The Master CFO Collection

Volume 2

What lies beneath?

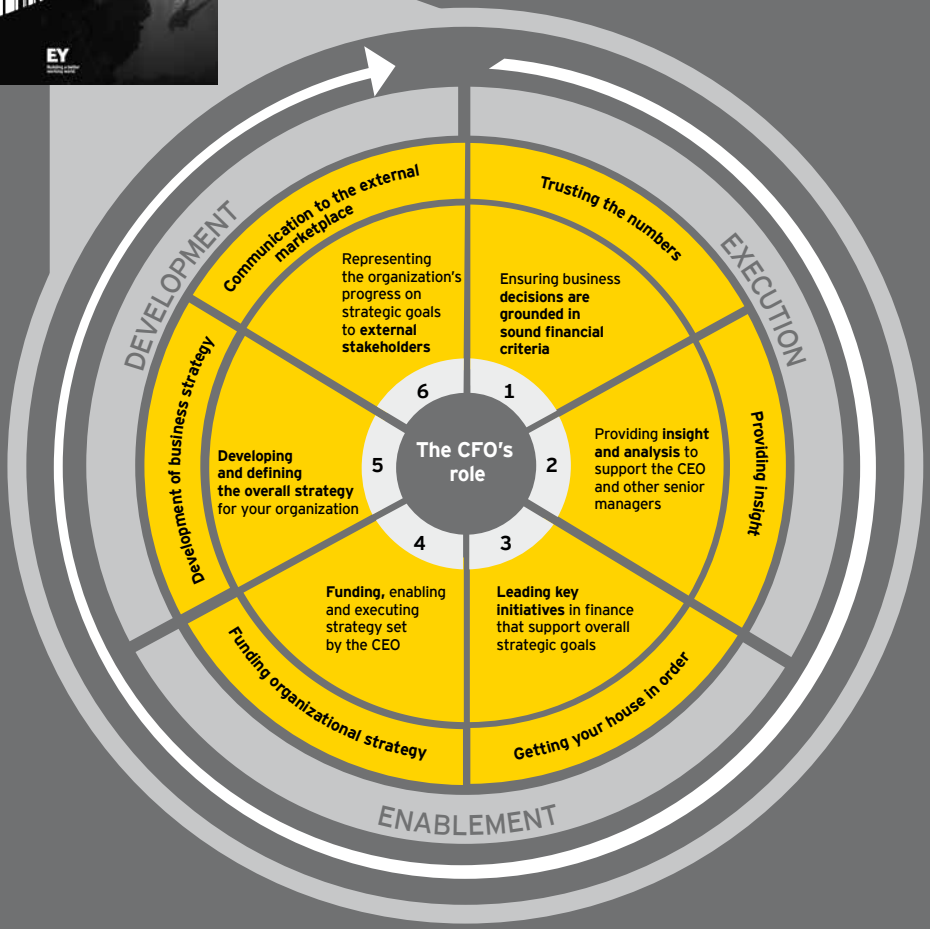
The hidden costs of entering rapid-growth markets

EY

Building a better working world

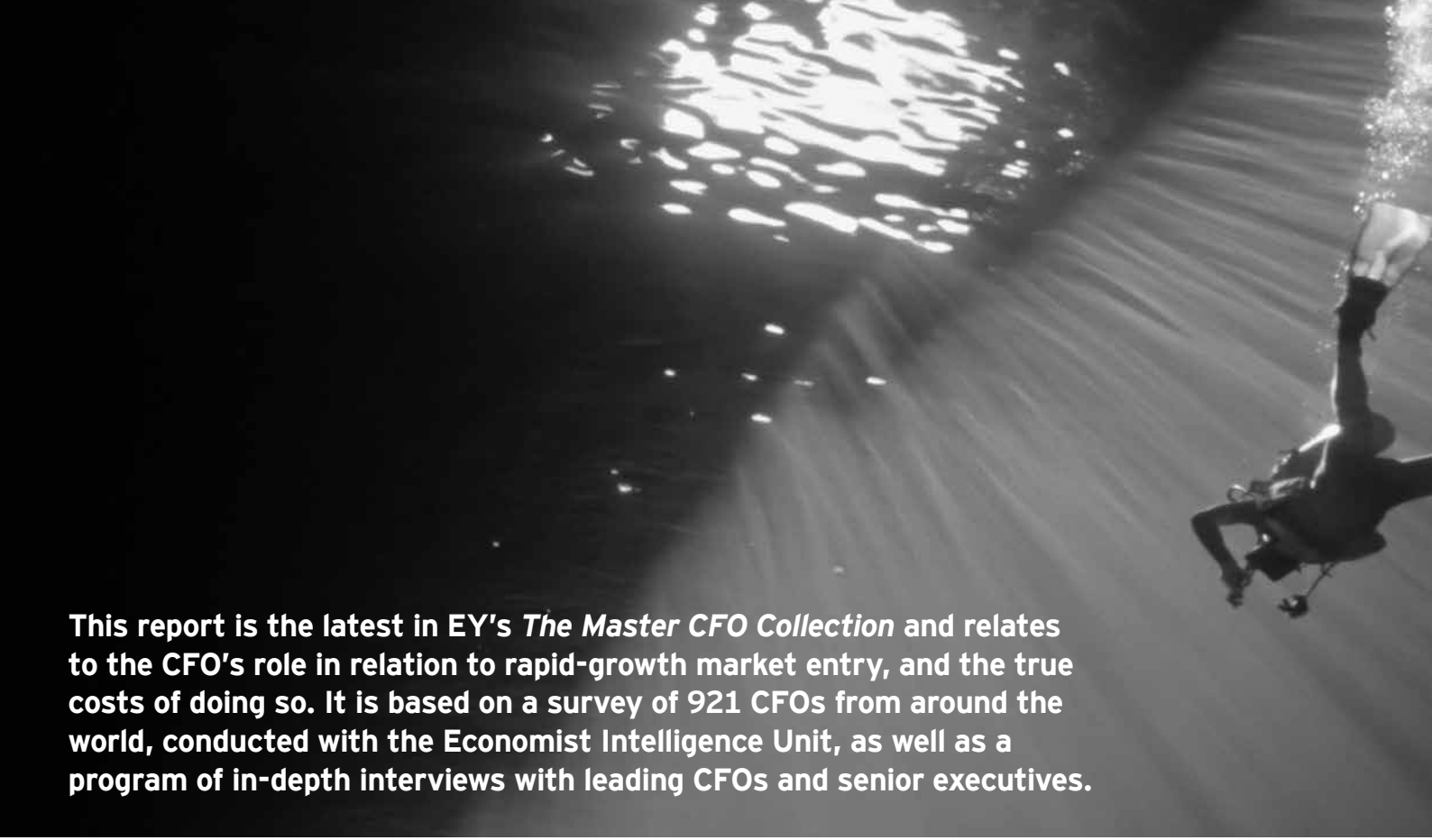
The CFO's role

We believe these six segments represent the breadth of the CFO's remit. The leading CFOs we work with typically have some involvement in each of these six – either directly or through their team. While the weighting of that involvement will depend on the maturity and ambition of the individual, the sector and scale of the finance function, and economic stability, they are all critical to effective leadership.



In this report

Executive summary: What lies beneath?	4
The good news story of the global economy	8
The role of the CFO	12
The hidden costs of investing:	16
Financing costs	**18**
Mode of entry costs	**22**
Operational costs	**28**
Regulatory costs	**34**
Human capital costs	**37**
Political costs	**42**
Ten lessons for CFOs	48
Respondent demographics	50
Other titles and contact information	51



This report is the latest in EY's *The Master CFO Collection* and relates to the CFO's role in relation to rapid-growth market entry, and the true costs of doing so. It is based on a survey of 921 CFOs from around the world, conducted with the Economist Intelligence Unit, as well as a program of in-depth interviews with leading CFOs and senior executives.

The Master CFO Collection is a collection of studies from EY which provide insight on events and experiences that CFOs encounter as part of their role. The series is a part of our CFO program, which looks at aspects of personal interest to CFOs, and future finance leaders, as they develop themselves and their teams, and learn from others in their community. For further information on other titles, please see the back of this report.

The CFOs and executives with whom we conducted the in-depth interviews include:

- Stefan Asenkerschbaumer, Chief Financial Officer, Robert Bosch
- Ron Bell, Chief Operating Officer, Actis
- Peter Bracke, Vice-President and Chief Financial Officer, Honeywell Transportation Systems
- Mikael Bratt, Senior Vice-President and Chief Financial Officer, Volvo Group
- Paul Brooks, Chief Financial Officer, Experian

- Robin Freestone, Chief Financial Officer, Pearson
- Deirdre Mahlan, Chief Financial Officer, Diageo
- Pinak Maitra, Chief Financial Officer, Kipco Group
- Pavel Mitrofanov, Deputy Chief Executive Officer and Chief Financial Officer, Metalloinvest
- Paul O'Flaherty, Finance Director, Eskom Holdings
- Frédéric Puistienne, Chief Financial Officer, Adisseo

Our thanks to all who participated and shared their experiences.

Executive summary: What lies beneath?

The opportunities in rapid-growth markets are undeniable. So are the potential risks and the likelihood that budget overruns can temper growth prospects. Over one-third of CFOs underestimate the costs, and 4 out of 10 the time, involved in entering markets where even the smallest miscalculation can erode profitability. Where others see primarily opportunity, the CFO must be able to spot complexity — the costs both manifest and hidden. This requires ongoing scrutiny, and not just an initial investment evaluation.

The choice of investment destination is becoming more diverse

The increasing importance of rapid-growth markets to their future prospects is encouraging multinationals to look beyond the first-tier rapid-growth markets, such as the BRIC countries, into less familiar economies. Although countries such as China and India will remain vital destinations for investment, finance leaders surveyed for this report say that their companies are also looking further afield, to countries including Indonesia, Thailand, Mexico and Ukraine.

The CFO must retain oversight at every stage of the investment

The CFOs surveyed tend to play a more active role at the pre-entry stage of investment than at the post-entry stage. In order to safeguard the promise of investment and sustain growth in markets where the pace of change is rapid, the leading CFOs interviewed stress the need for involvement at all stages of the process. Given that it may not be practical for the CFO to stay close to every investment in a global portfolio, the ability to delegate and secure the right balance of local and group finance expertise is critical.

More than one-third of companies underestimate the costs of investing in rapid-growth markets

Companies should not assume that rapid-growth markets are also low-cost ones. Among our survey respondents, more than one-third say that the overall costs of investing in rapid-growth markets were higher than they expected. Time overruns are an even bigger problem, with 43% saying that the investment took more time than they had anticipated. Unexpected costs in rapid-growth markets can be a serious issue. With low per capita incomes requiring investors to adopt a high-volume but low-margin business model, even small increases in costs can erode profitability.

Of the many and varied costs of market entry, there are six we have identified as areas of particular concern for CFOs. In order of the reported likelihood to overspend, they are:

1. Financing costs — rising inflation and currency fluctuations
2. Mode of entry costs — choosing the right partner and accuracy of valuations
3. Operational costs — R&D costs and finance function integration
4. Regulatory costs — evolving regulatory systems and high levels of bureaucracy
5. Human capital costs — shortage of the right talent and high levels of attrition
6. Political costs — Government instability and dealing with bribery and corruption

1. Financing costs: rising inflation and currency fluctuations are becoming key concerns for foreign investors

Surging capital flows into rapid-growth markets are stoking inflation and pushing up currency values. Although policy-makers in these markets are trying to cool their economies by tightening monetary policy, the potential for currency risk remains a key source of unexpected cost for foreign investors. International policy is creating another source of currency risk. Growing pressure on the Chinese Government to further revalue the renminbi and allow it to appreciate more quickly could raise costs substantially for exporters and alter the rationale for investment in China.

2. Mode of entry costs: choosing the right mode of investment is considered the most critical decision, with valuation a key challenge

When asked to advise their peers on where to pay most attention in relation to investing in rapid-growth markets, respondents point to the mode of entry as the most critical decision that must be made. Even more so than the investment destination. It also pays to take a long-term view. Over time, given increased liberalization in many markets, the mode of investment may need to change. Companies planning an investment should consider whether this will be possible and what the implications will be.

When acquiring companies in these markets, survey respondents consider valuation to be the key challenge they face. Although the situation varies from market to market, investors may find it difficult to extract accurate data on which to base a valuation. Another common problem is that disclosure levels may be poor, either because of regulatory shortcomings or a lack of cooperation from the seller. These challenges highlight the importance of obtaining data from multiple sources and using a combination of valuation methods to improve accuracy.

3. Operational costs: those related to R&D and finance function integration are the main operational concerns

Anything that increases the cost of production is a critical concern for CFOs, in markets that rely on very high volumes and very low margins to make profit. The highest unanticipated costs relate to R&D investment which, particularly for high-performing companies,[1] is on the rise. The increasing importance of rapid-growth markets is encouraging a growing number of companies to set up R&D centers in these economies to serve populations with fast-rising per capita incomes. Another key area of overspend relates to the integration and harmonization of reporting frameworks, IT systems and local finance talent to meet global reporting obligations.

[1] Those companies with EBITDA growth of above 11% over the last 12 months.

Executive summary: What lies beneath? (continued)

4. Regulatory costs: evolving regulatory systems and high levels of bureaucracy are the main areas of unbudgeted cost

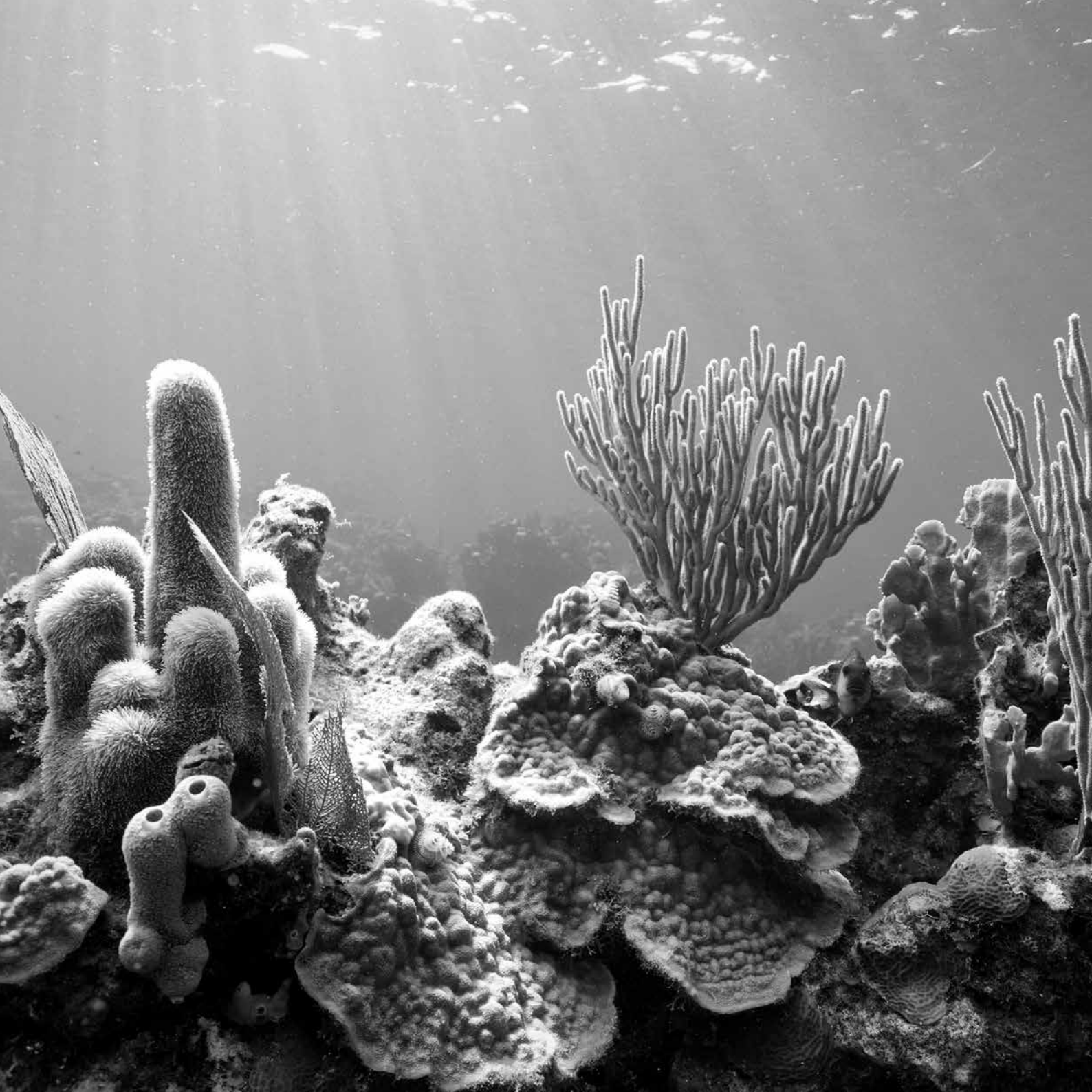
Obtaining the right licenses and permits is a particular challenge for survey respondents. As regulatory systems evolve, these costs may be streamlined but other compliance costs will rise as regulation becomes more demanding. Foreign investors should ensure that they "future-proof" their investments by anticipating future regulatory change and building that into their overall business case.

5. Human capital costs: attrition levels are the main reason for human capital overspend

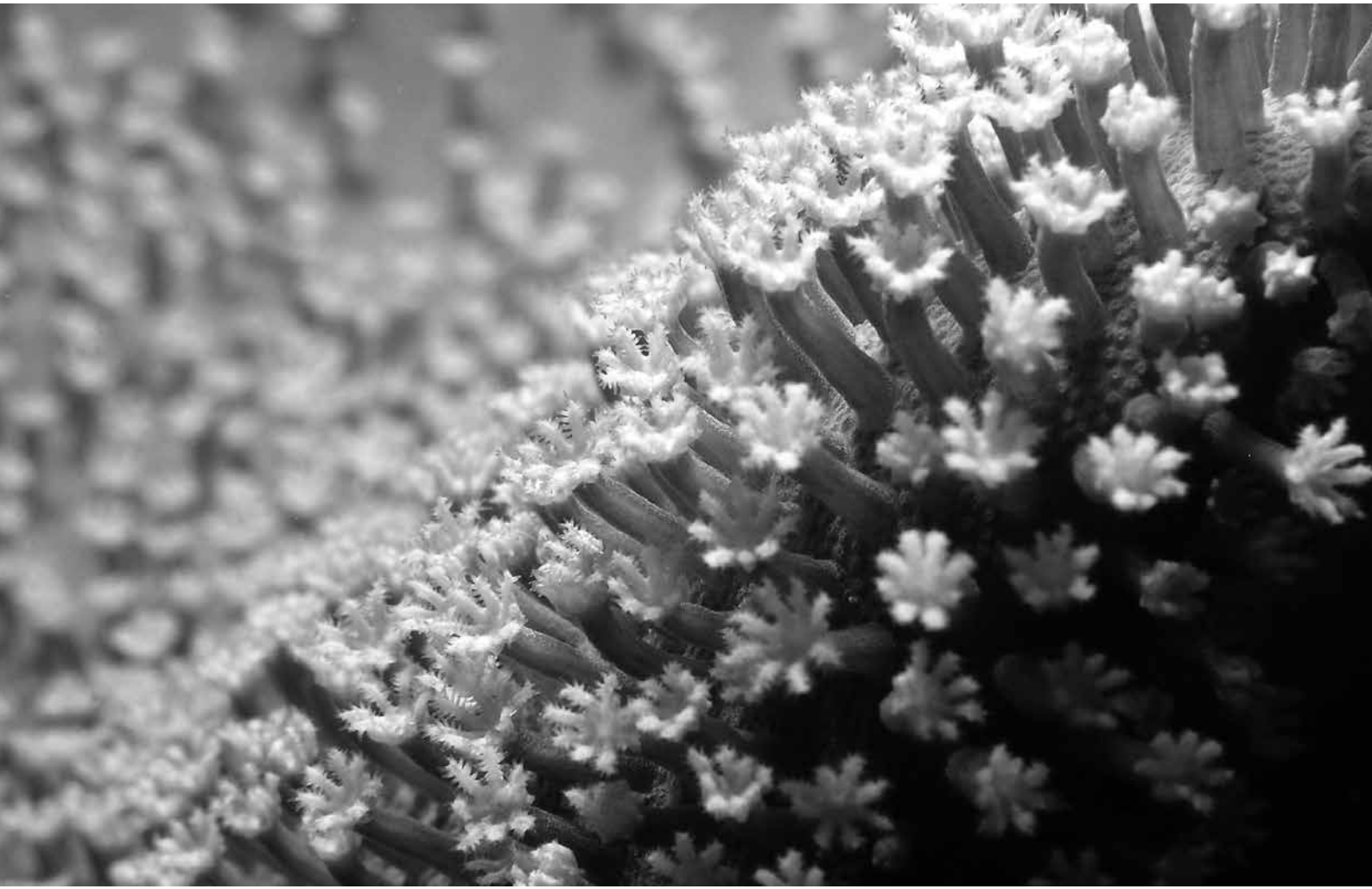
Rapid economic growth and rising demand for a finite pool of skilled workers are pushing up wages and creating high levels of employee turnover in many rapid-growth markets. To counter this problem, foreign investors need to build a brand as employer of choice, ensure that they build strong relationships with local communities and pay close attention to training and compensation policies.

6. Political costs: fear of expropriation has been replaced by bribery and corruption

The upheaval in the Middle East and North Africa in early 2011 brought political risk back to the top of the agenda. Political risk management forms a critical part of the pre-entry planning but should also stay on the radar throughout the life cycle of the investment. Although some political risks, such as expropriation, have diminished, others, such as bribery and corruption, remain a key concern. While acknowledging that local competitors and partners may be used to bribery as part of the normal course of doing business, zero tolerance is argued as critical by those CFOs interviewed, and a key consideration when determining investment destination.



The good news story of the global economy



"It's something that's on the radar of every board and investor. As a company, you want to be seen to be investing in those markets."

—Paul Brooks, CFO, Experian

Expansion into rapid-growth markets has become something of a mantra for growth-hungry CEOs. If a company does not have a rapid-growth market strategy, investors will want to know why.

With rising per capita incomes, favorable demographics and large populations, rapid-growth markets have significant momentum behind them. Most have come through the financial crisis with very little long-term damage and remain on impressive growth trajectories. According to the latest Global Economic Outlook from the International Monetary Fund (IMF),[2] emerging economies as a whole will grow by 6.5% annually in both 2011 and 2012. This compares with 2.4% in 2011 and 2.6% in 2012 for advanced economies.

For CEOs on the hunt for long-term growth, the statistics coming out of rapid-growth markets make for compelling reading, particularly in a context of sluggish growth in developed markets. Already, middle class consumers in the largest rapid-growth markets comprise two billion people who collectively spend US$6.9 trillion annually. In 2010, China overtook the US to become the world's largest car market. It is also the world's third largest market for pharmaceuticals (after the US and Japan) and will become the second largest market for consumer goods by 2015. And, despite having a per capita income of just US$4,300, China is now the world's second largest market for luxury goods after the US, with annual sales of US$17 billion.

High exposure to rapid-growth markets is proving a welcome boost to the performance of many multinationals. According to a recent research report from Thomson Reuters, S&P 500 companies that generate more than half of their revenues from overseas markets will see average growth of 10%, compared with 6% for those companies with more than half of their revenues from the US.3 A number of companies already derive more than 50% of their revenues from rapid-growth markets.

The huge growth potential of rapid-growth markets is encouraging a massive reallocation of capital and resources among the world's multinationals. In 2010, emerging and transition economies attracted more than 50% of the world's inflows of foreign direct investment for the first time. It was also the busiest year on record for emerging market transactions. According to mergermarket, there were 2,763 deals worth US$557.2 billion in these economies over the course of the year, which accounted for 26.7% of the global total.[4]

A number of those we interviewed for this study stressed the pressure on CEOs and CFOs to have a growth story for shareholders around their plans to capture the potential offered by rapid-growth market investment. "There's a real pressure on business to invest in markets such as Brazil, India and China," says Paul Brooks, CFO of Experian, a global information services company. "It's something that's on the radar of every board and investor. As a company, you want to be seen to be investing in those markets."

[2] http://www.imf.org/external/pubs/ft/weo/2011/01/index.htm

[3] http://blogs.reuters.com/india-expertzone/2010/10/19/us-top-lines-set-to-track-overseas-exposure/

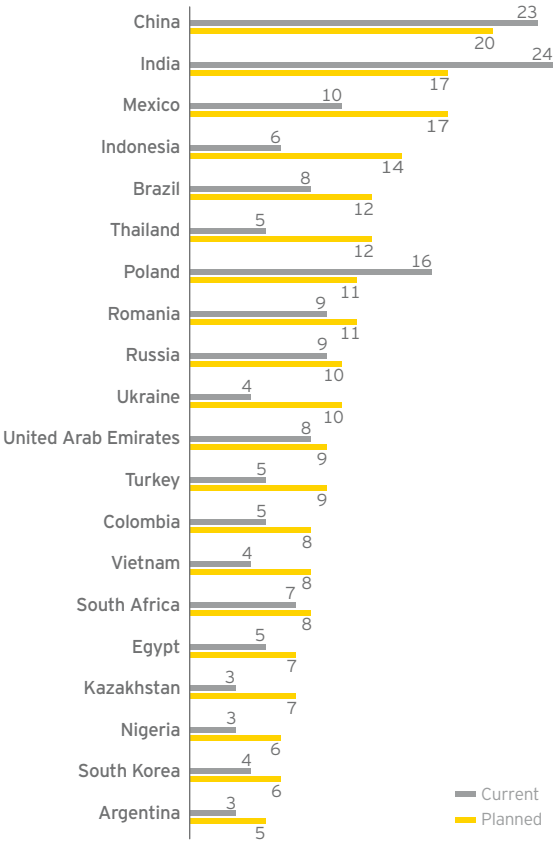
[4] http://www.mergermarket.com/pdf/Press-Release-for-Financial-Advisers-Year-End-2010.pdf

The good news story of the global economy (continued)

The choice of investment destination is becoming more diverse

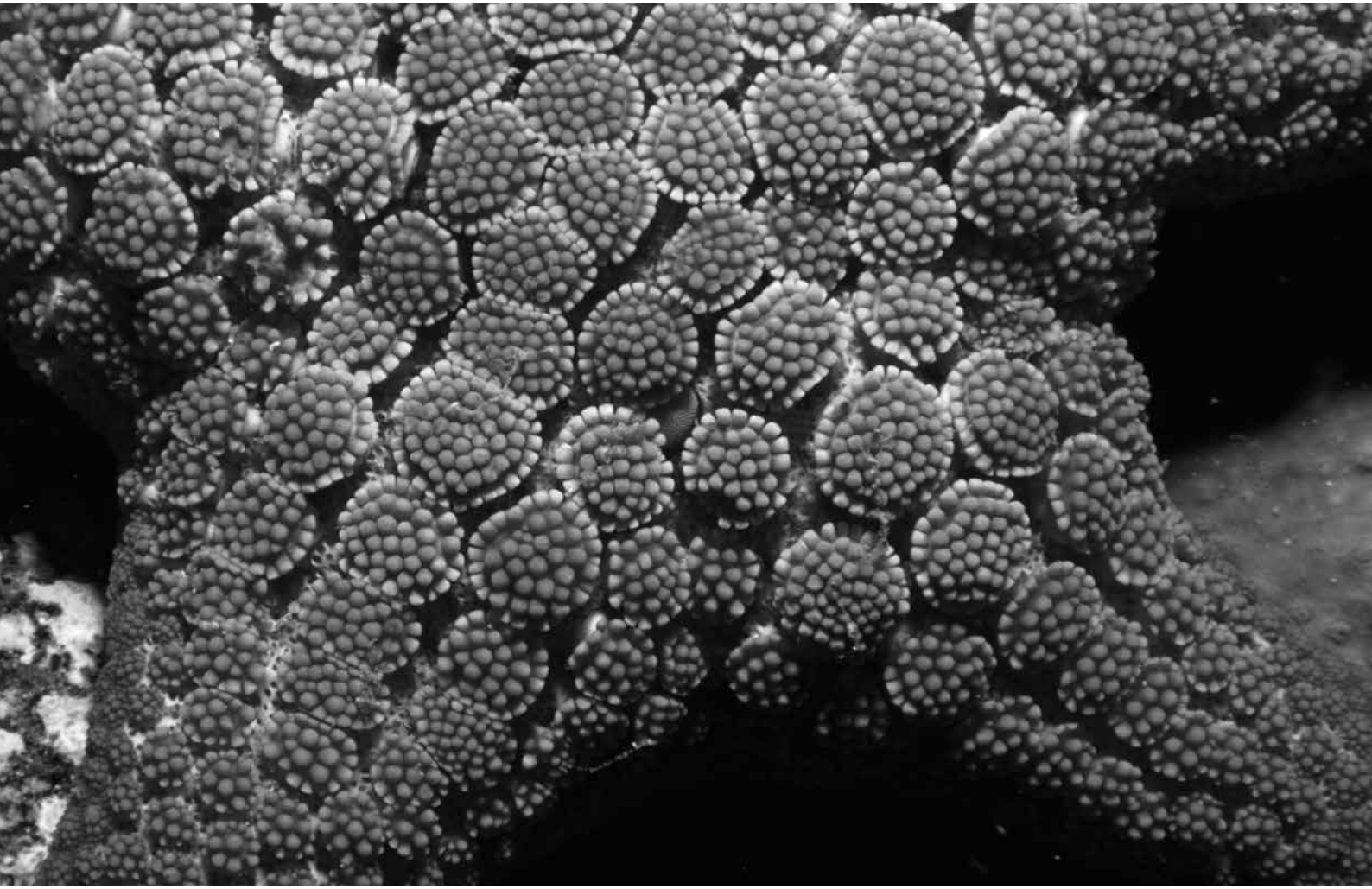
The increasing importance of rapid-growth markets to their future prospects is encouraging multinationals to look beyond the first-tier rapid-growth markets, such as the BRIC countries of Brazil, Russia, India and China, into less familiar economies. Although countries such as China and India will remain vital destinations for investment, finance leaders surveyed for this report say that their companies are also looking further afield, to countries including Indonesia, Thailand, Mexico and Ukraine (see chart 1).

Chart 1: In which of the following rapid-growth markets does your organization have significant investments, or is planning to invest significantly in the next two years?



Shown: percentage of respondents

The role of the CFO



"I make sure that the local business leaders are all thinking about the long-term as well as near-term growth. There's a real danger of throwing money at emerging markets and wanting to invest in everything."

—Deirdre Mahlan, CFO, Diageo

The CFO is uniquely tasked with finding a delicate balance between the accelerator and the brake. Their role is to develop and enable the growth plans of the business, while also ensuring that these plans are grounded in sound financial criteria.

In our previous study, *The DNA of the CFO*,[5] we described the CFO as having a "unique optic" — a particularly broad perspective over the entire business. This makes them uniquely positioned to drive, enable and evaluate rapid-growth market investments. At the pre-entry stage, the CFO can work closely with the CEO to determine how and where to invest. They can provide vital input to building a rationale and appropriate structure for the investment, and in funding and enabling its execution. Once the investment has been made, the CFO continues to play an active role in monitoring performance, identifying and assessing risks and ensuring that the investment is sustainable.

Yet, in the same report, we also described them as being the objective "conscience" of the business. So while they are singularly placed to play an active role in rapid-growth market entry, they also have a responsibility to temper the push to be in these markets at any cost.

"My primary role is to make sure that the business considers all aspects of the investment," says Deirdre Mahlan, CFO of Diageo, a consumer drinks business headquartered in the UK. "As well as being part of the initial decision over whether or not we should enter a market, I also make sure that the local business leaders are all thinking about the long-term as well as near-term growth. There's a real danger of throwing money at emerging markets and wanting to invest in everything."

This balancing act is further complicated when managing a global investment portfolio. The skills and judgment required in rapid-growth market entry is different to those deployed in mature markets. "In developed countries, the focus of the CFO has been on cost reduction," says Christian Mertin of EY's Advisory practice in India. "In markets like India, on the other hand, the challenge is how to manage growth that might be in excess of 20% a year. That requires a different set of skills entirely and means that CFOs need to think carefully about the team they build around them to deal with that growth."

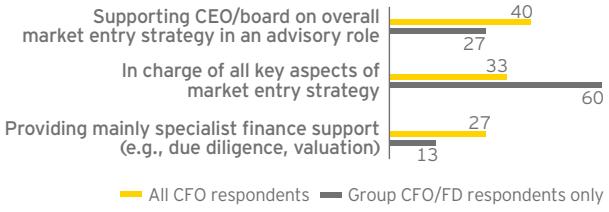
[5] *The DNA of the CFO: A study of what makes a chief financial officer,* EY, 2010.

The role of the CFO (continued)

CFOs tend to be more active at the pre-entry stage of investment

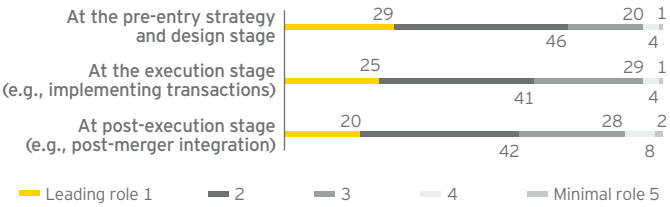
The CFOs we surveyed vary in the extent of their involvement in rapid-growth market investments. Around one-third say that they are in charge of all key aspects of market entry strategy, which unsurprisingly rises to nearly two-thirds for Group CFO respondents. A slightly higher proportion of 40% say that they primarily provide a supporting and advisory role. One quarter of respondents play a more traditional finance role, and only get involved in the more technical aspects of the investment, such as due diligence and valuation (see chart 2).

Chart 2: How would you describe your role in relation to entering rapid-growth markets?



The influence of the CFO is clearly felt at all stages of the process. However, their involvement does tend to diminish toward the post-execution stage. While 29% say that they play a leading role at the pre-entry stage, only 20% say that they do so during post-execution (see chart 3).

Chart 3: At what stage(s) do you play a role in your organization's strategy for entering rapid-growth markets?



One reasonable explanation for this is that the majority of CFOs are most actively involved in the earlier stages when their advisory and analytical input is required to bring discipline to the evaluation of the investment opportunity. They then delegate to team members during the execution and integration stages, retaining an oversight role.

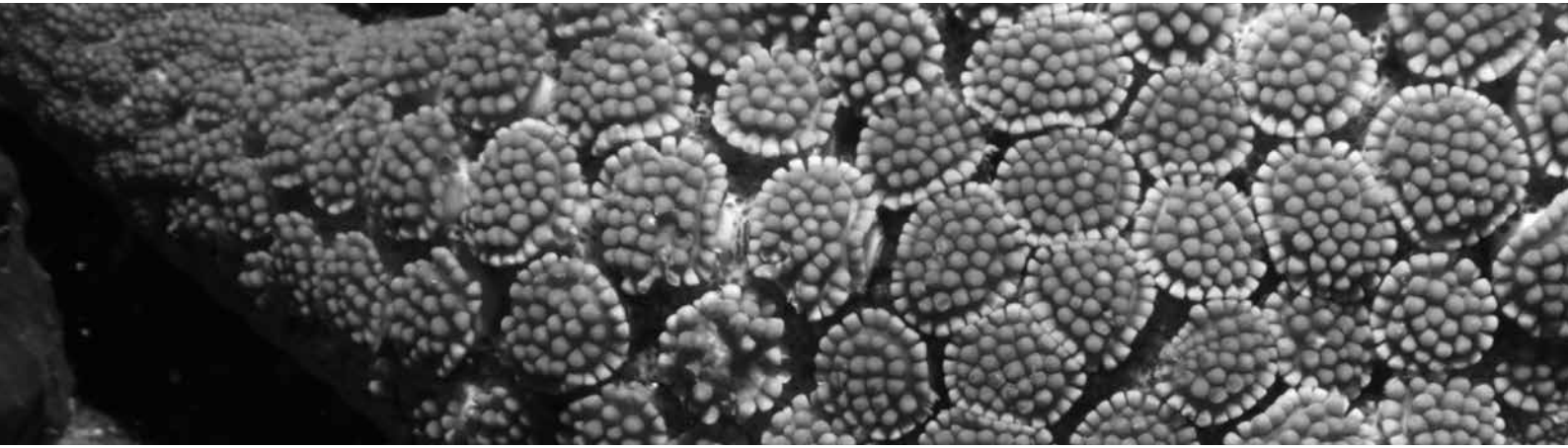
While good delegation is an essential capability for today's CFO, a number of the leading CFOs we interviewed stressed the need for CFOs to play an active role at every stage in the investment.

"When you enter these growth markets, the opportunity is an obvious fact, so don't spend time analyzing that. Instead, focus your attention on the execution because that is where the challenges lie."

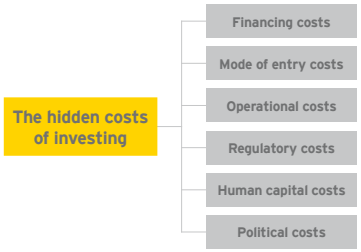
—Pinak Maitra, CFO, Kipco Group

"The CFO needs to be involved right from the concept stage through to finalization," says Paul O'Flaherty, CFO of Eskom Holdings, a utilities company based in South Africa. "Yes, you can delegate but you need to have the dashboards in place so that as you move along the investment process you are constantly back checking to make sure you are getting the return you expected." Pinak Maitra, CFO of Kipco Group, a diversified holding company based in Kuwait, goes further, "When you enter these growth markets, the opportunity is an obvious fact, so don't spend time analyzing that. Instead, focus your attention on the execution because that is where the challenges lie."

As investors chase a limited supply of targets in a market where they need presence to fulfill their growth ambitions, there may be increased pressure on the CFO to be actively involved in the integration stage of the investment. Where investors are competing on price to acquire assets, and the gap between valuation and price widens, there will be more of a need to integrate these assets as quickly and effectively as possible to remain competitive.



The hidden costs of investing



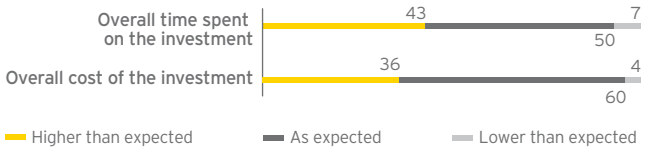
"Everything took much longer than we expected."

–Paul Brooks, CFO, Experian

The potential rewards of investment in rapid-growth markets are undeniable. So too are the costs – both manifest and hidden. Among our survey respondents, 36% say that the overall cost incurred in their recent investments in rapid-growth markets was higher than expected (see chart 4). A bigger problem than cost however, is time, with more than 4 out of 10 reporting that they spent more time than anticipated.

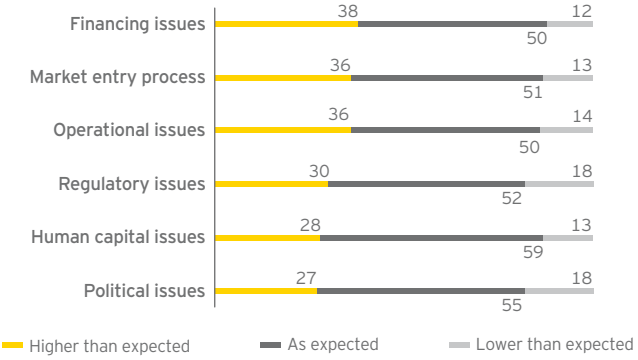
"Everything took much longer than we expected," says Mr. Brooks, of Experian. "The sheer bureaucracy meant that the licensing process alone involved multiple government agencies, then there would be a change in the individual handling it and everything would be set back again."

Chart 4: Thinking about recent investments that you have made in your main rapid-growth markets, how would you assess the overall level of cost incurred in the following areas?



The hidden costs and risks facing companies that invest in rapid-growth markets are many and varied. From our research, we have identified six in particular that are likely to cause problems for investors (see chart 5).

Chart 5: Thinking about recent investments that you have made in your main rapid-growth markets, how would you assess the overall level of cost incurred in the following areas?



The hidden costs of investing
Financing costs

According to survey respondents, financing issues are the aspect of investment in rapid-growth markets where costs are most likely to overrun, with 38% saying that they were higher than expected. As the core competency for the CFO, it is perhaps not surprising that these issues are front of mind. But the fact that more than one-third say that the costs were higher than expected does suggest that many companies are experiencing real challenges to making their investment a success. One reason why these costs may be so high is that CFOs and their teams may tend to focus on aspects of the investment where they expect to encounter problems, such as political risk, and assume that the financing issues will be less challenging.

Over the past decade, the economic and financial environment in most rapid-growth markets has become much more stable. Risks such as currency crisis or sovereign debt default have faded and one could argue that these are now more of a concern in some developed markets. Banking systems have become more mature and there are now major financial centers in Shanghai, Mumbai and Singapore. Countries like South Africa have also emerged as financial hubs, offering a range of capital markets services of a similar quality to those found in developed markets.

Inflationary and currency volatility is the main concern

Further volatility, however, cannot be ruled out. Low interest rates in developed markets and the quantitative easing program in the US have led investors to turn their attention to rapid-growth markets in search of yield. According to the Institute of International Finance,[6] net capital flows into emerging markets were estimated at US$908 billion in 2010, which is 50% higher than in 2009.

[6] *Source: IIF Research note entitled Capital Flows to Emerging Market Economies*

This surge of capital is pushing up currency values and stoking inflation, which is already rising as a result of surging food and commodity prices. This volatile situation is clearly one that worries multinational investors. "If you combine an environment of very high inflation, with potentially higher freight costs to export your products to developed markets, then I think that's a key concern for companies when investing in emerging markets," says Peter Bracke, Vice-President and CFO of Honeywell Transportation Systems.

High interest rates imposed by central banks trying to cool overheating economies can increase the cost of capital in some rapid-growth markets. But this is also encouraging an unprecedented carry trade, with financial investors in developed markets borrowing in low-yielding currencies, such as dollars or euros, and investing them in high-yielding assets in rapid growth markets. The concern is that surging debt issuance and rising interest rates in key developed world economies, such as the US, could reduce the availability of funds for rapid-growth markets that rely heavily on external financing. "A sudden withdrawal of these capital flows from rapid-growth markets could have a devastating economic impact," says Dougald Middleton, Leader of the Capital and Debt Advisory Group at EY.

When making an initial investment in rapid-growth markets, companies will typically obtain finance in their domestic market, rather than raising capital locally in the local currency. "In equity and bank markets, the rapid-growth markets story is a strong one and investors are happy to buy into it," says Mr. Middleton. "Then, as the business matures and the local currency earnings develop, there is a natural hedge in starting to raise more and more finance in the local market and local currency."

On the surface, raising finance in rapid-growth markets can appear expensive because interest rates are often high. But there are other factors to be taken into account, such as incentives for local investment that offer a reduced interest rate. "It often makes sense to mix the fund-raising in terms of local and international resources," says Rogerio Villa, Transaction Advisory Services Leader for Brazil at EY. "In Brazil, for example, you might get a cheaper interest rate when acquiring certain types of machinery or equipment, but you'd pay a higher rate for working capital. So you might try to raise funds locally for infrastructure, but overseas for working capital."

The hidden costs of investing
Financing costs (continued)

Among the survey respondents, currency fluctuations are seen as the key source of unexpected cost associated with finance (see chart 6). Foreign exchange risk management has always been a key area of responsibility for the finance function, but in a context of deepening rapid-growth market investments and ongoing volatility, this has become even more pressing. A growing number of multinationals are making use of currency hedging through instruments such as options and forwards to help them manage some of the risk.

Chart 6: Which of the following factors relating to financial issues in your organization's rapid-growth markets have proved to be more costly or time-consuming than originally anticipated? (Select up to three)

Some companies also apply "natural" hedges to their currency risk exposure by ensuring that they earn revenues and incur expenses in the same local currency. If revenues decline because of shifts in currency values, some of the losses can be offset by a reduction in costs. "You can try to hedge your risk by ensuring that you have both assets on the ground and liabilities, in the form of debt, in the same local currency," says Robin Freestone, CFO of Pearson, a publishing and education company headquartered in the UK. "If there is any political risk that causes a fall in currency, then, with your assets and liabilities matched, you have a natural hedge between the two."

For companies that invest in China, the potential further revaluation of the renminbi is another key source of currency risk. With international pressure mounting on the Chinese to allow the remninbi to appreciate more quickly, the prospect of a rising renminbi is becoming more likely. "Currency risk resulting from a rising Chinese currency is something that we watch very carefully," says Frédéric Puistienne, CFO of Adisseo, a manufacturer of animal nutritional additives and a subsidiary of the Bluestar Group, a Chinese chemicals company. "It is certainly possible that we will see the currency valued more highly than it was in the past."

The repatriation of cash from investments in some rapid-growth markets is also a source of concern for some CFOs. A number of countries, including China, India and Brazil, have strict regulations governing the repatriation of funds by multinationals. "Seeking government approval to repatriate money could be an issue," says Mr. Puistienne.

Lack of reliable ratings data complicates credit risk assessment

Credit risk is another key source of financing risk for multinationals (see chart 6). A common problem is that credit ratings for suppliers or customers can be difficult to obtain — either because suppliers have not obtained the ratings or because the ratings system is insufficiently developed. In some rapid-growth markets, credit bureaux have only been in operation for a short period of time. Mr. Brooks has first-hand knowledge of this issue in his role as CFO of Experian, a credit rating agency. In 2010, his company was awarded a full license to operate a credit bureau in India. "Setting up a credit bureau from scratch is always difficult but in India you have particular challenges," he explains. "For example, until fairly recently there was no unique personal identifier, like a social security number, and no real address structure or zip codes."

The importance of credit ratings to the smooth running of the economy is encouraging some governments in rapid-growth markets to provide incentives for local companies to obtain ratings. In India, for example, the Government has introduced a Credit Rating Subsidy Scheme that pays for up to 75% of the fee charged by the rating agency.

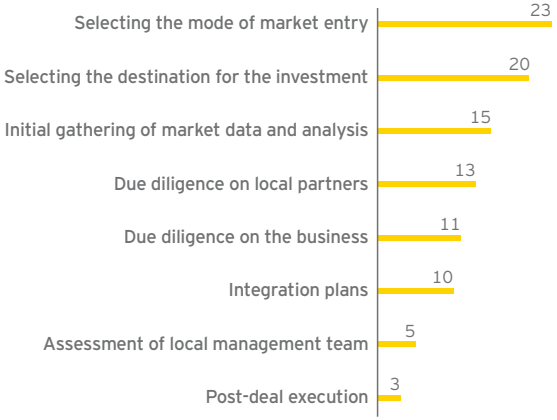
The hidden costs of investing
Mode of entry costs

Careful planning is a crucial factor in the future success of any investment. In rapid-growth markets, the pre-entry phase is especially critical. In addition to playing a vital role in selecting the destination for the investment, the CFO also needs to collaborate with other members of the senior executive team to determine the mode of entry and long-term strategic goals. "It's essential to sit down with the board and management to have a detailed discussion about the strategic goals of the investment," says Mikael Bratt, CFO of Volvo Group, a car manufacturer headquartered in Sweden. "It's always important to have a long-term vision of how the investment will evolve over time."

When asked to advise their peers on where to pay most attention in relation to investing in rapid-growth markets, respondents point to the mode of entry as the most critical decision that must be made. This is considered even more important than the destination for the investment itself (see chart 7).

Despite the importance of the market entry process, this continues to be an aspect of investment in rapid-growth markets that causes problems. Among our survey respondents, 36% say that the costs of market entry were higher than expected (see chart 5).

Chart 7: If you were to advise another CFO about investing in rapid-growth markets, to which of the following stages of the investment would you suggest that they pay most attention?



Often, the mode of entry will be determined in part by local regulations. In India, for example, there is a long standing ban on overseas multi-brand supermarket chains setting up retail stores. Single-brand retailers, such as Nike, Starbucks or Mothercare, can own a 51% stake in their Indian stores, but supermarket chains such as Wal-mart or Carrefour can only sell to wholesale customers, again via a joint venture with a local company.

"It's always important to have a long-term vision of how the investment will evolve over time."

—Mikael Bratt, CFO, Volvo Group

These regulatory constraints can force companies to be creative about their entry strategy in rapid-growth markets. Consider the example of Pearson, the publishing and education company, which wanted to ramp up its exposure to China. Because foreign investors are restricted in owning more than 50% of a publishing company, Pearson has entered the market via an adjacent route. In addition to a joint venture with a local publishing company, it has acquired companies that teach English as a foreign language, where there are no such limits on foreign ownership. It can then use these schools as a distribution channel for its English educational publications. "You've got to go in with a strategy that works for you in a particular market," says CFO, Mr. Freestone. "Because there are Chinese regulations on the percentage of a publishing company we can own, we decided to take a different route."

Companies must also bear in mind that their initial mode of entry may need to change at some point in the future, and this can add significantly to the overall costs of the investment. Over time, ongoing market liberalization in rapid-growth markets may broaden the available choices for market entry. Over the past decade, for example, the Indian Government has made a number of changes to the rules governing foreign investment in the telecommunications sector. Equally, a company may find that it outgrows its initial mode of entry and needs to adopt a different approach. Either way, the implications of a changing investment strategy need to be carefully considered.

"Often, part of the long-term plan is an evolution from one initial market entry method to another," says Ms. Mahlan of Diageo. "It's important to understand the implications of that. In some markets, when you attempt to shift the relationships that you've built, your initial distribution network becomes destabilized when you then say you're going to go off and do this on your own."

Choosing a partner is about more than the numbers

In cases where multinationals need to work alongside a local company, the selection of partner is absolutely critical. "It is very important in these markets to find out who you're going to bed with," says Mr. Maitra. "You have to spend an enormous amount of time evaluating potential partners and getting to know them. In emerging markets or fast-growing markets, the difference between success and failure is the partner."

Arpinder Singh, Leader of EY's Fraud Investigation and Dispute Services in India, advises companies to conduct what he calls "integrity due diligence" before committing to a joint venture with a local company. "You have to get under the skin of a potential partner because if you go by official records alone, you won't find out very much," he says. "You need to know what the partner's customers think, whether regulators have any concerns, and whether the company has a good credit history and is ethical in its dealings."

The hidden costs of investing
Mode of entry costs (continued)

For many companies interviewed for this report, attitudes to bribery and corruption form an important part of this due diligence phase. This is particularly important for companies headquartered in countries with legislation preventing bribery of foreign officials, such as the US and UK. "We spend a lot of time looking at how a potential target conducts business and performing commercial due diligence on how are they getting contracts," says Mr. Freestone. "Particularly when you're dealing with governments, you need to be absolutely clear that the way you're getting the business is not something that you're going to be ashamed of later."

The impact of teaming up with a local partner on existing commercial relationships also needs to be considered. "If you go with a local company that is part of a bigger group, and that group competes with some of your customers, it can create a bad reaction and potentially exclude you from doing business with them," says Mr. Bracke of Honeywell Transportation Systems.

When multinationals form joint ventures in rapid-growth markets, there is a good chance that it will be with a family business. Some estimates put the percentage of gross domestic product accounted for by family-run companies in rapid-growth markets as high as 70%. The governance of a family business, in which personal and professional affairs are closely intertwined, can sometimes be quite different from that of a listed multinational. "When you work with a family business, you need to understand the family tree and work out who are the real decision-makers," says Harriet Mossop, Leader of EY's Financial Accounting Advisory Services in India. "Often, the power is concentrated in the hands of a senior family member, so it's important that senior executives from the multinational know who that individual is and have access to them."

Accuracy of valuation data and seller disclosure are the biggest hurdles for acquirers

It is easy to see the appeal of the M&A route to entering rapid-growth markets. When regulations permit such an approach, acquisitions give investors greater control than a joint venture, and also provide quick access to market share, skills and existing distribution channels.

As with partnerships and joint ventures, a cultural fit between acquirer and target is an important determinant of success. If the two companies to be merged share similar values, the integration process becomes much more straightforward. "When I look back at acquisitions that haven't worked for us, often it's about the culture, where the fit just wasn't right," says Mr. Freestone. "Those cultural considerations, whether it's ethics or just attitude to customers, become quite important in emerging market acquisitions."

Compared with developed market transactions, the valuation process in rapid-growth markets can be fraught with risks. Indeed, survey respondents see valuation as the aspect of market entry where costs or difficulties are most likely to be greater than anticipated (see chart 8).

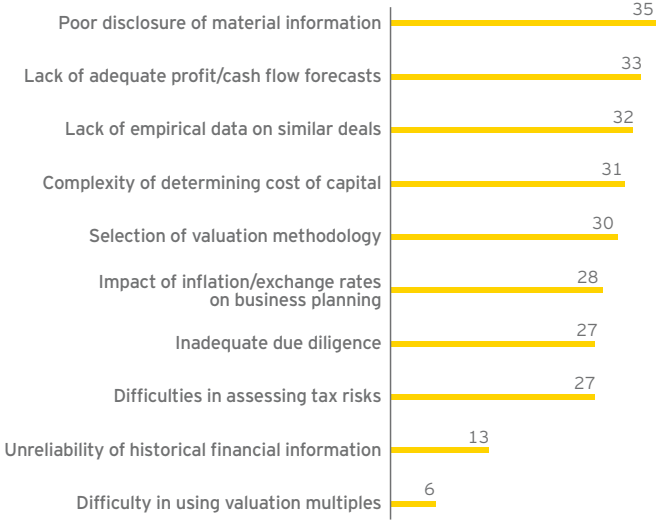
Chart 8: Which of the following issues relating to market entry plans proved more difficult or costly than originally anticipated? (Select up to three)

A key barrier to effective valuation in rapid-growth markets is a lack of reliable data. Although the maturity of capital markets varies widely from market to market, they can often be illiquid and shallow compared with developed markets. This means that there are few comparable transactions on which to base a valuation. In valuations based on discounted cash flows, calculating a discount rate can also be challenging because different assessments of risk can lead to very different valuations.

The hidden costs of investing
Mode of entry costs (continued)

At the same time, disclosure requirements may be less rigorous, which can make financial data less reliable. Among the survey respondents, poor disclosure of material information is seen as the biggest challenge when valuing assets (see chart 9).

Chart 9: When valuing assets in rapid-growth markets, please select those factors that are most likely to cause difficulties for potential investors? (Select up to three)



One possible reason for these challenges is that accounting standards in some rapid-growth markets may place less emphasis on disclosure. In Brazil, for example, there was until recently no requirement for non-listed companies to be audited, which makes it more difficult for foreign investors to have confidence about reported financial statements. "It's very common in rapid-growth markets to find a situation where you don't have audited financial statements and where the governance requirements are very different from developed markets," says Mr. Villa. "Companies planning an acquisition therefore need to work closely with advisors to obtain and ensure the reliability of financial information."

These challenges with valuation highlight the importance of obtaining data from multiple sources and not relying exclusively on information provided by the seller. "You need to look at different scenarios and not just take figures presented by your potential targets at face value," says Stefan Asenkerschbaumer, CFO of Robert Bosch. "It's also important to establish clear boundaries and be prepared to cancel the project if you are not comfortable with the data that you receive."

> "We've seen multiples in China, India and Brazil get really quite high on the back of expected growth for a long period into the future, so I think there is definitely a danger of overpaying for assets."
>
> —**Robin Freestone,** CFO, Pearson

Using a combination of valuation methods can also help to paper over some of the cracks in available data. A common method is to combine discounted cash flows with probability-weighted scenarios that measure the risk a company potentially faces. "We look very closely at the sensitivities to sales in emerging markets," says Mr. Freestone of Pearson. "These markets remain volatile and so it's difficult to be sure about just how sustainable their growth will be. This means that we always question the top-line forecast in our model and subject it to fairly rigorous tests."

Overpaying may be the only option

At a time of unprecedented enthusiasm for rapid-growth markets when there are large amounts of money chasing a limited supply of targets, there is also a danger of overpaying for assets. "There are risks in any assumption of sustained economic growth and the ability of an acquirer to capture market share," says Mr. Freestone. "We've seen multiples in China, India and Brazil get really quite high on the back of expected growth for a long period into the future, so I think there is definitely a danger of overpaying for assets."

Pavel Mitrofanov, Deputy Chief Executive Officer and CFO of Metalloinvest, urges potential investors to take a long-term view and look across the entire cycle before agreeing a price. "You really need to take the mid-cycle view and apply very strict parameters and assumptions when you take a look at the valuation of your investment target," he says.

Yet at the same time, companies may not have a choice but to pay a premium. With shareholders expecting them to invest in rapid-growth markets, and with growing competition for investment, acquirers are increasingly competing on price. "The fact that valuations are so high means that there is more pressure to integrate assets quickly in order to remain competitive," says Alexis Karklins Marchay, Capital Transformation Leader for EMEIA[7] at EY. "This may mean that, in future, CFOs will need to be more hands on with the integration stage of the investment than previously."

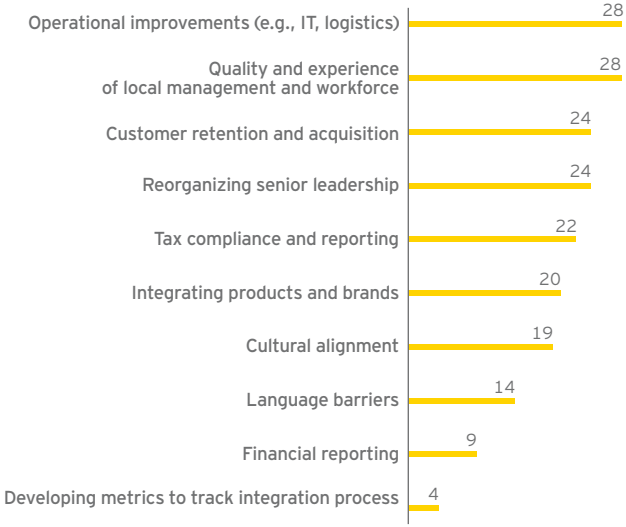
The risk of paying too highly for rapid-growth market assets has encouraged private equity firm Actis, which specializes in rapid-growth markets, to focus on proprietary sourcing, control investments, complex cross-border investments and a buy-and-build strategy to its acquisitions. Buy-and-builds involve buying smaller companies in fragmented industries led by leading-class management teams, and then combining them with other bolt-on acquisitions. "Working with sellers of smaller enterprises and putting them together into larger platforms is one way of getting an attractive entry valuation and putting capital to work at lower multiples," says Chief Operating Officer, Ron Bell.

[7] *Europe, Middle East, India, Africa*

The hidden costs of investing
Operational costs

In *The DNA of the CFO,*[8] a key theme that emerged was the increasing trend for CFOs to take on operational responsibilities. In the context of rapid-growth market investments, this becomes even more critical because of the potential for unexpected costs and risk. Among our survey respondents, 36% say that the costs associated with operational issues were higher than expected (see chart 5 on page 17). They also consider operational improvements to be the most costly aspect of merging or integrating rapid-growth investments (see chart 10).

Chart 10: When merging or integrating rapid-growth market investments with your own organization, which of the following aspects do you typically find most challenging? (Select two)



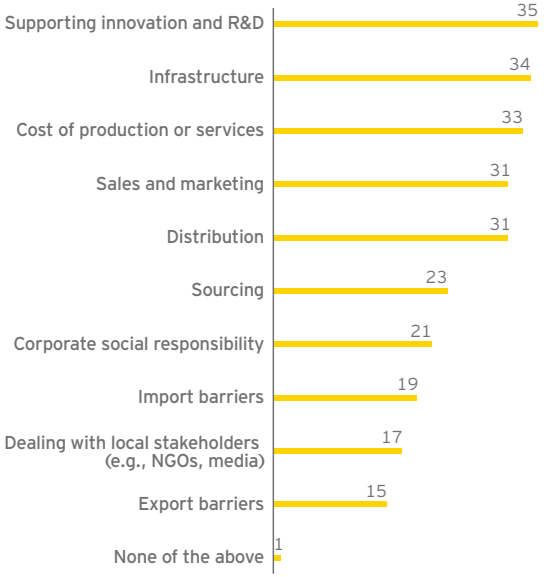
[8] *The DNA of the CFO: A study of what makes a chief financial officer,* EY, 2010.

Unexpected operational costs are particularly important in rapid-growth markets because companies typically operate on a model that relies on high volumes but very low margins. Anything that increases the cost of production can erode these margins, threatening overall profitability. "In countries like India, which have large populations, everyone competes on price and volume in order to increase their market reach," says Mr. Arpinder Singh. "This means that you need a completely different business model, in such high growth markets, that relies on low cost and thin profit margins but massive volumes."

The innovation agenda is driving cost

Asked about the operational issues in rapid-growth markets that were most likely to lead to higher than expected costs, respondents point to supporting innovation and R&D as the leading factor (see chart 11). Almost three-quarters of respondents say that they plan to increase spending on R&D relating to development of new products for rapid-growth markets in the next 12 months (see chart 12 overleaf). This increase is largely driven by respondents from high-performing companies, which correlates with similar findings from our *Competing for growth*[9] study, in which product and service innovation emerged as a key competitive differentiator for high-growth companies.

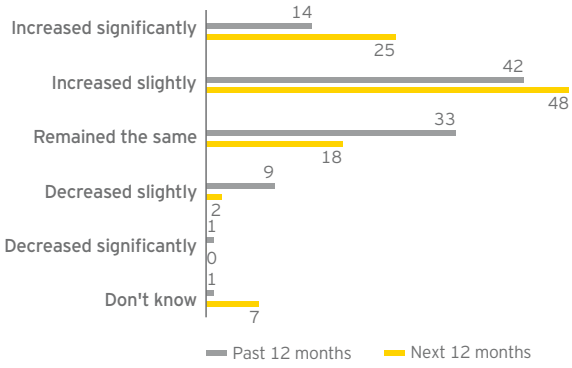
Chart 11: Which of the following factors relating to operational issues in your organization's rapid-growth markets have proved to be more costly or time-consuming than originally expected? (Select up to three)



[9] *Competing for growth: How business is growing beyond boundaries*, EY, 2011.

The hidden costs of investing
Operational costs (continued)

Chart 12: Insofar as you know, how has R&D spending, as it relates to the development of new products in rapid-growth markets, changed over the past year and is likely to change over the next 12 months?



Often, this increased spending takes the form of opening new R&D centers in rapid-growth markets with a remit to innovate for local markets. This decentralization of R&D will be an important determinant of future revenues in rapid-growth markets because it enables companies to develop more relevant products and services. But, in the short term, it creates additional costs, including the need for local engineers.

The second highest area of unexpected costs relates to infrastructure. This is particularly true in those sectors that rely on distributing physical goods. "In Brazil, the Government is spending US$85 billion over the next three years to upgrade its infrastructure," says Marcos Almeida, Partner at EY Terco in Brazil. "Until then, logistics in Brazil will remain challenging. Whenever you have a problem with ports or airports, it adds time and that leads to increased costs for investors."

Multinationals can also be surprised by the complexity of distribution. In the US, a company may have only two or three distributors for its products, but in a country such as India, it may need as many as 20. "Companies seeking to distribute products in India may need a distributor in every state because of local statutes," says Mr. Arpinder Singh. "CFOs really need to understand the regulatory environment for distribution and factor this increased complexity into their cost calculations."

Harmonization of the finance function is top of mind

When acquiring assets or managing joint ventures in rapid-growth markets, particular care has to be paid to integrating and harmonizing reporting frameworks and IT systems. Companies that enter into a joint venture or acquire a local business may find that existing accounting and reporting systems are fairly rudimentary, compared with global leading practice. Record-keeping may be done manually and accounting systems may be basic. "It's easy to underestimate the challenge and investment required to implement adequate systems that are on a par with the rest of the organization," says Robert Partridge, Leader for Transaction Advisory Services at EY in China.

Extensive use of cash or cheques, rather than electronic transfers, can add a layer of complexity to the problem. "When you've got cash transactions that are taking place off the books and not reported, there's a danger that these are being used to help facilitate unethical business practices," says Mr. Partridge. "The whole area of controlling cash from an internal control standpoint is key."

The ability of a multinational to invest in strengthening existing finance processes and systems will depend in part on the control it has over the investment. At one end of the spectrum, a Greenfield investment provides a high degree of control because the investment is built from scratch and the company can impose its own risk and controls framework. Alliances and joint ventures, however, offer less control because the multinational must work with a local company that has its own systems and practices. "When you have a non-controlling stake, the ability of the CFO to improve systems and processes is much more of a challenge," says Mr. Partridge. "Even with an M&A transaction where you take on 100% ownership, you inherit legacy practices that can take time to change."

The willingness of partners to commit to integration and upgrading of finance systems is an important factor to be considered. "We see a lot of CFOs facing a real challenge in getting to an appropriate financial reporting environment when you've got a local partner that just doesn't – at least early in the relationship – see a value in those investments," says Mr. Partridge.

In addition to requiring investment in systems and processes, investors may also find that they need to ramp up the skills in the local finance team to meet more demanding global reporting obligations. Local finance teams in rapid-growth markets may be unfamiliar with the kind of "business partnering" activities that have become the norm in developed world finance functions.

"If you think about a mid-market domestic Chinese company that finds itself in a joint venture with a FTSE 1000 company, it's a very different skill set that's required," says Mr. Partridge. "There are a lot more demands on timely reporting and the quality of the information – it's not just reporting what happened, but being able to create information that allows the business to make better decisions rapidly."

The marriage of local and global: striking the balance between autonomy and control

Successful investments in rapid-growth markets require multinationals to build local teams and give them autonomy for decision-making. The pace of business in some rapid-growth markets is so fast that decisions often need to be taken quickly, without resorting to reporting lines back to corporate headquarters. But this autonomy needs to be balanced with a strong risk and controls framework, so that decisions taken locally happen within agreed parameters.

"Your risk and controls framework needs to be robust when buying into these markets," says Mr. Freestone, CFO of Pearson. "You've got quite a challenge in making sure you get your financial data out to meet your monthly reporting schedules and that the control infrastructure is robust enough to deliver those with integrity. This is where your regional management need to get fully involved in the integration of that company."

Greater autonomy for local managers increases the requirement for documentation and a mechanism to discuss any deviations from global policies. "You might find that local Indian or rapid-growth market managers want to give higher discounts than other places in the world," says Mr. Arpinder Singh of EY. "That's fine, but the risk is that this does not get documented and discussed with the parent company. You can easily end up with a lot of problems where there are huge differences across markets because local autonomy has gone unchecked."

A good approach to striking the balance between autonomy and control is to recruit a local managing director who understands the domestic business environment and culture, but have a CFO working alongside him or her from the corporate headquarters. "A local managing director knows the regulations, customers and business environment so is best placed to make decisions about the direction of the business," says Mr. Arpinder Singh. "But then you can put in place a CFO from the parent company who can bring the global best practice in terms of reporting and controls. You'll often find that 80% of the controls across the world are similar, so it makes sense to have someone who can import that global knowledge into the local market."

A blend of local insight with a strong link back to the corporate headquarters offers a powerful combination that greatly enhances the chances of investment success. "You need to combine the benefit of deep local insight and relationships from experienced people on the ground, who will spot nuances that newcomers will miss, with a broader global perspective from head office," says Mr. Bell of Actis. "If you put the two together, I think that enables you to really understand the trends and subtleties of a particular market while still bringing global best practice to the investment."

Over time, multinationals can improve the blend between global and local using talent management programs that give managers opportunities to work in different regions of the world. As we explored in our recent publication, *Finance forte: The future of finance leadership,*[10] CFOs who have experience of managing both mature and rapid-growth markets will be in high demand. This highlights the importance of building career paths for senior finance professionals that provide exposure to markets at different stages of development.

"If you can rotate local managers to head office for six months then you make them aware of the values and principles that we have," says Mr. Bratt, of Volvo Group. "Equally, you need to send people from head office out into the regions. It's all about a mix."

Although companies vary widely in their approach, it often makes sense to place a regional layer between the local management team and the global headquarters. This team combines regional knowledge with a close link back to the corporate headquarters and the ability to consolidate local information and reporting at a regional level. "You need a good strong layer of regional management sitting above the country management who understand how things are done in that locale," says Mr. Freestone.

[10] *Finance forte: The future of finance leadership,* EY, 2011.

"You need to combine the benefit of deep local insight and relationships from experienced people on the ground, who will spot nuances that newcomers will miss, with a broader global perspective from head office."

–Ron Bell, COO, Actis

The hidden cost of investing
Regulatory costs

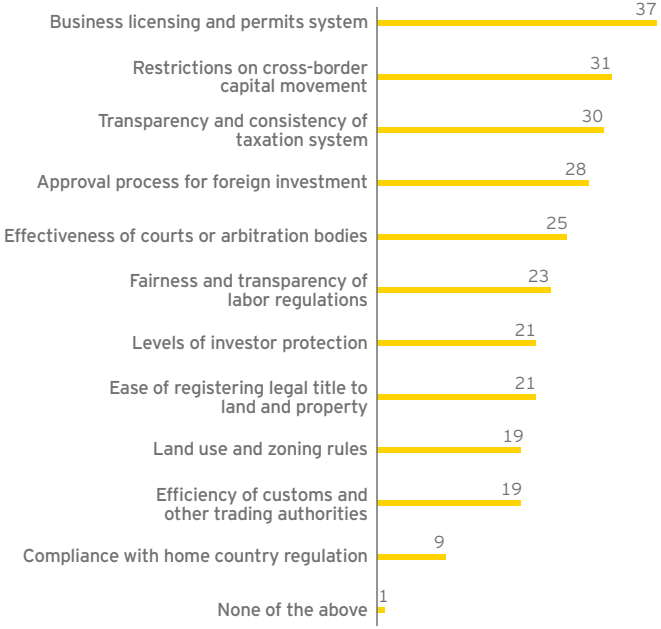
Although many rapid-growth markets have made progress in streamlining bureaucracy and regulatory systems in recent years, the costs and time spent dealing with these issues can still be extremely high. Among our survey respondents, 30% say that the costs associated with regulation when entering rapid-growth markets were higher than expected (see chart 5).

In some cases, the problem may be that regulatory systems are still in an early stage of development, which means that rules are unclear. Elsewhere, the challenge may be excessive complexity and bureaucracy, with overlapping responsibilities and unnecessary form-filling. In Brazil, for example, it has been calculated that filing a tax return can take up to 13 times the OECD average in terms of man-hours required.[11]

Among our survey respondents, problems obtaining licenses and permits are seen as a particular burden with rapid-growth markets (see chart 13). "Don't underestimate the level of bureaucracy and what that can do to slow you down in terms of obtaining permissions and licenses," says Mr. Freestone. "It's also essential to ensure that you know how those permissions were obtained because if you're not very careful, you may find that you are in breach of the Foreign Practices Act or the UK Bribery Act."

[11] *http://blogs.ft.com/beyond-brics/2010/12/15/navigating-brazils-bureaucracy-is-not-a-day-at-the-beach/*

Chart 13: Which of the following factors relating to regulatory issues proved more costly or time-consuming to your business than originally expected? (Select up to three)



Even if the due diligence phase shows that the right licenses are in place when making an acquisition, this does not always mean that this will remain the case in future. "You might think that you have the right licenses in place but then find that they expire and require you to spend another six months getting new ones," says Ms. Mahlan of Diageo. "By that stage you could be out of business."

"It's just a matter of time before all the best-in-class rules and regulations and controls around the world will come into India. As an investor, you need to anticipate that and make sure that you build these costs into your investment rationale."

—Arpinder Singh, EY

Build in the cost of future regulatory reform

Companies must also consider that in many rapid-growth markets, while regulatory environments are still evolving, they will become more mature over time. In order to ensure that their investments remain profitable over the long term, multinationals must "future-proof" their cost base in anticipation that these regulations will tighten. "It's just a matter of time before all the best-in-class rules and regulations and controls around the world will come into India," says Mr. Arpinder Singh. "As an investor, you need to anticipate that and make sure that you build these costs into your investment rationale. If you don't, you might find the investment is not as profitable as it first seemed."

Along with the complexity of dealing with tax administration in a country such as Brazil, high rates of taxation can also add substantially to the cost of the investment. But in some rapid-growth markets, generous tax incentives can help to reduce this cost. Mr. Almeida advises investors in Brazil to build thorough tax models that take into account every aspect of the investment. "Taxation in Brazil is very high so you need to get the right tax incentives in place at the start to make your project viable," says Mr. Almeida. "If you don't take a rigorous approach to your tax modeling, you are going to have a tax cost overrun that will be very difficult to deal with later on."

With many rapid-growth markets ramping up their enforcement of tax administration — and particularly of multinationals — it pays to take a conservative approach to tax planning. "Rules are changing and the tax authorities may take a different interpretation at any point in time," says Mr. Arpinder Singh. "There's a big grey area but it's much safer to be conservative and have enough protection in case a decision or interpretation goes the wrong way."

Secure access to local knowledge of tax and regulation

Perhaps the key point when managing all aspects of regulation is to ensure good local knowledge on the ground. Building teams of individuals and advisors who have a deep understanding of fast changing regulatory and tax systems is vital to ensure that unanticipated costs and delays do not multiply. "I think that commercial companies in emerging markets can do a lot more to really embed stakeholder relations into their business," says Mr. O'Flaherty of Eskom Holdings. "They should set up proper regulatory or government departments, with a strong representation from finance, that have responsibility for building effective relationships with governments and regulators, and really understand the impact these stakeholders have on the company."

More broadly, investors in rapid-growth markets should ensure that regulation is not just considered as a necessary evil that needs to be tackled at some point in the investment process, but as a core strategic issue that forms a key part of the overall investment rationale. Multinationals that come to rapid-growth markets with a mindset that regulation is a tactical issue and a mere adjunct to the business case are sure to encounter problems. In rapid-growth markets, it pays to take regulation seriously and ensure that it is fully embedded in the entire investment process.

The hidden costs of investing
Human capital costs

Human capital management in rapid-growth markets is a delicate balance between supply and demand. Rising skill levels and a young population means that there is a strong supply of workers in many markets. In countries such as China and India, massive government investment in further education has ensured a steady stream of graduates who combine business skills with deep local knowledge. And as opportunities for employment proliferate in these markets, there is a "reverse brain drain" of skilled managers who originate from rapid-growth markets returning home from countries such as the US. "The talent pool is extremely strong and you've got a very good training background for both chartered accountants and MBA graduates," says Ms. Mossop of EY.

Demand for talent is outstripping supply

Despite this rising availability of talent, demand continues to increase so rapidly that it is outstripping supply in many markets. This rising demand for skilled workers, when combined with high rates of inflation, is placing significant upward pressure on wages in many rapid-growth markets. In India, which has the highest inflation rate of any Asian country, the Federation of Indian Chambers of Commerce and Industry estimates that wages increased by 15% in 2010.[12] In China, every province has increased the minimum wage in the past year, sometimes by as much as 20%.[13]

Fast-rising labor costs can mean that the original assumptions about the return from an investment can prove unrealistic over time. "You can't be sure when you launch a project whether you will have the same labor cost advantage in two years' time," says Mr. Puistienne of Adisseo. Among our survey respondents, almost 30% say that the human capital costs of investing in rapid-growth markets were higher than expected (see chart 5 on page 17).

Equally, companies also need to consider other factors beside the cost of labor. "You need to take into account the level of productivity that you can expect from local workers," says Mr. Karklins Marchay of EY. "Labor costs may be low, but so might productivity and that may be a more important factor to consider overall."

[12] *http://www.ft.com/cms/s/0/37b742de-7cb4-11e0-994d-00144feabdc0.html*

[13] *http://www.ft.com/cms/s/0/30f7f9e0-1277-11e0-b4c8-00144feabdc0.html#axzz1QgCmwpFV*

"The very people you've hired and trained then become more difficult to retain. It's a constant and ongoing challenge."

–Deirdre Mahlan, CFO, Diageo

Frequent offers of better-paid employment can lead to rates of employee turnover that are much higher than in developed markets. Some business process outsourcing providers in India, for example, are experiencing attrition rates of up to 50% a year. For the CFOs questioned for this survey, high rates of employee turnover are the most significant unanticipated cost related to human capital that they face (see chart 14).

Chart 14: Which of the following human capital issues proved more costly or difficult than originally thought? (Select up to three)

A common frustration for multinationals is that investment in training for employees can lead to higher attrition rates by making them more marketable. "The very people you've hired and trained then become more difficult to retain," says Ms. Mahlan of Diageo. "It's a constant and ongoing challenge." According to Mr. Karklins Marchay one of the critical aspects of the acquisition process is to identify the key people you want to retain within that company. "To do this successfully, it takes more than just pay, when they can potentially negotiate a larger salary elsewhere. It's about creating the conditions whereby they feel a part of something bigger; where they are proud of being associated with the acquirer; have the opportunity to contribute to strategy; and feel they own a part of the success of the new venture."

Although the rates of attrition can be high in rapid-growth markets, it is important to accept that they will be a fact of life in economies that are experiencing rapid-growth. "As an organization, we need to learn to live with higher turnover rates than in developed markets," says Mr. Bratt. "Looking at it from another perspective, high rates of attrition also mean that you can attract good candidates from other companies as well. The key challenge is for the recruitment office to be alert and quick to identify the best people."

The hidden costs of investing
Human capital costs (continued)

Multinationals entering rapid-growth markets must also compete for talent with fast-growing local competitors. These companies, which are often at a somewhat earlier stage of their development, typically offer local employees attractive packages to recruit and retain them. "Privately-owned enterprises in China not only offer competitive compensation rates but also share options," says Lee Li of EY's Advisory Services in China. "This is very attractive for ambitious local workers."

Ms. Mahlan notes that, as domestic multinationals in rapid-growth markets become more established, the balance in terms of recruitment is tilting in their favor. "Five or six years ago, everybody in China wanted to work for a big global multinational," she says. "Today, I think there are many local companies that are being quite aggressive on both pay and in appealing to a sense of patriotism among local workers."

Investing in your employer brand is the most effective strategy against attrition

Dealing with high levels of employee turnover requires companies to adopt a range of approaches. Even though the costs of training can easily be lost when employees move elsewhere, an ongoing, broad training program can be a powerful tool for retention. "As well as offering courses that relate specifically to the job, companies should also offer their employees a broader suite of training, including English and personal development," says Mr. Villa of EY. "This can send out a signal to employees that you care for their welfare and can help with workforce retention."

In China, the influence of Communism and predominance of the state-owned enterprise model mean that the concept of employment for life is still strong. Although multinationals cannot offer this to employees, fostering a sense of long-term development for employees can be reassuring. "For Western companies coming into this market, creating a culture where people feel like they've got a real long-term career is pretty important," says Mr. Li. "The ones that do it well certainly have fewer challenges with retention so long as they're also paying a decent wage."

Engagement with local communities and an appreciation of the local culture also helps to build a strong bond between the local workforce and the company. "You'll certainly want to celebrate the local festivals and make sure that you have something big happening as a company around key celebrations," says Ms. Mossop of EY. "This helps employees feel that the company is sensitive to their local culture. At the same time, you can also think about celebrating some of the festivals from the home country. So it's a meeting of minds between the two."

To compete in such a fiercely competitive labor market, multinationals need to position themselves as employers of choice. "You need to build a brand as an employer," says Ms. Mahlan. "In many of these markets, who people work for is very important to them. In addition to demonstrating to employees that you value their personal development, and constantly checking your compensation plans to ensure that they remain competitive, the values of the business are important."

The metrics that lie behind those compensation plans need to be considered carefully, particularly for the finance function. In general, it is important to have incentives that encourage ethical behavior, rather than rewarding growth. "Bonuses for back office employees should be based on key performance indicators like governance, risk management and following policies and procedures," says Mr. Arpinder Singh. "If you try to reward finance teams on growth and profitability, there is a danger that it will encourage them to cut corners and resort to unethical behavior."

The hidden costs of investing
Human capital costs (continued)

Cultural differences: ignore them at your peril

There is a common, but misguided, assumption that globalization will lead to a one-size-fits-all business environment in which cultural differences no longer matter. Although there are undoubtedly similarities between operating in rapid-growth and developed markets, companies ignore cultural differences at their peril. "Multinationals that come in and try to impose their own culture from overseas in rapid-growth markets almost always fail," says Mr. Li.

An obvious difference — between some markets at least — is language. "It's amazing how many companies underestimate the impact of language barriers on integration," says Mr. Li. "To be able to transform a company and achieve full integration, you've got to be able to speak the same language. Most Western companies think that this means everyone has to speak the same language as them. It takes a long period of time to reach a situation where you have linguistic integration."

Cultural differences do not end with language barriers. Multinationals investing in rapid-growth markets may find that business practices differ, sometimes considerably, and it can take time to find common ground. For example, Mr. Almeida points out that the approach taken by Brazilians to business negotiations can seem unfamiliar to their peers from North America or Europe. "Americans and Europeans tend to be very straightforward in their approach," he explains. "But Brazilians are more indirect and more creative. Not everything is spelled out and sometimes you need to make improvisations."

Mr. Puistienne notes that multinationals can encounter a different attitude to contracts when investing in China. "In China, the Letter of Intent and the continuing relationship are important. They are very careful about good communication and the spirit of the discussion."

Although it is easy to oversimplify cultural differences in rapid-growth markets, an acceptance that they exist is often the first step to creating a culture that blends a global mindset with local sensitivities. "It's important to realize that you may need to take the corporate culture of the multinational and change it a little bit to be successful in a country like India," says Ms. Mossop. "How you combine the two and create what the Indians would call 'a masala,' or mix, between the global culture and the Indian culture is really critical."

"To be able to transform a company and achieve full integration, you've got to be able to speak the same language. Most Western companies think that this means everyone has to speak the same language as them."

–Lee Li, EY

The hidden costs of investing
Political costs

In recent years, ongoing programs of liberalization and the development of more market-friendly government policies in most rapid-growth markets have led to a steady decline in political risk. Government policy has become more stable and predictable. And although there are exceptions to the rule, the risk of the expropriation of assets has fallen as governments recognize the economic benefits of foreign investment.

In some cases, companies may overestimate the extent of political risk, basing their judgments on an outmoded perspective. Africa, for example, has made considerable progress in improving overall political stability in recent years. But many companies still base their perception of the entire continent on the handful of countries that are experiencing political instability. "There's a perception that Africa is more politically risky than other rapid-growth markets but the reality is that the continent as a whole has moved on considerably in terms of democratization and political stability since the Cold War," says Michael Lalor, a Partner at EY Advisory Services Limited in South Africa. "Political risk is an important consideration but companies need to think of it in the context of the overall opportunity that these markets offer. There can be an inherent advantage for those companies that think about the positives as well as the negatives."This is not to say that political risk should become any less of a consideration. Although the overall situation may be improving, companies ignore political risk at their peril. The Arab Spring of 2011, in which the Governments of Tunisia and Egypt fell and those of Bahrain, Libya, Syria and Yemen have come under intense pressure, serves as a potent reminder that political stability in rapid-growth markets should never be taken for granted. Overall, more than one-quarter of respondents have found that political risks when entering rapid-growth markets were higher than expected (see chart 5).

Although this political upheaval can be unsettling, CFOs interviewed for this report emphasize the need to take a long-term view and accept that there may be bumps along the way as rapid-growth markets grow in maturity. "A regime change might be troubling in the short term but it does not necessarily alter the investment profile of a country or the fundamentals of the investment," says Mr. Brooks of Experian.

The private equity firm Actis is one organization with direct experience of this. It has a major investment in Egypt and while the events of early 2011 were a source of concern, senior executives were keen to stress the importance of taking a longer-term view. "The message we're giving to our investors is, yes, it's a difficult situation there, but if you look at the underlying fundamentals, we're confident that the rationale for that investment remains sound," says COO, Mr. Bell.

In the wake of the financial crisis, there was concern that rising unemployment would encourage governments to step

"Once you have become involved in corrupt practices, you are trapped forever."

–Pinak Maitra, CFO, Kipco Group

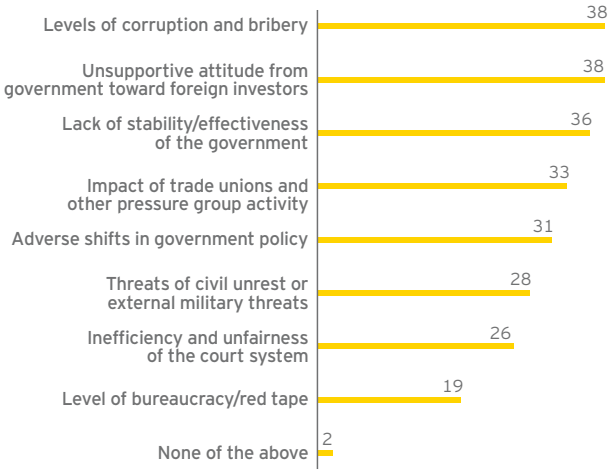
up protectionist policies. But although there have been isolated examples of this, for the most part this has not materialized. "Most of these markets are still hungry for the knowledge and experience that multinationals bring," says Ms. Mahlan. "As long as we see growth continue, increased protectionism is unlikely because rapid-growth markets are deriving benefits from multinational investment."

CFOs take a no tolerance stance on bribery and corruption

But while the overall picture for foreign investors is becoming more favorable, CFOs still have serious concerns about some aspects of political risk. Most troubling of all is the prevalence of bribery and corruption. For our survey respondents, levels of bribery and corruption are the most serious political risk that they face (see chart 15).

"Legislative and regulatory change, such as the UK Bribery Act, has made bribery and corruption a prominent issue on the corporate agenda," says David Stulb, EY's Global Fraud Investigation & Disputes Services Leader. "What's also changing is the level of enforcement. The reality is that if you're a large company and you don't have a robust anti-corruption program in place, you'll eventually find yourself in a whistleblower situation or in regulatory hot water."

Chart 15: Which of the following political risks factors proved to be more costly or difficult to manage than you had originally expected? (Select up to three)



According to Transparency International, corrupt politicians and government officials in developing and transition economies receive bribes totaling between US$20 billion and US$40 billion every year, which is equivalent to between 20% and 40% of all official development assistance.[14] "Corruption is something that people often underestimate," says Mr. Maitra of Kipco Group. "Once you have become involved in corrupt practices, you are trapped forever. You have to keep on saying no and finding ways in which you achieve your objectives without stooping to paying bribes."

[14] *http://www.transparency.org.uk/corruption-data*

The hidden costs of investing
Political costs (continued)

Avoiding bribery and corruption can be challenging, particularly as investors may be working with local partners who may have a different approach to conducting business. In this year's *European fraud survey,*[15] 81% of rapid-growth market respondents report that bribery and corruption is common place within business compared to 46% in mature markets. But a transparent, zero tolerance approach is vital. "Tone at the top is important, but it's critical to have substance as well as form," says Mr. Arpinder Singh. "A lot of top executives say they are tough on bribery and corruption, but unless there is a demonstration of this through action, it remains in form. CFOs should ask themselves: would the company sack a sales head over a US$250 bribe?"

Education and effective communication are essential to ensuring that leadership tone is more than rhetoric. "Nearly 80% of the European fraud survey respondents have not received anti-bribery or anti-corruption training, and only one-third thinks their anti-bribery policy contains clear guidance," says Mr. Stulb. "You don't have an effective business strategy unless everyone from the CEO to the 'shop-floor' understands compliance."

Before making the investment, companies should examine the scale of the problem in the destination country and work out whether it will be possible to operate there without becoming involved in unethical business practices. "The assessment should include substantive testing and interviews, and potentially some element of mystery shopping and data analytics if you truly want to understand if there are any issues," says Mr. Arpinder Singh. "It's also necessary to implement a regular risk assessment to see if the risks have shifted due to changes in the business."

In some cases, companies may need to take a view that the upsides of the market opportunity are outweighed by the risks. "It is important to assess the extent of bribery and corruption in a market as part of the investment decision-making process," says Mr. O'Flaherty of Eskom Holdings. "If, as a company, you subscribe to the highest levels of governance, then you may find it is not possible to invest in a country where bribery is endemic. You need strong tone from the top and no tolerance. If someone is found guilty they are fired. It's as simple as that."

Although companies may worry that a refusal to tolerate bribery and corruption means that they will lose out on business deals to less scrupulous competitors, there is evidence that a firm approach actually yields business benefits. According to Transparency International, companies with anti-corruption programs are less likely to lose business opportunities than companies without such programs.[16]

[15] *European fraud survey: Recovery, regulation and integrity,* EY, 2011

[16] Source: Transparency International's 2009 Global Corruption Report

"Tone at the top is important, but it's important to have substance as well as form. CFOs should ask themselves: would the company sack a sales head over a US$250 bribe?"

—Arpinder Singh, EY

Despite the prevalence of bribery and corruption, legal and regulatory intervention and increased attention to the issue among corporates are having an effect. "Governments recognize that bribery and corruption are bad for business," says Mr. Stulb. "Rapid-growth markets that don't take steps to address the issue will be left behind and become increasingly isolated. As a result, we're seeing a steady decline in the problem, although it's an ongoing process that will require ongoing intervention from both government and business to make further progress."

Stakeholder engagement is broader than the shareholders

For CFOs, an assessment of political risk forms a key part of the pre-entry phase. "Political risk is probably the number one element that we consider before making some significant investment," says Mr. Bracke of Honeywell Transportation Systems. "I don't think we want to go into any country where there would be some substantial risk."

Political risk is inherently difficult to quantify. CFOs can use cost of capital models to build up a picture of the returns they should expect in a given market, but a common problem with these is that there is insufficient historical data on which to base the measurement. Political risk insurance can offer some protection but it will not cover every eventuality and can be expensive.

Despite these difficulties, there are numerous approaches that CFOs can take to ensure that they manage political risk effectively. As with so many other aspects of rapid-growth markets, the first thing is to build strong, long-term relationships with local stakeholders, including governments, regulators, tax administrations and communities. "Companies with experience of investing in developed markets are used to communicating primarily with their shareholders. They often underestimate the time needed to build relationships with a much more diverse stakeholder group when investing in rapid-growth markets, including local government officials, unions and works councils," says Mr. Karklins Marchay.

Hiring finance managers locally who have knowledge of the local administration and authorities and the right contacts is vital. "It's very difficult for a Western manager to navigate complex political and regulatory environments," says Mr. Puistienne. "You need local knowledge to get the right approvals and deal with regulation."

This local knowledge should be combined with a robust risk and controls framework that enables CFOs to have confidence in the information on political risk that they receive. This will enable the CFO to track political risk — not just at the pre-entry phase, but throughout the life cycle of the investment — and have advance warning of when levels are rising and threatening the underlying fundamentals of the investment.

From top to bottom: how management can embed a zero tolerance approach to bribery and corruption

There are a number of largely common sense measures that give employees a reason to care about adhering to anti-bribery and anti-corruption measures, by linking them to their work and career advancement. The leadership of the organization needs to:

- Make ethical behavior a priority for the business and demonstrate its commitment to achieving this objective
- Conduct a fraud, bribery and corruption risk assessment and identify any gaps in current policies and procedures
- Where necessary, implement changes to these procedures, paying particular attention to training:
  - Be sure that training is truly tailored and relevant, reflecting the issues and day-to-day problems that employees are likely to encounter and how to address them
  - Take a risk-focused approach to who should be trained, on what, in which manner and how often
  - Ensure that integrity is reflected in the appraisal systems of the business

Ten lessons for CFOs

Every rapid-growth market has its unique opportunities and challenges. And although this makes it difficult to generalize about the practical implications of our research for CFOs, we believe that they should bear in mind the following when considering an investment:

1. **Place investment strategies for rapid-growth markets under the microscope**. CEOs on the hunt for growth and under pressure from investors are becoming increasingly excited about the prospects within rapid-growth markets. But while the opportunities are undeniable, CFOs have a key responsibility to evaluate rapid-growth market strategies and make sure that they stack up. An awareness of the real costs of investment is essential, and a healthy dose of skepticism can play an important role in tempering unchecked enthusiasm for rapid-growth markets.
2. **Pay close attention to operational costs**. Investment in these markets typically relies on a high-volume, low-margin business model. This can be extremely profitable, but problems quickly arise if operational costs prove higher than expected. In some cases, the profitability of the investment can be quickly eroded altogether. CFOs must ensure that they scrutinize operational costs carefully on a regular basis to ensure that the investment remains viable over the long term.
3. **Stay involved (or at least informed) throughout the process**. Our research suggests that the involvement of CFOs in rapid-growth investment is skewed toward the pre-entry stages. Once the deal is done, some CFOs take a back seat. But with rapid-growth markets evolving and changing quickly, this can be a risky approach. CFOs should either remain closely involved throughout the entire investment life cycle, or be able to build strong teams around them that can feed back accurate, honest information about the investment on an ongoing basis.
4. **Strike a balance between local and global knowledge**. Investments in rapid-growth markets rely on local knowledge for their success. But local knowledge alone is not enough. CFOs should ensure that there is a balance struck between local managers with a deep understanding of the business environment and strong oversight from the headquarters. Global talent management programs that give local and headquartered employees exposure to other markets can help to improve the mix of skills across local and global environments.
5. **Future-proof your investment**. The pace of change in rapid-growth markets is so fast that the business environment at the time of the deal is unlikely to remain the same for long. Markets continue to open up, regulatory environments are developing, and labor costs are on the rise. As well as considering the viability of their investment at the time of the deal, CFOs also need to test it against a range of future scenarios based on their expectations of future growth and development in the market.

"The long-term outlook for these economics is extremely bright. But growth at this rate inevitably means there will be bumps along the way ... accepting that these will happen is part of investing in rapid-growth markets."

6. **Carry out "integrity due diligence" on potential partners or acquisition targets**. The selection of partner or target is critical to the success of the investment. In addition to carrying out financial due diligence, CFOs should ensure that they conduct "integrity due diligence." This should include ensuring that there is a good cultural fit between the two organizations, and obtaining information about the local company from a broad range of sources, including customers, regulators and suppliers. This process helps potential investors gain confidence that the partner or target has a good credit history, is ethical in its dealings and adheres to values that match those of the investor organization.

7. **Become an employer of choice**. With competition for talent in rapid-growth markets unlikely to abate in the near future, CFOs need to consider how they will continue to attract and retain the best employees. They should take a long-term view, invest in training (even if this makes their employees more marketable to other companies), build strong relationships with local communities and ensure that their compensation packages remain competitive, particularly when compared with local companies.

8. **Put in place a strong risk and controls environment**. Managers in rapid-growth markets must have some degree of autonomy to make decisions locally, but this should be granted in the context of a strong risk and controls environment. This means that all decisions happen within agreed parameters, thereby preventing excessive variation across markets. A strong risk and controls framework also helps to influence the behavior of employees in local markets, deter unethical business practices and impose a strong "tone from the top."

9. **Accept that some costs will be high**. There should also be an understanding that some costs will be high, as this is an inevitable part of the investment process in rapid-growth markets. For example, as companies reallocate resources to take advantage of these markets, investment in local R&D centers is often a key aspect of the overall strategy. While the costs of this may be high in the short term, this decentralization of R&D will be an important determinant of future success in these markets.

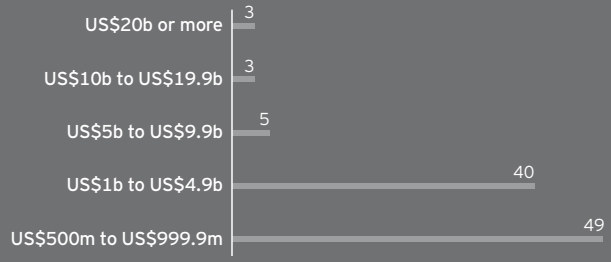
10. **Take a long-term view**. Much of this report has focused on the hidden costs and risks that can surprise multinationals when investing in rapid-growth markets. And while CFOs have a responsibility to be aware of these and, where appropriate, minimize them, they should also take a long-term view to assessing these costs and risks. With some rapid-growth markets experiencing GDP growth approaching double digits, the long-term outlook for these economies is extremely bright. But growth at this rate inevitably means there will be bumps along the way, including currency volatility, the possibility of asset price bubbles and political unrest. Accepting that these will happen is part of investing in rapid-growth markets. Yet in most cases, they will not affect the overall viability of the investment. Vigilance is crucial but the costs and risks should not deter investment.

Respondent demographics

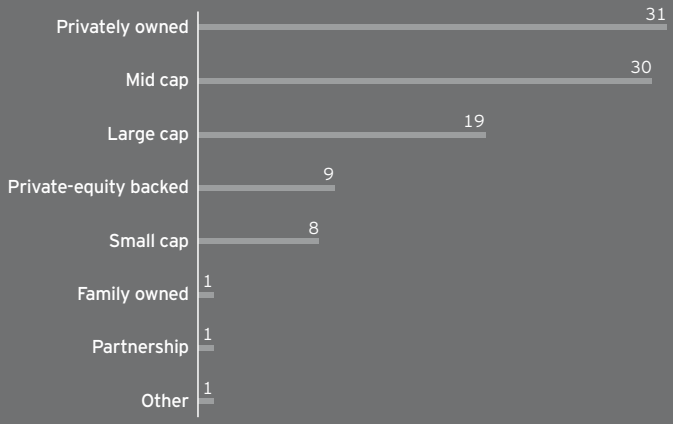
The following charts show the profile of the 921 CFOs we surveyed and the organizations they represent.

Job title

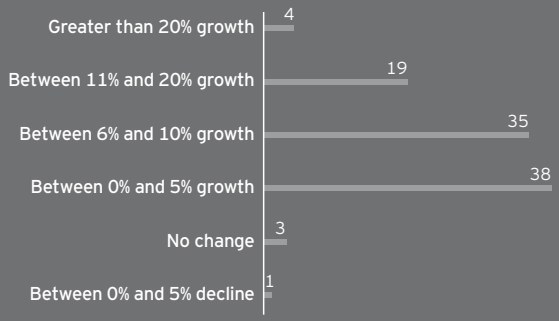
Organization's annual global revenue in last 12 months



Organization ownership

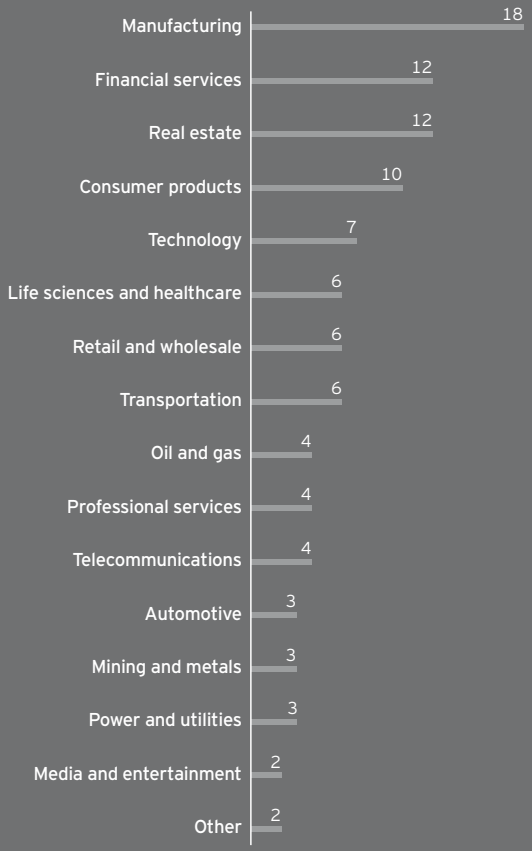


Organization's EBITDA growth in the last 12 months

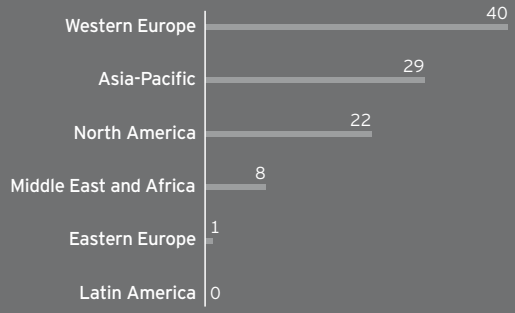


Shown: percentage of respondents

Primary industry



Region in which organization is headquartered



Other titles

This second editon of *The Master CFO Collection* will be followed by others in a collection which provide insight on the events and experiences which CFOs encounter as part of their role. The first edition addressed the role of the CFO in communicating with the media. *Back seat or center stage? CFOs and the Media* (October 2010).

Additional titles, which accompany this collection, include *The DNA of CFO* (July 2010) and *Finance Forte: The future of finance leadership* (March 2011).

For further information on these titles, and our program of investment in CFOs across Europe, the Middle East, India and Africa (EMEIA), please go to www.ey.com/cfo, or contact:

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