Brand new order

Profitable localization in Asia's emerging markets

Path to success for Japanese companies

Building a better working world

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Foreword

Emerging markets are not new. However, they have reached an inflection point. While many companies have expanded their businesses into emerging markets to tap their growth potential, just 20% of companies interviewed for this report are classed as high performers currently able to both generate accretive margins and sustain significantly high growth.

Comparing the high performers with the rest and analyzing the factors behind their success, it became clear that they were able to balance numerous apparent contradictions in Asia's diverse and volatile emerging markets. It also became clear that many Japanese companies did not give sufficient decision rights to local operations—a major impediment to success in the highly competitive emerging markets of Asia. As such, Japanese companies face different challenges than other leading global companies.

Compared with other global companies, Japanese companies tend to lack clear strategic direction and are unable to secure sufficient investment in terms of either personnel or financing. It is vital for Japanese companies to redefine their expansion into Asia, with well-focused investment and the efficient utilization of limited management resources.

If Japanese companies are to successfully expand in emerging markets, they will need to do business differently from what they do in Japan. Making decisions based on incomplete information and building flexible supply chains are important factors to such expansion.

Japanese companies, as well as global companies already established in emerging markets, must consider how to develop approaches for unmet needs,diligently monitor and delegate authority, and utilize diverse human capital to successfully achieve further growth.

This report presents EY Japan's view of what Japanese companies need to do to profit, rather than lose, in emerging Asia, along with research conducted by the Global Consumer Products Center of EY. We hope you find it interesting and valuable reading.

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Japan Consumer Products
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Profitable localization in Asia

in 2013, we conducted a survey and in-depth interviews with senior executives at leading consumer product and retail companies expanding their businesses into Asia.* To identify the challenges faced by Japanese companies in Asia's emerging markets and the path to success, we also conducted research focused on Japanese companies. This report is based on interviews with these executives and industry specialists combined with EY research.

Profile of survey respondents

253

Global companies surveyed (consumer products and retail sectors)

35

Japanese companies surveyed (consumer products and retail sectors)

9

Countries represented in addition to Japan: China, India, Indonesia, Malaysia, Singapore, Taiwan, Thailand, Vietnam and South Korea.

*For this study, EY commissioned the Economist Intelligence Unit (EIU) to survey 253 C-suite and senior executives of large multinational organizations in the consumer product and retail sectors. The respondent distribution is shown above.

The external research was supplemented with 23 in-depth interviews with C-suite and senior executives from the leading companies in the consumer product and retail sectors.

> In just 10 years, competition and complexity in emerging markets has grown beyond all recognition. Today, effectively developing and implementing strategies related to areas, such as targeting, management resource allocation and monitoring, matters more than ever.

Mariko Asao

Japan Consumer Products
Japan Consumer Products Analyst

I

The position of Asia's emerging markets

The need for more effective strategy formulation and implementation

Turning to emerging markets as a source of growth is not a new idea. Many companies have expanded into developing countries to tap their potential growth. However, concerns have arisen about a possible slowdown in emerging as well as developed markets. Also, "in just 10 years, competition and complexity in emerging markets has grown beyond all recognition. Today, effectively developing and implementing strategies related to areas such as targeting, management resource allocation and monitoring matters more than ever." said Mariko Asao, Japan Consumer Products Analyst at EY.

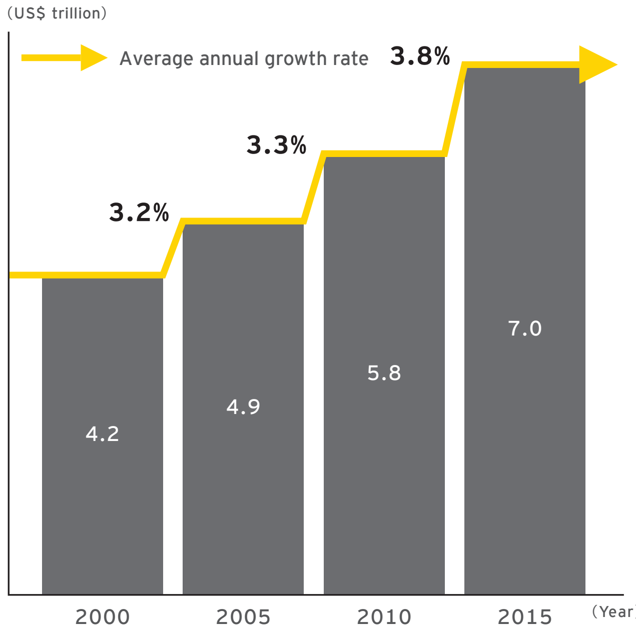
Toward a source of profitable growth

However, this does not mean that Asia's emerging markets are becoming less important. Most consumer products and retail companies handle consumer staples, which have steadily expanded even as economic growth fluctuates. In the future, we can predict robust increases in demand due to structural changes, such as population growth and urbanization. Based on EY's survey of more than 250 retail executives in Asia engaged in consumer product and retail businesses, 69% believe that emerging markets will be the main engine of growth and profits for their companies over the next three years.

During the course of the interviews, we heard that, amid ongoing sluggish performance in developed nations, overall sustainable growth relies on profitability growth in developing countries, and therefore strategic and active investment of limited management resources is becoming more important. It is no longer enough for consumer product manufacturers and retail companies to focus on achieving revenue growth and capturing market share in emerging markets. The time has come when these markets must become the engines of profitability as well as growth.

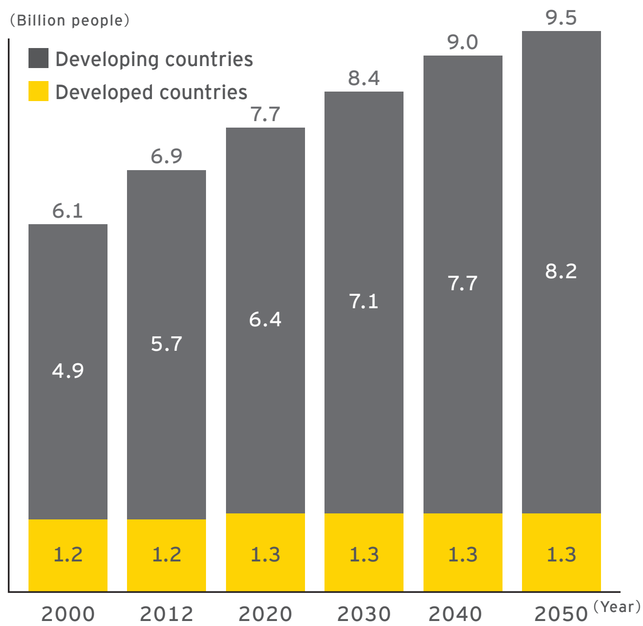
Despite growing concerns about developing countries, we expect that structural changes, such as population growth and urbanization, will drive steady growth in the demand for consumer staples.

World consumer products market size (projected)



Source:EY

World population prospects: the 2012 revision



Source: "World population prospects: the 2012 revision," United Nations Department of Economic and Social Affairs

II

Profitable localization in Asia:
path to success for Japanese companies

How can Japanese companies deliver profitable growth from developing countries?

Based on our comparative analysis with global companies, we think Japanese companies need to address the following points:

Challenges and imperatives for Japanese companies

II - i

Redeveloping strategy in Asia's emerging markets

Securing economies of scale: efficient allocation of management resources

Against a background of diverse and granular markets, rapid change, undeveloped infrastructure and high cost of capital, many companies have come to realize the difficulties of generating accretive margins in Asia's emerging markets. Japanese companies, in particular, often do not invest enough to generate profits, so securing economies of scale is a major challenge. It is also a challenge for leading US and Europe companies, but those high performers that have secured strong growth focus closely on strategic allocation of management resources.

One example of this strategic allocation is the investment of management resources according to the stage of business. This involves understanding the business portfolio not according to business line but according to growth phase — whether it is still in the initial investment stage or it is driving growth and so on — and allocating investment accordingly. However, even in business at the initial investment stage, some companies make bold investments, aiming to reach the self-sustainable growth stage as fast as possible.

Another example is the portfolio approach. Both Japanese and other global companies tend to allocate resources to areas where their company is strongest, but what differentiates the global companies is their strategy of building a portfolio across multiple target demographics and product categories rather than over-specializing in a particular area. This allows them to react to market changes as well as secure economies of scale at the same time. To differentiate themselves and build a presence in developing countries, global companies make highly focused investments in their chosen area; for example, one company has decided to

Tsukasa Yoshimoto

Japan Consumer Products
Consumer Products Center Advisory Service Leader

In Asia's heterogeneous emerging markets, access to final consumers, brand control, and the ability to closely understand and manage cost structures optimized for local distribution practices are vital.

launch new local brands for the first time in over 100 years.

Competition for opportunities in emerging markets is intensifying, and without a clear direction or adequate investment in terms of either personnel or finance, profitable growth is an increasingly distant goal. Based on our recent research and comparative study of global companies, we believe it is important for Japanese companies to redefine their expansion into Asia in order to effectively utilize limited management resources.

II - ii

Japanese companies face challenges in expanding into emerging markets

Asia's emerging markets are important to Japanese companies. In research carried out by EY Japan, the majority of companies that had already moved into Asia expect Asian nations to become engines of growth and profitability in the next three years. Regardless of the scale of revenue, all companies already in Asia plan to continue or expand their businesses there.

However, this is fraught with difficulty. The following are some of the challenges many Japanese companies face when expanding into Asia.

Making decisions on the basis of incomplete information

Many survey respondents expressed the opinion that a lack of data and information was the most significant challenge when expanding into emerging markets. This attitude toward imperfect or incomplete data and information is one area that frequently differentiates Japanese and leading global companies. When expanding into emerging markets in particular, availability and accuracy of government statistics and market data is often low. However, it is unrealistic to wait until accurate data can be gathered before penetrating the market. In fact, considering the pace of change in emerging markets, it is impossible to acquire completely reliable and accurate data.

Decision-making in such uncertain environments requires "hypothesis-driven thinking." First, companies must quickly determine what is known and what is unknown using available data and information on hand. They subsequently carry out necessary research, analysis and deliberations based on their hypothesis, and translate the results into timely decision-making.

In addition to hypothesis-driven thinking, to maximize the probability of success when expanding abroad, it is important to anticipate risk scenarios and prepare responses. At the same time, companies must verify and monitor how far the hypothesis differs from reality and make strategic adjustments or changes as required.

It is not just the high performers of Europe and the US who excel at hypothesis-driven thinking. Actually, not one Japanese company already in Asia gave "lack of data and information" as one of its top three concerns when expanding into the region. Of these companies, many cited "underdeveloped legislation and operational instability" as major challenges, and they operate with the awareness that uncertainty is a fact of life in emerging markets. The real challenge is how to deal with these issues.

Building flexible supply chains

In Asia's emerging markets, many companies are faced with inadequate supply chains. Various obstacles need to be overcome from procurement through to sales, including distribution infrastructure, quality issues and retail network building. In contrast to the Japanese market, with its high-level infrastructure and intermediary distribution functions, emerging markets have a higher ratio of traditional retailers and lack wholesalers, so companies must build their own distribution systems for products. Penetrating emerging markets in Asia requires more than just "producing good products at a low price."

In addition, within the same country there can be large regional variations in consumer characteristics, channel composition and the like, so it is vital to build the optimum distribution network for each area. From our survey, we found that the high performers achieving profitable growth in Asia's emerging markets make use of a wider array of channels compared to struggling companies. In particular, it is notable that the high performers tend to build retail networks or stores of their own, and that they make use not just of modern retail methods but also more traditional methods as well.

This kind of strategy may seem to take excessive time and money, but high performers achieve efficient operations by examining each market on a granular level while clustering countries and markets that share common characteristics.

In Asia's emerging markets, many global retail companies have built a modern distribution system, including distribution centers, which leads to retailers strengthening their positions. Accordingly, it is also necessary to deal with local business practices and costs unfamiliar in Japan, such as distribution center fees and listing fees. Such unfamiliar practices are seen not only in the modern retail industry, but also in traditional retail and ecommerce. "In Asia's heterogeneous emerging markets, access to final consumers, brand control, and the ability to closely understand and manage cost structure optimized for local distribution practices are vital." said Tsukasa Yoshimoto, Japan Consumer Products Center Advisory Service Leader at EY.

It is not only consumer products companies who face such a challenging situation. Global retail companies are also struggling to attract consumers in a fiercely competitive market — for example, competing with local players who have a deep understanding of local consumers and dealing with the rising tide of e-commerce. In terms of merchandise

policy, cooperation with consumer products companies has become a strategy differentiator, and consumer products companies need to build supply chains that can rapidly respond to the changing needs of consumers and retailers.

Many companies use external distributors in the initial stage of market penetration, but high performers do not just train distributors. They also share costs and profits with them and therefore build a granular, flexible supply chain, which leads to the development of a symbiotic relationship between company and distributor. Also, after establishing a presence in the market, companies can ensure thorough supply chain management through creating their own sales network and begin to differentiate themselves.

II - iii

Aiming for further growth

In the previous sections, the focus has been on the challenges that many Japanese companies face when entering very different markets. However, there are Japanese companies already establishing a presence in Asia's emerging markets. From this section onward, the focus will be on the factors we consider to be important for Japanese companies to further grow their businesses in Asia, secure profits and enter a phase of self-sustainable growth.

Developing approaches for unmet needs

Many companies recognize the importance of being "consumer-driven" in product development. However, there are cases where local needs are not sufficiently considered in product development when high-end markets are the target. Of course, there are also cases where just being a global product constitutes added value, and there are also markets where needs similar to those of Japan emerge in line with economic growth.

However, at the same time, it is vital not to forget that "diversity" and "change" are keywords in emerging markets. In our survey, respondents pointed out the need to be wary of overvaluing economies of scale. High performers focus on constantly picking up on diversity and change among consumers and responding to it rapidly and flexibly. Cost and efficiency are important, but it is vital not to compromise on providing value to consumers in pursuit of those goals.

As an example, one company not only carries out field research in emerging markets during product development but also locates its product development facility locally and has researchers live in that country to better understand local consumers and rapidly perceive any changes. Another company does not just assign employees to emerging market cities, but also gathers them periodically to share information, monitor local developments, and build and maintain a system for rapid decision-making.

Creating a new market is also extremely important. Many companies are facing a shortened product cycle and growing development costs against a background of rapidly changing consumer characteristics and tastes and the need to keep pace with the competition. In contrast, if companies can create a market by presenting new categories or inventing new business models that meet a previously unfulfilled or unfeasible need, the market will be huge and the company will gain long-term pre-eminence.

Japanese companies have a long established reputation for high quality and technical skill. In our survey, some respondents rated Japanese companies highly in areas such as developing packages and sales methods tailored to local environments, and developing products and services that introduce a new set of values, such as health, cleanliness and environmental protection. If Japanese companies reconsider their positioning of Asian markets, development policy and organizational design, they can uncover potential needs through in-depth observation of local consumers and develop systems that allow rapid and flexible product development utilizing existing strengths, thus addressing the huge unmet needs of emerging markets and creating significant room for greater sustainable growth.

Diligent monitoring and delegation of authority

In the volatile, diverse emerging markets of Asia, we believe that local empowerment is the key to generating profits. In our survey, it has become clear that high performers skillfully manage numerous apparent contradictions by actively promoting localization while maintaining discipline to realize profitable growth.

However, through our research, interviews and debates with industry specialists, it is clear that in Japanese companies, the global head office tends to play a greater role than local offices. Naturally, the "right balance" of centralization and decentralization differs according to business line and phase. However, even taking this into account, in many cases Japanese companies do not delegate sufficient authority to the local level. We believe the background to this trend is a lack of commitment to securing revenue and profit growth through overseas expansion, or unclear positioning of overseas expansion in the overall company strategy.

High performers design a clear investment strategy with regard to strategic and investment criteria, such as the scope and investment budget of operations, hurdle rates and payout periods. Their investment policies are tailored to each region; for example, in some areas, they plan to turn a fast profit, while in other areas, they accept up-front investment for certain fixed terms in order to realize future profits.

On the other hand, within the scope of investment strategy, authority in areas such as product development, supplier selection, marketing, channel selection and partnerships and alliances is often entirely delegated to the local level.

"Companies realize agile local investment decisions through initial

"Companies realize agile local investment decisions through initial agreement, in the planning stage, between the headquarters and local subsidiaries in terms of investment policies and authorization, which enables local management to accelerate smooth implementation within delegated areas of authority."

Takeshi Hitomi

Japan Consumer Products
Strategic Solutions Group

agreement, in the planning stage, between the headquarters and local subsidiaries in terms of investment policies and authorization, which enables local management to accelerate smooth implementation within delegated areas of authority," said Takeshi Hitomi, Japan Consumer Products Center Strategy Leader at EY.

Thorough monitoring is also important. Local leadership may make decisions within the scope of their authority, but must also be accountable to the head office. To achieve profitable growth, accountability and globally consistent and effective strategies are vital. Moreover, even if the head office understands the importance of delegating authority and promotes localization, sometimes local leadership feels that empowerment is insufficient both in area and extent. To close this perception gap, communication between the head office and local leadership must be re-evaluated and strengthened.

Utilizing diverse human capital

In order to maintain a consistent global strategy while promoting the delegation of authority to the local level, it is important to secure and use the right human capital. High employee turnover, high annual wage increases and a lack of skills are some of the common issues found in emerging markets, and securing the right people was a problem many companies pointed out in our research and interviews. Japanese companies in particular have limited experience of using personnel from outside the company or sector, and the difficulty of securing the right human capital is one factor in their inability to delegate authority at the local level. Moreover, if expansion is achieved through corporate acquisition and the old leadership stays in place, it could be difficult to maintain a consistent global strategy.

In reality, this struggle to secure and utilize human capital is not just a concern for Japanese companies, but was also emphasized in our research and interviews globally, indicating intensified competition for human capital in emerging markets. Within this wider trend, the main difference between high performers and other companies is that high performers use a variety of approaches to establish and cultivate local leadership, such as actively educating the management in local companies, employing and dispatching human capital from other companies abroad and other local companies, as well as sending people from the head office.

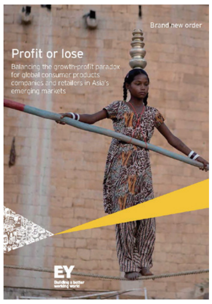
In addition to securing local leaders, cultivation of local staff is also important. From our survey, one area in which Japanese companies were strong was workplace morale, reflected in initiatives such as *kaizen* (continuous improvement) or "5S," and following a set of procedures closely when doing business or providing a service. If Japanese companies can realize these elements of high-quality operations in Asia's emerging markets, we think they can also create a new market, as mentioned previously.

High performers also promote systems to share best practices among management in each country and region and utilize the merits of being a global company. Conditions vary widely in each country or region, but we believe that finding commonalities and accelerating the rollout of best practices horizontally across the company is a factor in increasing profit further and securing sustainable growth.

Issues for global companies; realizing both profits and growth

In this report, we have explored some of the ways Japanese companies in particular may realize growth and secure profits in emerging markets.

In our report *Profit or lose: balancing the growth-profit paradox for global consumer products companies and retailers in Asia's emerging markets,* we compare and contrast successful high performers with other global companies in terms of moving from achieving revenue growth to achieving profitable growth. We also describe eight business imperatives that we believe global companies need to implement in order to succeed. See the report here:



Profit or lose: balancing the growth-profit paradox for global consumer products companies and retailers in Asia's emerging markets

For further information visit
http://www.ey.com/GL/en/Industries/Consumer-Products/Profit-or-lose

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Consumer products companies are operating in a brand new order, a challenging environment of spiraling complexity and unprecedented change. Demand is shifting to rapid-growth markets, costs are rising, consumer behavior and expectations are evolving, and stakeholders are becoming more demanding. To succeed, companies now need to be leaner and more agile, with a relentless focus on execution. Our Global Consumer Products Center enables our worldwide network of more than 16,000 sector-focused assurance, tax, transaction and advisory professionals to share powerful insights and deep sector knowledge with businesses like yours. This intelligence, combined with our technical experience, can assist you in making more informed strategic choices and help you execute better and faster.

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