Risk, Opportunity and Astonishing Growth: Harnessing the Potential of Emerging Markets

First-hand lessons from China, Brazil, India, Philippines and beyond.

Quick take: Product development cycles in China, from conception to marketable product, may move in three- or four-month timelines, versus the 18–20 months one might see for a traditional multinational in the West.

"Fewer than expected multinational food and beverage companies are really leveraging the emerging market growth," says Michael Honan, managing associate at Linklaters (*www.linklaters.com*). "But recently there's been a clear shift toward emerging economies. Most of these economies—like the BRIC countries [Brazil, Russia, India and China]—have high consumer demand in food and beverage, high market growth rates and potential for production bases for the industry."

"The world has just suffered from an intense crisis, with huge impact on the global economy," says Julia Fernández, olfactive design studio manager, Americas, at IFF. "This has impacted millions of consumers, the way they spend their money and the way they observe the brands. But, mostly, it impacted the way brands and companies invested into new markets—an upside-down economy that created opportunities aplenty."

Honan says that the number of middle class households in emerging market economies is forecast to grow to about 3 billion by 2015, while an Ernst & Young report notes that there are 525 million middle class people "in Asia alone."[a]

"By 2030, so many people will have escaped poverty that the balance of geopolitical power will have changed completely, and global trade patterns will also be unrecognizable," the Ernst & Young report continues. "The 20 years in between will see more and more people entering the middle classes with new money and demands, and economists hope these consumers can help rescue the global economy. Meanwhile, companies used to serving the middle-income brackets of the old Western democracies need to decide how to supply the new bourgeois of Africa, Asia and beyond."

"Even when taking into account the risks of going into emerging markets, there is massive opportunity," Honan concludes. We believe the appetites of emerging markets—innovative markets for the global food and beverage brands—is a fantastic opportunity and will compensate for the drop or plateau in demand in the more developed economies."

[a]*http://www.ey.com/GL/en/Issues/Driving-growth/Middle-class-growth-in-emerging-markets*

Understanding the Risks

"You have to understand an emerging market before you go in," says Honan.

This includes understanding the macro-level stability of the country a company is considering entering, including credit risk, governmental investment expropriation risk and political stability risk. To illustrate, Honan says, the sovereign risks in Russia or Indonesia are higher than those of South Korea.

"The stability of the country you're going into will give you certainty in the stability of your investment," he adds.

Corruption risk is also a major factor to consider.

"Multinationals, particularly from the United States and United Kingdom, are subject to far-reaching rules and regulations around bribery," says Honan. "Going into an emerging market, you have to consider how that fits in with your local regulations. The corruption risk in places like India, Russia and Mexico is something that multinationals will have to bear in mind, and make sure they will be able to put in place the necessary structure to ensure that they can manage that risk."

Honan's comments came just as GlaxoSmithKline executives came under investigation for potentially bribing doctors and hospital administrators in exchange for prescribing the company's drugs. The scandal was widely reported, illustrating the risk and backlash local corruption can deliver.

Investor protection within developing markets must be kept in mind as companies expand into new territories.

"Going into an emerging market, you have to be aware that the liability of your directors, potential lawsuits against the agency and the protection of your investments in that country are going to be different from the home jurisdiction," says Honan.

Brazil's tax system, for example, is a "critical issue" for companies considering expansion in that country, Honan says of the notoriously antiquated and complex network of rules and regulations.

Finally, the relevant legal restrictions facing multinationals should be considered before moving into a new market.

"For example, in India there are certain restrictions on certain types of ownership in some sectors," Honan says. "There may be restrictions on how much of a business you can own, and restrictions on employing foreign personnel."

He adds, "Each emerging market you look at will score lower or higher in each of those risks, so you need to take them into account."

"Companies can reduce their exposure to risks by structuring their strategy correctly and selecting their local partners carefully," says Honan. "We often see clients choosing a joint venture route with a local partner in emerging markets, which will counterbalance some of the investment risks and give them access to the local knowledge they need."

Growth Opportunities: China, Philippines and Brazil

"Not surprisingly, China offers the greatest opportunity, both in terms of potential growth and as a competitive production location for Asia," says Honan. "In China, the number of middle class households is forecast to grow from currently less than 3 million to more than 30 million in 2020, which indicates increased food and beverage demand."

Urbanization in China has boosted aspirational consumer behavior in which Western trends are followed closely, explains John Cavallo, general manager at Trilogy Flavors, Shanghai, which services many mid-level and local customers in China. With nearly 200,000 Chinese students having studied in the United States on visas during the academic year 2011–2012, it is no surprise that new habits and brand awareness are rapidly developing in the Chinese population.

"This generation is experiencing more global products than in the past, and developing different taste requirements for products when they return to China," says Cavallo.

"Consumers demand high quality," Cavallo continues. "Companies must have the ability to deliver product constancy. Successful companies will develop products and target the needs of this segment, developing products that this generation and their families can grow with." Cavallo adds that beverage, savory and dairy products—including yogurt, yogurt drinks and ice cream—represent growth segments for the flavor industry in China to offer quality flavor profiles utilizing natural ingredients, while also delivering product consistency. Meanwhile, he says, on-the-go/convenience products for the breakfast segment represent an area for future growth. While China's rapid and robust economic expansion has boosted awareness and demand for new products modeled on Western brands, the Philippines represents a more "basic" market ruled by acute cost-consciousness. Consumers are not preoccupied with global brands, instead seeking basic products for family consumption.

Complex taxes in Brazil, interpersonal relationships in China and more: The economic opportunities for multinationals in emerging markets are immense, as are the intricacies that must be addressed.

"Beverage and savory appear to be the leading food areas for growth," Cavallo says of the Philippines. "Toppings for rice and fast home cooking foods are key in this market. Beverage is also a key segment, with many local brands actively participating in the market."

Meanwhile, as in China, rapid economic transformations in Latin America are reshaping the lives of consumers and, as a result, their needs and expectations.

"Better growth prospects and low interest rates in major [Latin American] economies have triggered a welcome resurgence of capital flows to the emerging economies," says Fernández. "These capital flows, however, come with the attendant risk of inflation pressure and asset bubbles."

Brazil, of course, is the largest single market opportunity for flavor and fragrance companies and their customers. With a stable economy, growing middle class, increased purchase power, rising luxury niche and growing retail industry, the opportunities are significant.

"The 'average' Brazilian has become the new gold," says Fernández, "with marketing and innovation targeted to people who have never before had their needs examined. We are in a period of accelerated evolution. After the recession, brands and retailers got permission directly from the consumer to change the way we do things, to experiment with retail, and to refresh economic and communication methods, and the way we do business. In some ways, this is a revolution, a great opportunity to change the dialogue between consumers and brands."

As in China, Brazilian consumers are being exposed to fragrances from global functional brands, which offer new ingredients, odor profiles and benefits, which in turn are upending expectations, according to Fernández.

"Brazil is opening up to a more vibrant and complex fragrance palette, and fine fragrance is driving the path, inspiring other categories such as hair care, personal wash and even home care," she says. "We expect that the companies will start investing on more local developments, to address very specific needs of the Latin consumers. In hair care, this has been a trend over the past 10 years, and now we see its reflections with fabric conditioners and personal wash categories. Latin Americans are starting to demand higher sensoriality in their fragrances choice, while balancing their traditional choices with long-loved brands and fragrances."

Sales channels are multiplying and expanding in parallel with Brazil's market growth, offering opportunities for brand footprint expansion, multiple points for targeting consumers and, as a result, bigger sales. "The entrance of international cosmetic brands investing in retail has increased the product offer," says Fernández. "While direct sales is still the largest distribution channel, key beauty and fragrance brands are dialoguing with consumers through the expansion of awareness of the brands, either via seasonal store-based retailing or social media. Brazilians are one of the leading nationalities using Facebook and Twitter."

Fernández continues, "Retail is becoming more sophisticated, with leading international brands opening stores and operations in Brazil. The drugstore retail has also shifted. Due to new legislation, most prescription medicines are no longer available on the pharmacy's aisles. This has opened a new space for brands. Most big drugstore chains have created and remodeled the beauty area. This has also impacted the growth of emerging segments, such as depilatories, feminine hygiene soaps, cosmetics and sun care."

Complicating matters, however, is the fact that Latin American consumers are cost-conscious, but demand high-quality scents with significant substantivity and lingering freshness. Fernández notes that her company's research has found these consumers to be "highly sensorial and emotional when choosing even the most functional products, such as powder detergents."

Fernández, meanwhile, has identified unusual crossovers between consumers in Latin America and Southeast Asia: "You would be surprised with the similarities between Thailand and Brazilian consumers; or Colombia and Indonesia. We look at a plethora of angles to create our fragrances. It's not only about creating fragrances; it's about owning the emotional connection, to be established with consumers."

Booming Market and Health Concerns

As China has greatly Westernized in recent decades, so too have its diet and health problems. Often the contrast can be seen in a single household, with the parents maintaining a healthy weight on a traditional diet, while their Western-oriented children consume non-traditional foods and suffer weight issues.

Cavallo explains that childhood disease, including diabetes, and a growing elderly population, is changing the food and beverage needs of the Chinese population, most notably in the cities, where discretionary income is growing fastest. Rural residents, meanwhile, have limited access to Western brands and styles of food, and address most health concerns with traditional palliatives, if at all.

"There's concern in the marketplace about obesity," says Cavallo. "In the major cities where consumers have higher incomes and more Western-type products are entering the market, consumers are becoming concerned about childhood obesity, heath, and sugar and salt consumption and reduction."

According to figures released by the Chinese Center for Disease Control and Prevention (*www.chinacdc.cn/en/*), average Chinese waistlines have grown from 63.5 cm in 1985 to 76.2 cm in 2012. Between 1992 and 2002, the country's overweight rate rose about 40%. Accompanying this weight gain, of course, is increased incidence of diabetes and cardiovascular disease. While these health issues plague many markets around the world, the issue in China is uniquely staggering given the size of the population, which is currently estimated at 1.3 billion.

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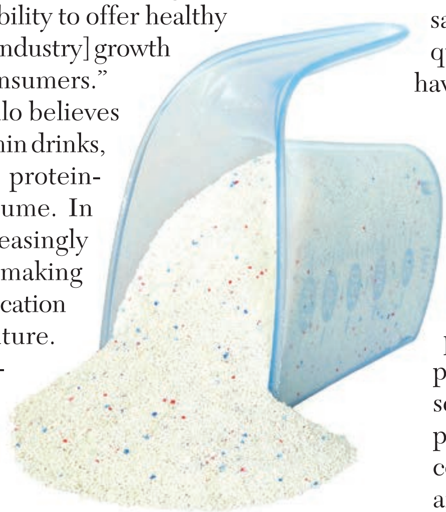
"China has the world's largest number of diabetics," says Cavallo. "Approximately 90 million [citizens] have type-2 diabetes, more than the number of people suffering in the United States and India combined. This is a recognized health problem from the standpoint of the government and health ministries, and action must be taken to correct this for future generations. It is well accepted that as countries become more wealthy, lifestyle changes associated with diabetes increase. Diets change and physical activity decreases. Having the ability to offer healthy alternatives will certainly support future [industry] growth and provide a better quality of life to consumers."

These healthy products, which Cavallo believes will likely gain market share, include vitamin drinks, bio-active products, supplements and protein-containing foods that are easy to consume. In addition, Chinese consumers are increasingly preoccupied with health and beauty, making them a strong potential market for beautification drinks and cosmetics beverages in the future.

"The culture is attuned to TCM [traditional Chinese medicine] products, and realizes the benefits that can be achieved through eating and drinking," says Cavallo. "Successful flavor companies will help local manufacturers bring these products to market."

For the growing elderly population, which may experience changing taste sensations and a diminished ability to swallow, new health and nutritional products such as pharmaceutical or protein beverages could offer opportunities for consumers and product developers. Bone health and muscle integrity concerns lead the field in health concerns for the aging population, so product development will likely address those facets, too. Because there is a tradition of using food for more than just satiation in markets such as China, Vietnam and the Philippines, these types of products could potentially be broadly embraced.



Latin American consumers are cost-conscious, but demand high-quality scents with significant substantivity and lingering freshness; Julia Fernández of IFF notes that her company's research has found these consumers to be "highly sensorial and emotional when choosing even the most functional products, such as powder detergents."

Local Tastes: One Size Does Not Fit All

Cavallo has worked with companies developing products for local tastes, rather than simply copying a Western brand profile. For instance, he says, ice cream in the Asian market can be a "highly designed product," elaborately engineered to highlight color, texture and shape, and can sometimes resemble things such as flowers.

"It's all based on local tastes, which change region to region," says Cavallo. "If you broke China up into four quadrants—north, south, east and west—they all have different awareness of brands and product expectations. In Hong Kong, consumers are brand-oriented; the population consists of sophisticated consumers focusing on high-value products. In Shanghai, consumers are brand-, quality and fashion-conscious. Their habits change quickly and so show little brand loyalty. In central and northwest areas, consumers aspire to products produced elsewhere, and are willing to pay a premium. Their habits change quickly, and are sensitive to the price/quality value proposition a product offers. In the northeast area, i.e., Beijing, consumers look for functionality. These consumers are more likely to purchase local brands and look for value when making purchases. It's not simple to do business there."

He adds, "If a company wants to develop business in China, and they try to use the same strategy in the north as in the south, or try to use what works in Shanghai in southern China, they'll find out quickly that consumers are very different. Consumers are looking for different things in different regions; it's far from a homogenous market. The [flavor and fragrance] profiles, what the consumers are looking for, the types of end-use products, the cost and value proposition—it's all very different. It's very difficult to sell the same product to the mass [market]. That's why a partnership, working with local distributors, local brokers is very valuable."

The Value of Local Partnerships: Knowing What Sells

"There are ways of achieving [local access]," says Honan, "including combining with a local partner when you first enter the market."

"In China, success is achieved [by] having the right products at the right price, which meet local taste requirements," says Cavallo. "In the past, many companies tried to service the Chinese market without having a local presence. They tried to capitalize on offering Western-profile products into the market. In my opinion, this never leads to successful business development. Companies realized that the taste requirements are very different, meaning local development is required."

Cavallo adds, "In many cases, local partners … know what works in different regions. You can save a lot of time by working with these distributors, because they know what's going to sell. If you're trying to sell a particular flavor profile for a particular segment and price, they know what the local [customers] are doing and what the other flavor houses are offering. That's a good way, in my opinion, to do business."

Honan adds, "We've recognized a number of multinationals that have gone into China have struggled to match the fast-evolving consumer expectations there. That, perhaps, has come as a surprise to them."

He continues, "There are ways to mitigate that risk [by] understanding the market you're going into. You can't achieve success without local knowledge."

Rapid Development Cycles

"In emerging markets, particularly in the consumer space, first-mover advantage is key to success," says Honan.

"Mid-level companies are putting out three more products by the time the larger companies put out one," says Cavallo, highlighting the pace of doing business with some Chinese companies.

"Moving into an emerging market, you have to be willing to commit capital, even when working with local partners," says Michael Honan (Linklaters), who often sees multinationals underinvest in new projects.

Product development cycles from conception to marketable product may move in three- or four-month timelines, versus the 18–20 months one might see for a traditional multinational in the West. At the same time, many companies in Asia do not feel the pressure of having to be first-to-market, allowing them, according to Cavallo, to replicate the successful product facets, such as taste, aroma and value proposition. "Asian companies tend to develop products based on instinct, rather than traditional brand management, like in developed countries," Cavallo explains. As a result, he says, "Efficient technology transfer to the local market and the know-how to make it work is key, as is an openness to share not only ideas, but technologies."

Cavallo continues, "When you do presentations in China, you're rarely dealing with marketing people. Brand managers are not really the ones designing the scope of the products. They do not always rely on consumer testing—you're not talking that language." He adds, "I have experienced that, in China and other Asian countries such as Philippines, Korea and Japan, R&D drives the development of new products. In some cases, they [pursue] a 'market-follower' strategy, capitalizing on the best elements of the product or new brand being considered."

As a result, he says, the focus is much more technical than traditional processes, with discussions centering primarily on benefit and differentiation. R&D staff will be much more involved in the "rationalization" and creation of a product in China than in the West. "It's not unusual for a company to hire an outside marketing [firm] to track the brand, rather than doing it themselves," Cavallo explains. The level of technical discourse is a result, in part, of a highly educated Chinese workforce, says Cavallo. While an Asian market such as the Philippines might feature less technical expertise, China has developed many professionals with flavor- and fragrance-oriented degrees (organic chemistry, analytical, ingredient interaction, etc.) into the workforce.

"These people enter the industry and work on the technical areas they know best," says Cavallo. "These are the people you work with in the product development arena. When you meet with them, you tend to have a much more technical discussion. A valuable supplier is one that they perceive to be open, knowledgeable, trustworthy and someone they can develop a long-term relationship with."

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Guanxi: Indispensable Relationships

"The relationship element is really important for a lot of companies … because business is done through relationships," Cavallo says of the Chinese market.

Often described as *guanxi*, or the interconnected dynamics of personal relationships, these ties are the DNA of business in China. These not only open doors for doing business, but also build trust and sturdy alliances when product, financial or other troubles arise. These relationships create flexibility between suppliers and customers, but also follow-through.

"That's how partnerships are really assessed," says Cavallo. "It's a very different way of doing business."

He adds, "Companies entering the Chinese market must have a presence and build awareness, and this takes time. It is my opinion that, for foreign companies to be successful, they must hire the best local people available who understand the market and day-to-day business dynamics."

In addition, Chinese companies need not just business partners, but also technical partners. As a result, suppliers can often be called to share expertise in an open way to allow local companies to better understand products with which they have no experience. Technology discussions with a spirit of cooperation can solidify customer relationships. This builds respect and adds value in the eyes of the customer. Hesitation on the part of the supplier, conversely, can negatively impact the relationship.

"Technology is a driver for success," Cavallo explains. "Companies must be able to offer technical solutions at a cost suitable to what the market can support. Companies must be willing to share technologies and prove that they can be considered local partners."

Beyond BRIC: Future Growth and Risk Drivers

"The 10 fastest growing food and non-alcoholic beverage markets for the next five years will be in emerging markets," says Honan. "BRIC countries will dominate growth in emerging markets in terms of scale, but there are other jurisdictions that won't be far behind, including Indonesia, Mexico and Turkey."

The Establishment Post recently reported that Indonesia has nearly 250 million consumers, 7 million of which are middle class. According to Nielsen (*www.nielsen.com/id.html*), Indonesia's personal care market grew 13% in 2012, while the food and beverage market grew 11% during the same period.

Meanwhile, a 2013 Frost & Sullivan (*www.frost.com*) report notes that, by 2025, more than 75% of Turkey's population will be urbanized.

"Between 2020 and 2030, the working age population (15–64 years) is set to account for nearly 70% of Turkey's population," the report adds. "As the demographic composition of the country changes, its strong infrastructure system will provide the necessary support to sustain this growth."

Meanwhile, The World Bank reports, "Mexico's middle class has grown since the turn of the century, with close to 17% of the population joining its ranks between 2000 and 2010. Social programs and better access to education boosted the country's workforce." Mexico's El Instituto Nacional de Estadística y Geografía (INEGI) tells a slightly different story. According to INEGI, Mexico's middle class comprises 39.2% of the population.[b]

It's also important to keep an eye on which markets might be most or least affected by macro-economic fluctuations around the world. For instance, Honan says, South Korea and Indonesia would be relatively insulated from any breakup of the eurozone. Instability in the Middle East and a hike in oil prices, on the other hand, would affect Russia and Mexico relatively little due to their strong energy positioning. Despite regulatory and labeling issues in Latin America, Fernández, sees continued opportunities ahead.

"The continuous investment of international companies will boost the offers for consumers, and impact the olfactive preferences as launches continuously expand the olfactive portfolio offer," she says. "We also expect a turning point on the personal wash market, as some producers have started shifting bar soap to shower gel options. We saw this shift happening in Thailand 10 years ago, and Latin America seems to be paving the same path. Lastly, I foresee an increase of sensoriality, even on the most functional products and traditional smells, such as pine, lavender and citrus."

Risk-taking is Crucial

"The fast-growing markets with the greatest scale often have the greatest risks," says Honan. "China has the greatest opportunity, but has a greater risk than other emerging markets. In India, you have to be aware of the price sensitivity of the food produced there, how it impacts the consumer."

Despite the numerous risk factors in need of consideration, the opportunities, in Honan's opinion, outweigh the dangers.

At the same time, he says, "Moving into an emerging market, you have to be willing to commit capital, even when working with local partners. A multinational coming from the developed world must be willing to take investment initiative over a long period of time. Often, companies tend to underinvest in emerging markets, because they're concerned about the risk. But you have to be willing to make that investment in order to make the return in the long term. Going into emerging markets, you have to … adapt your products and operating models and management structures accordingly to give you success."

[b]*http://www.inegi.org.mx/inegi/contenidos/espanol/prensa/Boletines/Boletin/Comunicados/Especiales/2013/junio/comunica6.pdf*