure and capabilities in place, expansion is unlikely to be effective.”

Lilliana Choi, Manger of Corporate Strategy and Development,
Jebsen and Company Limited

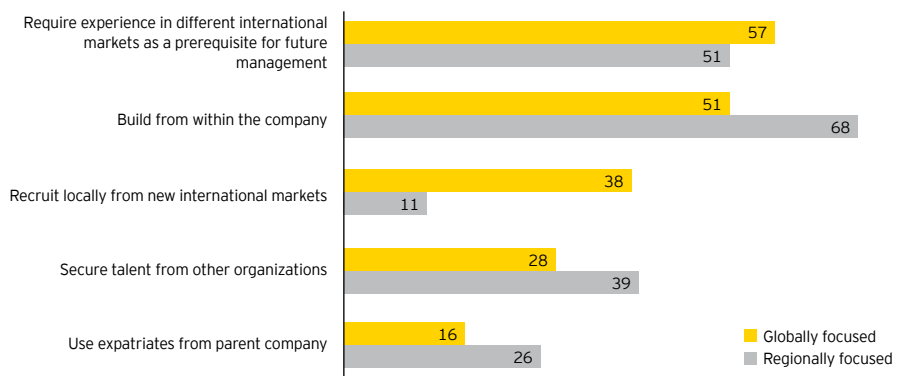
Reducing reliance on expatriates. Although some personnel from the corporate headquarters are important to retain the link back to the center, it is important to strike a careful balance between global and local. “If you send everyone from head office, they may understand the corporate culture, but they’ll miss the nuances of what is required to operate locally,” says Steve Ferguson, Asia-Pacific Banking and Capital Markets Leader at Ernst & Young. “Equally, if you just let the local people run a business, you’ll find that you’ve lost a bit of control. So it needs to be the right blend. The really tricky balance is in training and mentoring people so that they can eventually take over the business and run it for you rather than having to fill it with expensive expatriates.”

Emphasizing global training and mobility programs. Ensuring that managers have a more international outlook and experience requires training, as well as a strong global

management program that enables mobility between regions. Dr. Sarasin Viraphol, Executive Vice-President of Charoen Pokphand, an agribusiness conglomerate based in Thailand, says his company is

looking as far afield as the US for training opportunities: “We are talking with a number of potential partners in academia and industry across the US to explore how we can improve the training of our people in Asia.”

Figure 9: In building your international management team, which approach will you most emphasize over the next three years



Note: Scores shown = percentage of respondents.

Spotlight

Yeo Hiap Seng and the importance of a global mindset

Yeo Hiap Seng is a food and beverage company based in Singapore that produces brands including Yeo’s, H-Two-O and Justea. It has a market presence in 25 markets, including the US, Australia, New Zealand, mainland China, Hong Kong (SAR), Japan and Europe, and has ambitious plans to expand its presence, with a particular focus on Southeast Asia.

Koh Boon Hwe, non-executive Chairman of the Board, believes that “it’s crucial to build a management team with a more expansive global mindset. We want our managers to have the independence to operate autonomously.”

The difficulty of finding high-caliber food industry executives in many markets exacerbates this challenge. “It’s very difficult to find people who have expertise in food science and especially in the quality aspects of running a food business,” says Koh. “You can find these skills in the P&Gs and Nestlé’s of the world, but it’s a lot tougher to find them in local food and beverage companies.”

Talent challenges are not universal, however. Koh argues that marketing talent is relatively easy to find, and that it is always better to rely on executives from local markets rather than import expatriates from elsewhere. “In most

cases, local marketing managers understand Asian customers better than anyone you could find in the US or Europe,” he says.

In cases where the company does rely on expatriates, Koh argues that it is essential for these managers to adapt to local conditions. “We need to be able to send individuals from the headquarters who understand how we operate in our manufacturing and operations, and yet at the same time are sensitive enough to local markets,” he explains. “You need managers who can capture that local information and transmit it back to headquarters.”



Challenge 4: full international expansion requires shoring up infrastructure and capabilities

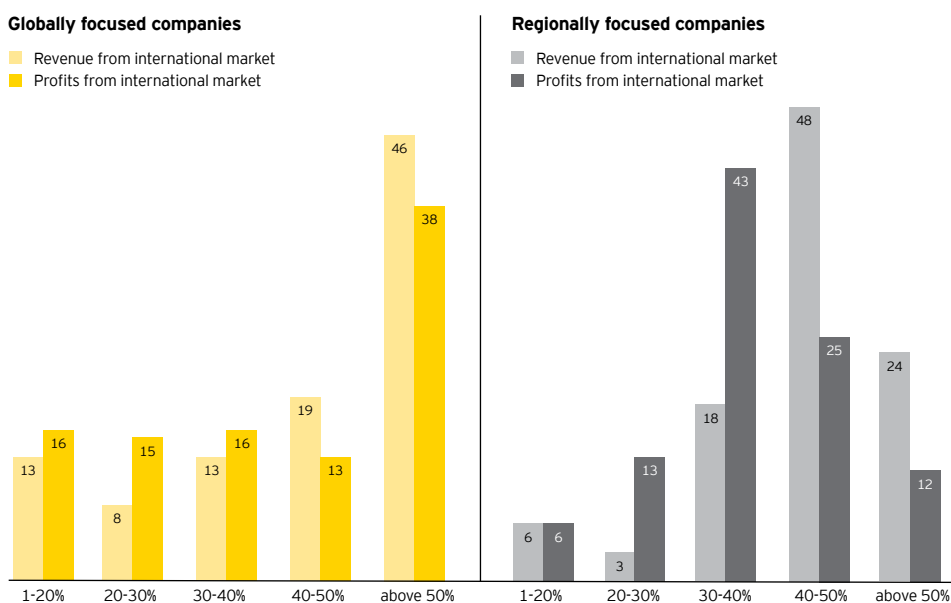
Many Asian companies are still at a relatively early stage of their overseas operations. Their priority is often investment and gaining market share, rather than increasing margins. At relatively lower levels of international expansion, profitability matches or even exceeds revenues. However, as companies approach the point where half of their revenues come from international markets, then for many, profitability begins to fall behind revenues. The threshold appears to be about 40%. This is the case for both global and regional companies: 46% of the globally focused companies generate more than half of their revenues from international markets, but only 38% derive the same proportion of profits from those investments. Similarly, among the regionally focused companies, 48% generate nearly half of their revenues from international markets, but only 25% obtain the same proportion of profits. Among the 24% of regionally focused companies that generate more than half of their revenues from international markets, only 12% derive the same proportion of profits (see Figure 10).

One reason for this pattern may be that global expansion brings with it greater complexity, which can increase costs and drive down profitability. Companies may need to make several changes to their operations to improve the balance between profitability and revenues.

The path to profitability is dependent on many factors, but our respondents point to some functional areas where changes will be most required to ensure the success of their company's international expansion plans. These include strategic planning, financial management, internal communications and financial reporting (see Figure 11).

"You have to make sure you have an infrastructure that is well set up for global expansion," says Lilliana Choi, Manager of Corporate Strategy and Development at Jebsen and Company Limited, a marketing and distribution conglomerate focused on Greater China and based in Hong Kong (SAR). "Without the right structure and capabilities in place, expansion is unlikely to be effective."

Figure 10: What percentage of your revenues and profits are currently generated outside your company's home country?



Note: Scores shown = percentage of respondents.

Developing a sophisticated finance function.

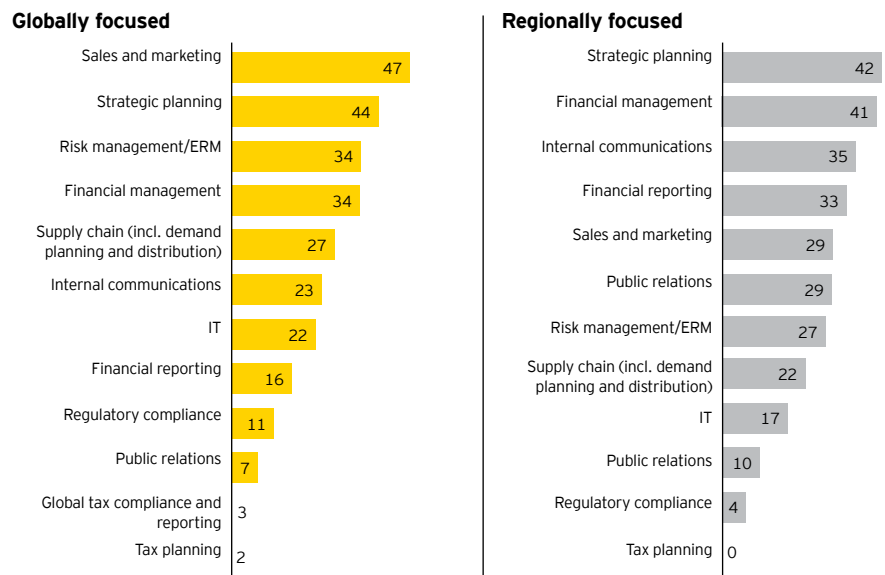
Deeper international investment places a much greater burden on finance functions. They must come to grips with multiple financial and accounting environments, which can vary considerably from market to market. They must deal with different interest rates, manage currency risk, and consider an appropriate funding mix between local and overseas financing.

Enhancing tax planning. Given this strong focus on financial management, it is perhaps surprising that, for both regionally and globally focused companies, tax planning is so low on the agenda. And yet tax can play a very important role in accelerating the transition to profitability. "Any company expanding overseas needs a strong tax governance model and the ability to plan their expansion in a tax-effective way," says Jim Hunter, Asia-Pacific Tax Leader of Business Tax Services at Ernst & Young. "Without this focus, companies will not only lose the opportunities from optimizing the tax position but also expose themselves to risks that could be quite severe in terms of cost to the business."

Controlling risk. Rapid growth exacerbates risks, because managers may become too focused on keeping pace with opportunities

rather than putting in place appropriate controls. "If the aim is to grow rapidly internationally, then the potential for that to be done in a way that strains or compromises risk controls and compliance increases," says Don Vangel, Senior Advisor on banking supervisory and regulatory matters in Ernst & Young's Financial Services Organization. "It's important to have the right incentives and controls in place to manage expansion that occurs at a distance from central control functions, and to ensure that growth is deliberate and sustainable."

Figure 11: Which of the following functional areas will require the most significant changes in order to ensure the success of your company's international expansion plans?



Note: Scores shown = percentage of respondents.

“Any company expanding overseas needs a strong tax governance model and the ability to plan its expansion in a tax-effective way.”

Jim Hunter, Asia-Pacific Tax Leader, Ernst & Young

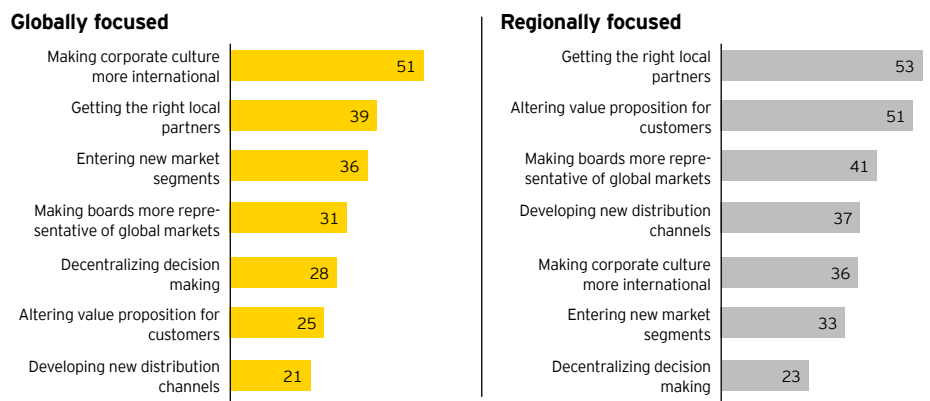
Rudi Tsai, Director of Strategic Development at Pacific Andes, one of Asia’s largest seafood companies, emphasizes the importance of frequent communication between headquarters and local management teams to manage risk and spot opportunities. “We stay in very close dialogue with the local management and have scheduled meetings through video conferencing with senior management of the group companies,” he explains. “This exchange of ideas helps us become aware of impending issues more quickly and allows us to resolve them together.”

Robust risk and control frameworks can provide valuable security by ensuring that decisions at a local level are being made within agreed parameters and with a clear framework of “non-negotiable” values and behaviors. Nick Brewer, Group Chief Operating Officer at Noble Group, Asia’s largest diversified commodities trading group, emphasizes that risk management is key to his company’s competitive advantage. “We’ve invested a lot of time and effort into building our internal risk management function, both at a business and corporate level, in parallel with creating a strong culture within the organization,” he explains. “As a result, we have a very flexible, empowered organization with strong checks and balances – which allows us to make quick and informed decisions.”

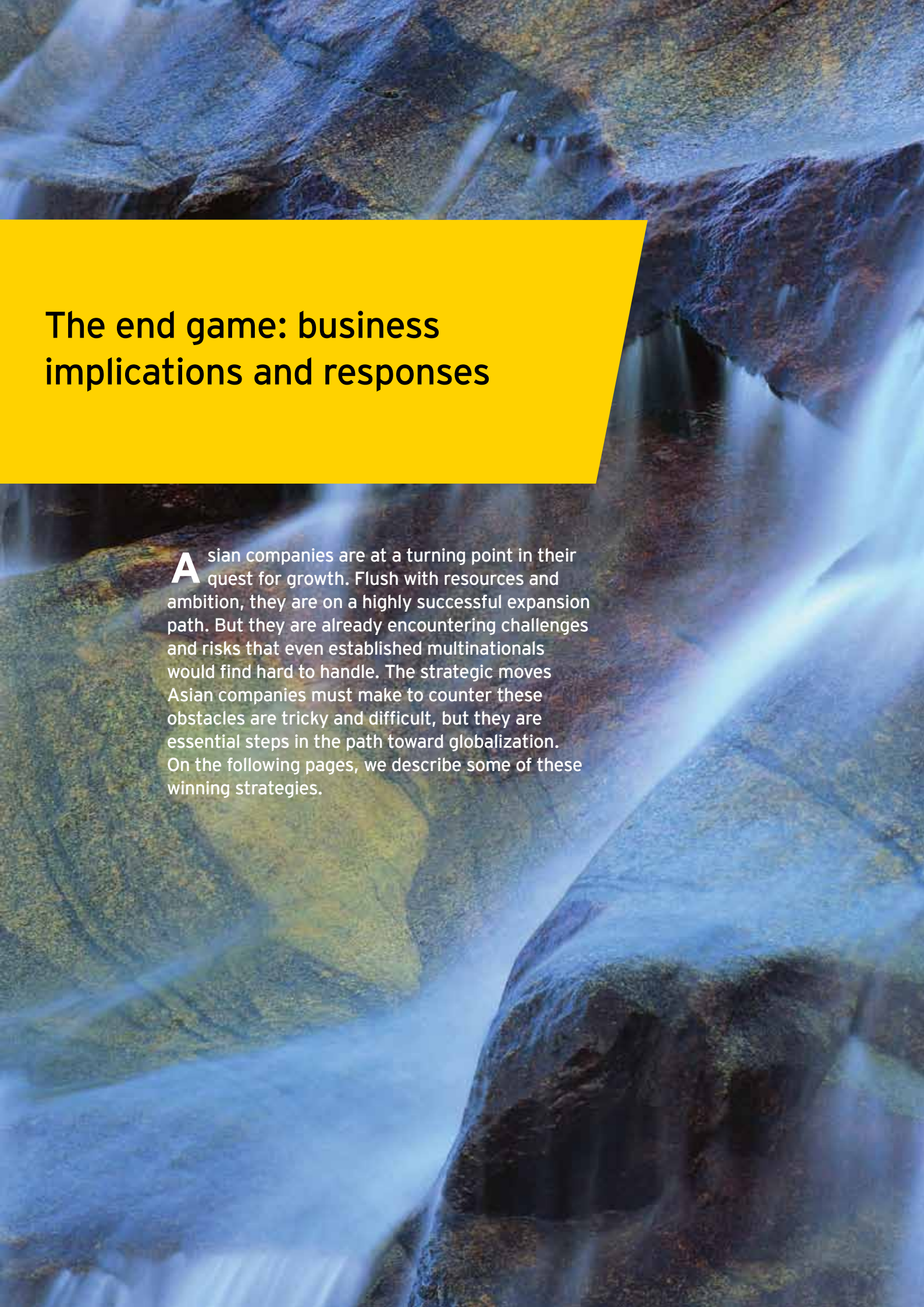
Forming transformational relationships with partners.

Companies must build strong, mutually beneficial relationships with suppliers and other partners, and consider how collaboration can move these relationships from being purely transactional to transformational. Asked about the changes that will be most important for their business to succeed with its international expansion plans, regionally focused companies point to finding the right partners as one of the top two factors (see Figure 12).

Figure 12: Which of the following changes will be most important for your business to succeed with its international expansion plans?



Note: Scores shown = percentage of respondents.



The end game: business implications and responses

Asian companies are at a turning point in their quest for growth. Flush with resources and ambition, they are on a highly successful expansion path. But they are already encountering challenges and risks that even established multinationals would find hard to handle. The strategic moves Asian companies must make to counter these obstacles are tricky and difficult, but they are essential steps in the path toward globalization. On the following pages, we describe some of these winning strategies.



Recommendations for global companies

Put in place robust risk management. A more diverse international footprint and the need for greater autonomy at the local level emphasize the business case for a robust risk management framework. This should enable innovation and autonomy at a local level but do so within a set of parameters and rules that give business leaders at headquarters comfort that the company's values are being upheld. A robust risk system will provide early warning of problems on the periphery of the organization, giving managers better information and more time to respond. Risk can also be harnessed for business advantage and turned into tangible financial results. Our research has shown that companies with more mature risk management frameworks can outperform their peers financially (see box, "Sophisticated risk management enhances financial performance").

Make the transition from investment to profitability. For many globally focused Asian companies, the priority remains investment and growth. This means that profitability is not always top of the priority list. But as these investments mature, they will need to do more to introduce efficiency and increase productivity. This will require a greater focus on process, a consideration of where economies of scale can be derived and detailed tax planning.

Take steps to make the corporate culture more international. To succeed in global markets, companies need a corporate culture that reflects the diversity of their customer base and operations. By recruiting managers with experience of different markets, reducing reliance on expatriate workers, and putting in place global talent management programs that

enable the flow of key talent around the world, companies can disseminate best practice and create a more international workforce.

Choose which functions should be global or local. Autonomy for local managers helps to ensure that products and services are relevant to the local customer base, but not everything needs to be decentralized. Companies need to think about where they can derive economies of scale without compromising local relevance. Functions such as finance and IT are often good candidates for centralization. It is also possible to create platforms for services that are delivered locally. For example, a company may create a centralized marketing function that provides capabilities to local markets, but allow the local markets to interpret and apply these capabilities in their own way (see box, "Agreeing on autonomy").

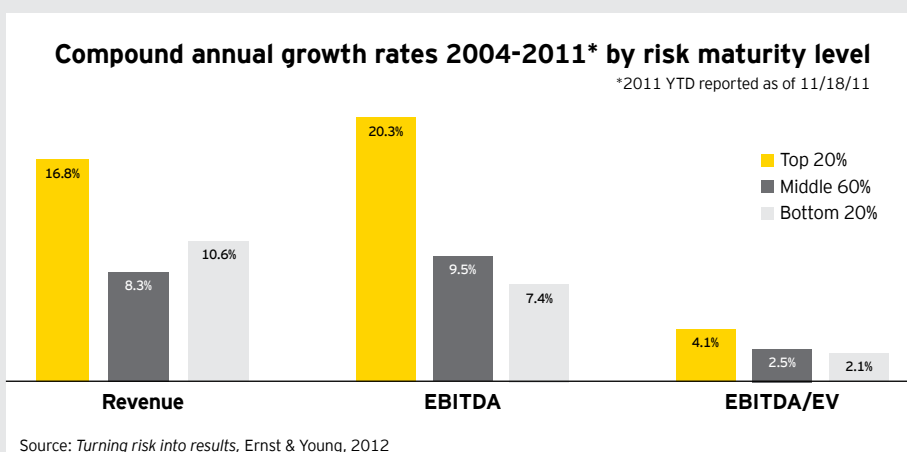
Sophisticated risk management enhances financial performance

Companies with more mature risk management practices outperform their peers financially, according to a recent Ernst & Young survey. Based on interviews with 576 companies around the world and a review of more than 2,750 analyst and company reports, we assessed the maturity level of risk management practices and found a positive relationship between risk management maturity and performance. Our key findings include:

- ▶ Companies in the top 20% of risk maturity generated three times the level of EBITDA as those in the bottom 20%.
- ▶ The top-performing companies in terms of risk maturity implemented on average twice as many of the key risk capabilities as the lowest-performing group.

▶ Financial performance is highly correlated with the level of integration and coordination across risk, control and compliance functions.

▶ Effectively harnessing technology to support risk management is the greatest weakness/opportunity for most organizations.



Recommendations for regional companies

Prepare for greater competition. Over the next few years, Asia will remain a dominant recipient of inward foreign direct investment. As companies from both inside and outside Asia continue to target the region, this will increase competition - for assets, talent, resources and customers. Regional companies need to consider the impact of this trend on their prospects, and whether they need to join other regional companies in looking outside Asia for new opportunities.

Build the capabilities for international expansion. Regional companies seeking to build a global footprint must ensure that they

get the basic infrastructure capabilities in place before making bold moves. They need managers who have an understanding of international markets, and core functions, like finance, HR and IT, that can support multiple markets.

Rethink organizational design to enable greater local autonomy. Making the transition from regional to global requires Asian companies to rethink their organizational design and reporting structure. Greater geographic scale makes it more difficult to control from the center. These companies should therefore consider devolving greater

autonomy to regions, but do so within a set of parameters and risk frameworks.

Leverage global resources. Even companies that do not see their growth opportunities beyond Asia will need to think globally. Increased competition means that regional companies will be under greater pressure to ramp up their innovation, product and service mix and talent pipelines. By building partnerships with companies outside Asia, or acquiring companies with the right resources and expertise, regional companies can leverage global resources to ensure that they remain globally competitive.

Agreeing on autonomy

By Allen Morrison, Ph.D., Professor of Management Practice, INSEAD

Much is made of the conflict between corporate centralization and local autonomy, but what is often overlooked is that autonomy is mostly rooted in behaviors and values. One of the most difficult challenges to overcome is changing the mindset and behaviors of employees. It is one thing to communicate the importance of local autonomy; it is quite another for employees to believe it. Here are some steps that corporate leaders can take to promote and inspire belief in autonomy:

- ▶ **Bring in staff from other countries.** Organizational power will always reside at corporate headquarters. Because of this, successful companies realize that if powerful headquarters' leaders want to know and trust those that are not citizens of the headquarters country, they have to bring "foreigners" in and bring in a good number of them. The best way to build trust is to work together.
- ▶ **Allow early expatriation.** Working and living overseas can have a huge impact on international skills and attitudes and the creation of personal networks. Managers that have worked in multiple countries also have greater organizational savvy—they know how things get done and they know how to access organizational

resources. Early expatriation is an important tool in developing competent and trusted managers in foreign affiliates.

- ▶ **Focus on leadership development.** Formal training and development programs can provide tools to help managers make sense of what they have learned, recognize patterns and build and test judgment. For affiliates to enjoy greater autonomy, local leaders need to improve their competence and strengthen their global awareness. Given that foreign affiliates are often too small or poorly staffed to manage the leadership development challenge alone, corporate or regional headquarters needs to take charge of this activity and make it a top priority.
- ▶ **Use symbols wisely.** Successful leaders understand the power of symbols to signal the importance of certain behaviors. Symbols can include such things as high-profile rewards or punishments, visual signs (logos, artwork, etc.), or the placement of certain employees in high-profile positions. Employees pay attention to these kinds of symbols and look for alignment between the symbols and the strategy of the firm. Symbols that promote local autonomy can have a dramatic and nearly immediate impact on the attention and priorities of the audience.

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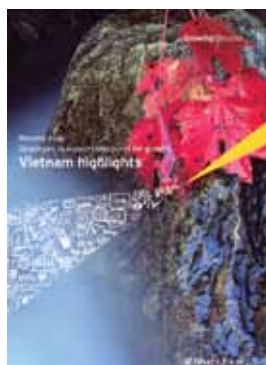
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