UK
TRADE &
INVESTMENT

ACCESSING INTERNATIONAL MARKETS

SURVIVE AND PROSPER: EMERGING MARKETS IN THE GLOBAL RECESSION

Economist Intelligence Unit

The Economist

About this report

Survive and prosper: emerging markets in the global recession is a UK Trade & Investment (UKTI) report written in collaboration with the Economist Intelligence Unit. The report seeks to examine opportunities within emerging markets in the context of the current economic climate. Many companies have felt the adverse effects of the global recession, which, coupled with the poor performance of the developed world, has increased the urgency for companies to seek new markets in the emerging world. It follows a previous report by UKTI, *Tomorrow's Markets,* also written in conjunction with the Economist Intelligence Unit, published in September 2008.

To gauge opinion, in July-August the Economist Intelligence Unit conducted a global survey of over 540 companies from across 19 business sectors. Over 40 per cent of the executives interviewed worked for companies headquartered in emerging markets; the remainder were from companies based in developed countries. Almost half (48 per cent) were small and medium-sized companies with annual global revenues of US$500 million or below; 18 per cent had global revenues of US$10 billion or above. Just under half (48 per cent) of the interviewed executives were C-suite or board members across a wide range of business functions.

EXECUTIVE SUMMARY

The worst of the current global recession may now be over. Overall, emerging markets have performed better than developed economies (which have suffered their worst economic downturn in over 60 years). But conditions vary widely and are far from rosy. Although China and India have continued to grow rapidly, albeit at a less relentless pace than previously, Latin America has performed as poorly as Western economies, while Eastern Europe has performed even worse.

Apart from the impact of the economic downturn, companies in emerging markets continue to face numerous (and in some cases worsening) operating challenges. Yet optimism about the long-term prevails. Indeed, given the relatively poor performance of developed markets over the past two years, companies, arguably, may have more incentive to seek new markets in the emerging world.

The key findings of the report are highlighted below.

■ China and India keep emerging markets in the black.

Emerging market economies have outperformed those of developed countries in 2009, but this is due largely to the continued high growth (and market size) of China and India. Without these two countries, emerging market economies would contract this year, although, with the exception of Eastern Europe, they would still fare less badly than developed economies.

■ The crisis has hurt business everywhere, but emerging markets remain attractive…

Almost 90 per cent of surveyed companies said that the global downturn has had an adverse impact on their business, but emerging markets seem to support global profitability. Among companies headquartered in developed countries that derive more than 5 per cent of their revenues from emerging markets, 40 per cent said that their financial performance was better than that of their peers. By contrast, of those reporting less than 5 per cent of their revenues from activities in emerging markets, only 24 per cent reported their financial performance as being better than that of their peers.

■ …even though foreign investment has started to decline.

Foreign direct investment (FDI) into emerging markets withstood the global economic downturn in 2008, but plummeted in the first quarter of 2009 by 37 per cent year on year. The sharpest decline was in Eastern Europe. But the collapse in FDI will have more of an impact on developed markets in 2009; inflows are forecast to dip (temporarily) below those to emerging markets.

■ The "decoupling" debate rages on.

The relatively strong performance of China and India might suggest a degree of independence from Western economic performance. However, the GDP growth gap in recent years between developed and emerging markets overall has remained at 5-6 percentage points, indicating continuing linkage. Companies themselves are also divided over the extent to which recovery in their emerging markets business depends on improving conditions in Western markets; just under half (47 per cent) said it was to a "limited extent", and 42 per cent said to a "great extent".

■ State intervention has helped some investors…

Actions taken by governments in emerging markets to counter the downturn have helped both local and foreign investors. This has been particularly the case where massive fiscal stimulus packages have involved major spending on infrastructure, and boosted purchasing power of poorer consumers.

■ …but political fears increase and credit risks rise.

Political risks and unclear bureaucratic regulations as well as poor infrastructure and talent shortages are perceived as the greatest obstacles to operations in emerging markets. Moreover, a significant proportion of survey respondents felt that macroeconomic instability and shortage of credit had worsened over the past two years.

■ Caution over the short-term gives way to longer-term optimism.

Most survey respondents expressed caution about opportunities in emerging markets over the next two years. But almost three-fifths expected to derive more than 20 per cent of their total revenues in emerging markets in five years' time—almost double the current proportion of 31 per cent. This is a more sober outlook than expressed by survey respondents in UKTI's 2008 report, *Tomorrow's Markets*, but suggests that investors prepared to stay the course still believe that returns from emerging markets over the long term will be worth the investment.

■ Asia is the future investment region of choice.

China, India and other Asian markets are the preferred investment destinations over the next year and next five years. In comparison with a similar market ranking by UKTI in 2008, Asian markets now dominate the top-ten list of non-BRIC future investment destinations to the detriment of markets in Eastern Europe.

THE "GREAT RECESSION"

The world experienced a "Great Recession" in 2009. It avoided a "Great Depression", thanks largely to the unprecedented scale of monetary and fiscal policy action of leading economies, but average performance in 2009 will nonetheless be the worst since the end of the Second World War. Given this background, it may seem remarkable that some emerging markets have continued to grow during the past year. Whereas the economies of developed OECD countries are forecast to contract by 3.7 per cent in 2009, emerging markets are still expected to record positive growth, on average of 1.8 per cent. However, the percentage-point decline in growth compared with 2008 is similar to that in the developed world. Thus the gap between developed and emerging market GDP growth - at purchasing power parity (PPP) weights - in recent years has remained at 5-6 percentage points.

China and India keep emerging markets in the black

Much of the emerging market performance in 2009 is, of course, due to the continued high growth rate (and large size) of China and India. This is the reason that average emerging market growth will remain positive. However, even if China and India are taken out of the equation, most emerging markets will have outperformed the developed world in 2009. However, Eastern Europe, which has suffered very badly in the downturn (see box, *A tale of two regions*) is a notable exception, while the average GDP decline in 2009 in Latin America will be only marginally smaller than in the developed world.

A similar picture is evident when looking at inflows of foreign direct investment (FDI) to emerging markets. Initially resilient in the downturn throughout 2008, inflows started to dry up in the first quarter of 2009, recording a year-on-year decline of 37 per cent—a performance that is unlikely to improve for the full year. All regions are likely to take a big hit, with Eastern Europe being worst affected, and China least affected (see box, *Turning off the tap*).

The macro-economic and FDI data is supported by survey respondents' views of which emerging markets have been hit hardest by the crisis. China, India, the rest of developing Asia and Brazil are seen as being least affected; Russia, Central and Eastern Europe and Latin America (excluding Brazil) are the worst-affected regions.

Eastern Europe v Asia: A tale of two regions

Economic performance has varied considerably across the emerging market regions. The global crisis has hit Eastern Europe particularly hard. Poland is the only major economy in the region that is expected to avoid recession in 2009. The recession in Western Europe led to a sharp decline in Eastern Europe's exports and the global crisis greatly limited the region's access to external finance. The collapse in activity across much of the region since the fourth quarter of 2008 has been extraordinary, and may get worse: average output is forecast to contract by just under 6 per cent in 2009. Unlike in other emerging markets, there has been little positive economic news coming out of the region in recent months.

By contrast, developing Asia is forecast to grow by 4.5 per cent this year. There are several reasons for the impressive Asian performance. The region's sharp decline in exports in late 2008 was exacerbated by the freezing up of trade finance, which is now flowing again. The region's fiscal stimulus was bigger and worked faster than elsewhere. In addition, most countries in the region have healthy government finances, which allowed them to spend, while low private-sector debt encouraged households and firms to spend government handouts. Asian banks were also in better shape than elsewhere and able to lend. Asia's prudence did not allow it to escape the global recession, but it made the region's monetary policy weapons more effective.

Turning off the tap: Foreign direct investment in emerging markets

Foreign direct investment (FDI) into emerging markets initially proved more resilient than inflows to the developed world in the face of the global crisis. Whereas FDI inflows to the developed world declined by 30 per cent in 2008, inflows to emerging markets actually increased, by an estimated 6.4 per cent in 2008.

However, first-quarter 2009 data for 54 countries (19 developed countries and 35 emerging markets accounting for almost 90 per cent of total global FDI inflows in 2008) were not encouraging, dropping by 46 per cent year on year in US dollar terms. The decline in inflows into emerging markets by 37 per cent was only slightly less drastic than for developed markets. By region, the sharpest decline, by 48 per cent, was into Eastern Europe, followed by Latin America (37 per cent) and developing Asia (27 per cent). China itself saw a decline of 20 per cent. Forecasts for the year as a whole are expected to be similar, with many countries in Eastern Europe especially suffering from a high degree of macroeconomic vulnerability and large external financing requirements.

The FDI fall reflects the sharply reduced availability of credit, the deep economic downturn in the developed world and many emerging markets, and a large-scale retreat from risk. Although global economic conditions are much worse than in the previous FDI slump in 2002, the current decline is being cushioned by several factors. These include: the existence of cash-rich firms from China and several other emerging markets that are still looking to expand abroad; investors taking advantage of low valuations; external financing constraints in emerging markets that will drive

some privatisations; a large volume of distressed deals in the financial sector; and consolidation trends in several industries that will provide some boost to mergers and acquisitions (M&A) activity.

Although the Economist Intelligence Unit forecasts that FDI inflows into developed markets will drop below those into emerging markets in 2009 (48.5 per cent of total inflows into developed markets; 51.5 per cent into emerging markets), this is expected to reverse later when cross-border M&A transactions—primarily a developed market activity—pick up again.

Turning off the tap: Foreign direct investment in emerging markets (continued)

FDI inflows
(US$ billion unless otherwise indicated)

	2007	2008	2009(a)
World total	2033.3	1683.2	923.3
(per cent change)	43.2	-17.2	-45.1
Developed countries	1312.7	916.4	447.8
(per cent change)	48.0	-30.2	-51.1
Emerging markets	720.6	766.8	475.5
(per cent change)	35.2	6.4	-38.0
Sub-Saharan Africa	28.0	30.9	16.6
(per cent change)	75.2	10.5	-46.3
Middle East & North Africa	76.0	69.4	49.3
(per cent change)	12.7	-8.7	-28.9
Developing Asia	297.8	322.8	225.4
(per cent change)	38.7	8.4	-30.2
Latin America & Caribbean	127.2	137.7	82.1
(per cent change)	36.0	8.3	-40.4
Eastern Europe	166.0	184.6	91.9
(per cent change)	41.1	11.2	-50.2
per cent share developed countries	64.6	54.4	48.5
per cent share emerging markets	35.4	45.6	51.5

(a) Economist Intelligence Unit forecasts.

Sources: IMF; national statistics; Economist Intelligence Unit.

THE IMPACT ON COMPANIES

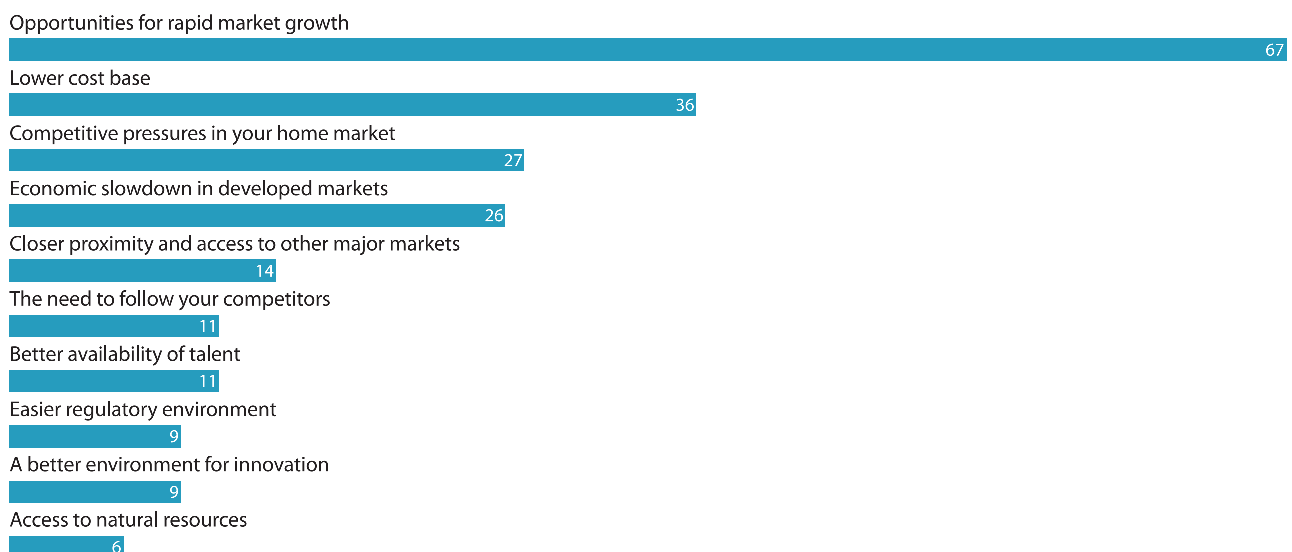
The crisis has hurt business everywhere...

Few companies have been left unscathed by the global crisis. Nearly 90 per cent of firms surveyed said that their business had suffered an adverse impact; around 50 per cent of these said that the adverse impact had been "significant", and 38 per cent reported a "marginally adverse impact". It is perhaps sobering to note that in UKTI's 2008 survey, *Tomorrow's Markets*, some 62 per cent of respondents believed that emerging market strength would offset the economic slowdown in the developed world. For many firms this is unlikely to occur in 2009. Nevertheless, that does not mean that companies have been unable to cope with pressures in emerging markets, and a few even claim to have prospered in adversity.

Despite—or perhaps because of—the economic crisis, companies continue to look to emerging markets for revenue growth. According to our 2009 survey, two-thirds of firms said that among their main reasons for investing in emerging markets in the past two years was the "opportunities for rapid market growth". In addition, 27 per cent cited competitive pressure in their home market, and 26 per cent cited the economic slowdown in the developed world. These factors suggest that the worsening economic climate in developed markets may even encourage Western-based companies to think more seriously about the potential rewards of investing in emerging markets.

Despite – or perhaps because of – the economic crisis, companies continue to look to emerging markets for revenue growth.

What have been the main reasons for your company investing in emerging markets in the past two years?
(per cent of respondents)



Source: Economist Intelligence Unit.

...but emerging markets remain a good bet

Even if emerging markets on the whole are not delivering the returns they once did, companies' financial performance appears to be related to the extent that they are involved in emerging markets. The survey findings provide some evidence that companies with sizeable emerging market operations tend to be more profitable than those with little or no operations in the emerging world. For those companies that derived more than 5 per cent of their revenues from emerging markets, the share reporting better financial performance than that of their peers was 39 per cent. By contrast, among the companies that derived less than 5 per cent of their total revenues from activities in emerging markets, only 28 per cent reported their financial performance as being better than that of their peers.

The correlation looks even stronger in the case of companies with headquarters in developed countries. Of those that derived less than 5 per cent of their revenues from activities in emerging markets, the share reporting better financial performance than that of their peers was almost 24 per cent. By contrast, among companies that derived more than 5 per cent of their revenue from emerging markets, 40 per cent reported their financial performance as being better than that of their peers.

The consumer healthcare business of GlaxoSmithKline (GSK), a global drug maker, is a case in point. Although the company has been hit by a significant dampening of demand in Europe and the US, it has done well in one of the few remaining fast-growing emerging economies, India. The company reports performance broadly in line with other successful fast-moving consumer goods (FMCG) producers in India that are averaging 15-20 per cent revenue growth in the first half of 2009, and this has provided a significant boost to the company's global sales.

Pain by sector

Performance during the recession has, of course, varied by sector. Our survey found that companies in sectors that are most sensitive to the business cycle have been most severely affected by the crisis. These include automotive, chemicals (and manufacturing in general), construction and real estate, transportation, and travel and tourism. Even in less-affected industries, such as many services, the crisis has had a significantly negative impact.

Tough and tougher
(per cent of companies by sector reporting a significant adverse impact)

Sector	%
Automotive	75.0
Chemicals	71.4
Manufacturing	67.6
Construction and real estate	64.7
Transportation, travel and tourism	63.2
Financial services	57.9
Logistics and distribution	55.6
Consumer goods	51.7
IT and technology	50.0
Telecommunications	50.0
Average	**49.8**
Agriculture and agribusiness	46.7
Entertainment, media and publishing	45.5
Retailing	44.4
Aerospace/defence	40.0
Energy and natural resources	38.5
Education	33.3
Healthcare, pharmaceuticals and biotechnology	32.3
Professional services	31.7
Government/public sector	16.7

Source: Economist Intelligence Unit.

As an example, one of the hardest hit sectors in one of the worst-affected regions is the hotel industry in Eastern Europe. According to Adrian Gray, General Manager of the 5-star Le Meridien hotel in Budapest, "this hotel is a fairly instant indicator of the way commerce is going, and we knew from about May 2008 that there was a change in the tide." The hotel's major clients were in the finance, automotive and real estate sectors, which "had an almost instantaneous affect on our business: forward bookings in conference tourism, in particular, just disappeared," he reports.

The experience has been slightly better for business process outsourcing (BPO), a staple of emerging market business for many years. Genpact, the world's largest, India-based, BPO operation, "has been hit hardest by developments in the US and Europe, where IT spending and decision-making have plummeted as clients battle to survive," according to Pramod Bhasin, the company's President and CEO. Moreover, 40 per cent of Genpact's business is centred on banking and finance, and another 40 per cent on manufacturing, including the troubled automotive industry. But Genpact's clients have been looking primarily to cut costs and unlock cash, so although big IT investments might have been shelved, clients have still been willing to outsource basic corporate functions, such as payroll or accounting.

Coping strategies

The extent to which companies have been affected by the crisis has in part depended on firms' ability to anticipate and prepare for the downturn. Approaches vary from ruthless cost cutting to developing new products. Nestlé, a food group, had early on seen the benefits of catering to poorer consumers, especially in Brazil, and was better placed when the crunch came. The firm developed a new range of cheaper products, especially for the poor and populous north-east; launched direct sales operations; adapted its marketing to specific groups of consumers; and boosted brand loyalty to retain customers, according to Alexandre Costa, Nestlé's Director for Regionalisation in Brazil. Nestlé intends to replicate this strategy in other Latin American markets.

Similarly, in India, a conservative pricing strategy and volume-driven growth is paying off for some companies such as GSK Consumer Healthcare (GSKCH). Shubhajit Sen, the company's Executive Vice President, reports that "the recession has...significantly reduced the price of advertising and inputs, while enabling us to pressure vendors for greater efficiency." Such a strategy "resulted in a first-half 2009 performance that was better than the last 10 years' annualised growth."

"The recession has…significantly reduced the price of advertising and inputs, while enabling us to pressure vendors for greater efficiency."

Perhaps the most common response has been to cut costs. Genpact wielded the axe as early as autumn 2007. Sensing impending distress in the US market, the firm froze hiring, kept salary rises to around 7 per cent (below market rates of 12 per cent), cut sales and administration expenses, and moved to much cheaper office space in smaller towns. It used freed-up cash to "invest in talent globally just as competitors have been forced to slough off theirs," says Mr Bhasin.

Mr Gray of Le Meridien was blunt about curbing bonuses, cutting the "thirteenth month" wage packet and demanding flexibility from employees: a virtual freeze on using sub-contractors meant maintenance engineers might be (and have been) called upon to help with laundry. In return, Mr Gray pledged to do everything to maintain full-time hotel jobs.

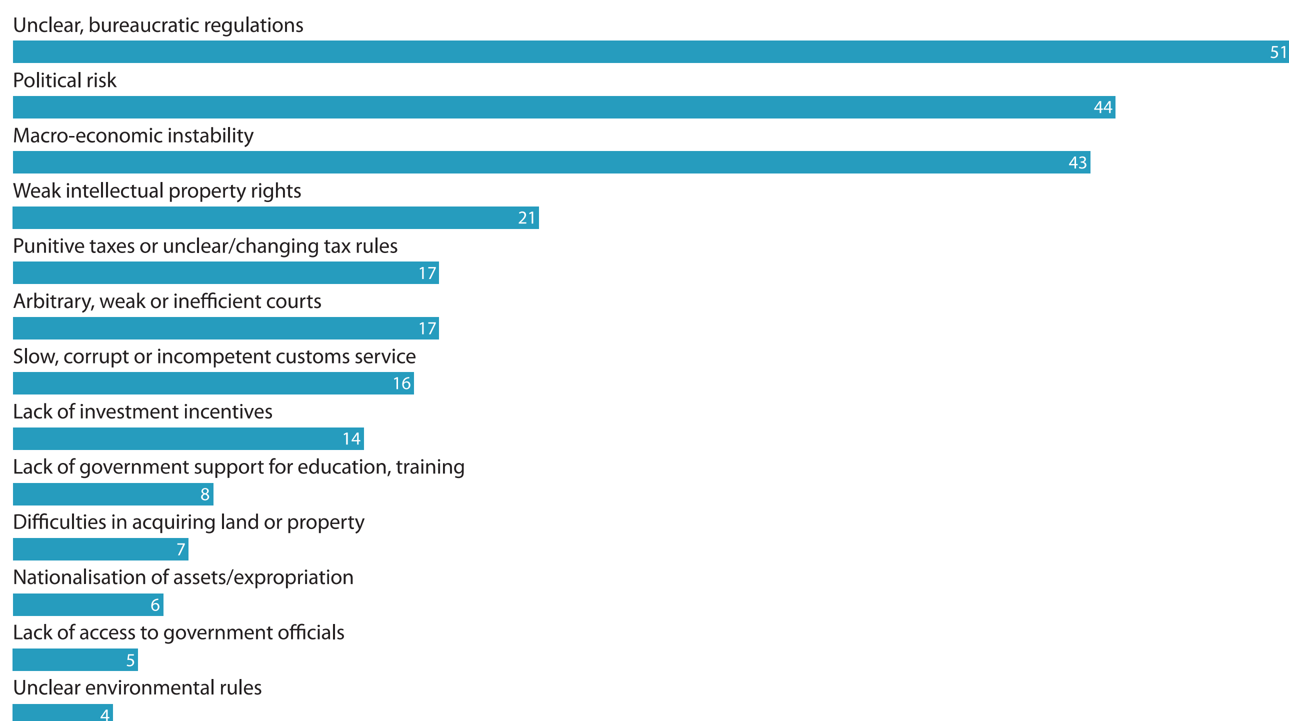
THE EMERGING BUSINESS ENVIRONMENT

Although corporate responses to the crisis differ depending on sector and location, most companies continue to face an array of state- and market-related obstacles. Many of these existed during the boom times, and will persist in the upturn. Some have inevitably intensified, such as the lack of credit availability and rising credit risk among suppliers and customers, but this is deemed largely a consequence of the current lending environment, and is expected to improve as economies return to growth.

Political fears increase

The big challenges remain at government level. Despite the current importance of, and preoccupation with, crisis-related economic impediments to investment, the survey responses indicated that unclear bureaucratic regulations and political risk are deemed the greatest government-related obstacles to doing business in emerging markets. These two factors were cited by 51 per cent and 44 per cent respectively of all survey respondents. If the risk of nationalisation and expropriation is combined with political risk, the percentage for the wider concept of political risk rises to 50 per cent—some seven percentage points higher than a similar question asked in UKTI's 2008 survey.

Which of the following government-related obstacles present the greatest challenges to your business operations in your main emerging markets?
(per cent of respondents)



Source: Economist Intelligence Unit.

In common with the findings of most investor surveys, political risk (inclusive of the risk of nationalisation and expropriation) is considered a greater obstacle by investors from developed countries than by emerging market investors—53 per cent compared with 45 per cent respectively. Indeed, for developed country investors, political risk exceeds unclear bureaucratic regulations in importance as an obstacle to business. These results thus mirror the findings of other surveys in recent years (including by the Economist Intelligence Unit) that show political risk generally moving towards the top of corporate agendas.

Several factors may explain these rising fears. Over the past two decades, economic and business reforms in many parts of the world have reduced the prominence of traditional barriers to investment and have thereby increased the salience of political risk among investor concerns. Global developments over the past decade appear to have heightened sensitivity to the risk of terrorism and other forms of political violence. In addition, political risk has become more of a concern as investors have expanded into an increasing number of new markets. Attention to political risk tends to be high during the first few years of operations in a new market, before sufficient familiarity and coping mechanisms are developed.

After bureaucratic regulations and political risk, the survey shows that the greatest government-related obstacle to investment in emerging markets (noted by 43 per cent of all survey respondents) is macroeconomic instability. This is unsurprising in the current circumstances, although it is the only government-related obstacle cited by a significant proportion of respondents, 44 per cent, as having worsened this year.

These three factors—bureaucratic regulation, political risk and macroeconomic instability—are considered to be far more important than some other traditionally perceived obstacles to investment in emerging markets. Arbitrary courts, slow and corrupt customs services, weak intellectual property rights protection, punitive tax rates and unclear tax rules are cited by 15-20 per cent of respondents. There is generally little variation between sectors on perceived obstacles to business, with a few, obvious exceptions: for companies in the energy and natural resources sector, political risk (53.8 per cent) and the risk of nationalisation and expropriation (19.2 per cent) were especially prominent concerns.

These political risks have to be set against the future opportunities. Thus Mr Bhasin of Genpact reminds fearful investors: "Emerging markets do present challenges, but companies that labour under misplaced fears will lose out. This we see from the experience of firms that avoided or left India and China in the 1990s, and now find it too difficult to get in."

"Emerging markets do present challenges, but companies that labour under misplaced fears will lose out. This we see from the experience of firms that avoided or left India and China in the 1990s, and now find it too difficult to get in."

State intervention has also helped investors

The influence of policymakers is not always negative. For a start, state largesse in the form of stimulus packages has been widely welcomed by companies. Nestlé's operations in Brazil benefited from the increase in purchasing power of the low-income segment of the population in São Paulo, following real increases in the minimum wage and social benefits. Similarly, GSK Consumer Healthcare has profited from various public spending programmes and excise tax cuts in India, where the National Rural Employment Guarantee Scheme has helped poorer consumers, boosting GSK Consumer Healthcare's rural sales by nearly 20 per cent.

Among companies seemingly least affected by the downturn have been those operating in counter-cyclical industries that are dependent on state spending. Bombardier Transportation India, which supplies equipment to the Indian Railways and to urban rail transportation projects, has benefited from state support for infrastructure spending aimed at combating recession, according to Rajeev Jyoti, the company's President and Managing Director. But he warns of risks of relying on state money in the long term: "While governments might push rail spending to pump growth, freight and people must ultimately travel to recoup these investments."

State investment in infrastructure aimed at countering recession has provided a boost for firms operating in other regions too. Philippe Delleur, Latin America CEO of Alstom, a French engineering equipment supplier, notes that although several energy projects have been delayed, large-scale investment projects were included in the growth acceleration programme launched by the government of Brazil—a country that suffers chronic transport and energy infrastructure shortcomings. Alstom won a series of contracts worth around €1 billion (US$1.42 billion) to supply two large hydroelectric dams, as well as various railway signalling and metro contracts, including in the federal capital, Brasilia. The projects were all backed by the state-owned development bank, which received US$55 billion of state money.

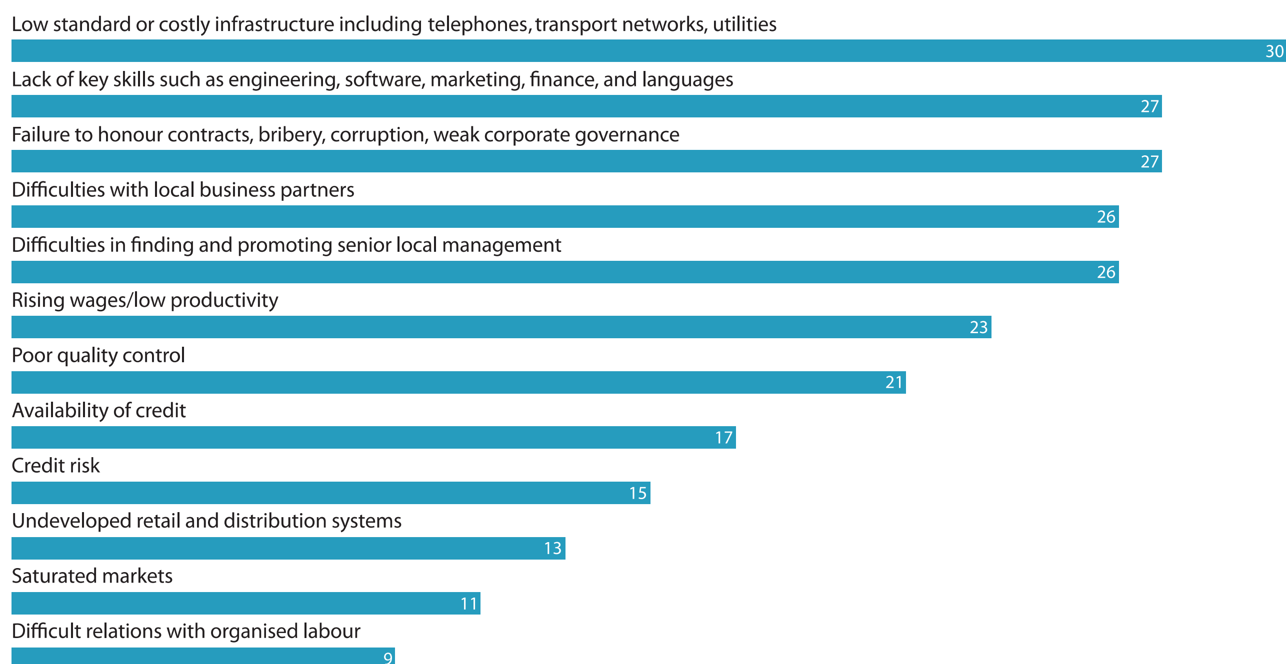
Seemingly small policy changes can also make a big impact. John Smith, a Director of Hungary-based Danubius Hotels Group, for example, praises the country's Bajnai government for reducing value-added tax (VAT) on hotels to 18 per cent (when general VAT has risen to 25 per cent). "This was an important concession for the hotel sector. Raising VAT to 25 per cent would have been an absolute bust for us—you simply cannot pass on the increase to customers in the current environment," he says.

Challenges on the ground

Unlike in the case of government-related obstacles to business, when it comes to operational business obstacles, no single factor stands out. However, poor and costly infrastructure, lack of key skills, failure to honour contracts and corruption, difficulties with local business partners and scarcity of senior local managers all continue to be deemed problematic. Infrastructure deficiencies loom large in particular for US investors (cited by 38 per cent of respondents). In this respect, the recent heavy investment in infrastructure, designed to stimulate the economy, in countries such as China may look appropriate, although the strategy has been widely criticised.

Talent shortages for management and technical skilled staff have long been the bane of cost-conscious investors. The squeeze is getting tighter according to our survey as improving skills levels drive up wages. The general global economic slowdown appears to have done little to ease staff shortages and rising labour costs: one-third of respondents said that the issue had worsened over the past two years, compared with one-fifth who said it had improved. This talent crunch, notes Mr Bhasin of Genpact, is causing senior-level IT and BPO managers to become more expensive in India than in the US, which cuts at the heart of the industry.

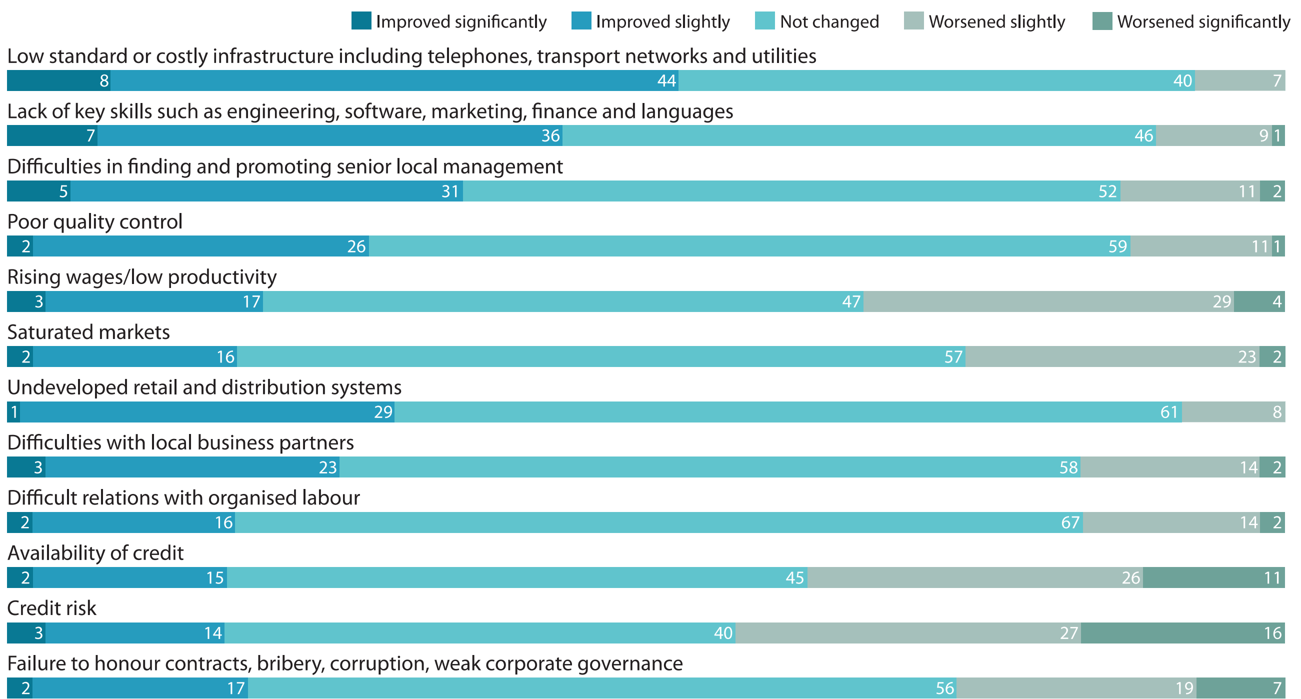
Which of the following operational obstacles present the greatest challenges to your business operations in your main emerging markets?
(per cent of respondents)



Source: Economist Intelligence Unit.

Most strikingly, although hardly surprising, 37 per cent of respondents felt that the availability of credit had worsened over the past two years, double the number who said it had improved. An even wider gap (43 per cent compared with 20 per cent) exists concerning the worsening credit risk situation. As liquidity improves in developed markets, this is expected to ease credit availability in emerging markets too.

To what extent have the above-mentioned operational obstacles in your main emerging markets improved or worsened over the past two years?
(per cent of respondents)



Source: Economist Intelligence Unit.

A STILL-CAUTIOUS OUTLOOK

The global economy is expected to recover in 2010-11, although the upturn will, initially at least, be relatively weak and fragile, especially in the developed world. The subdued global outlook reflects the need for massive balance-sheet adjustment in many economies and limited scope for sustaining a strong policy stimulus.

The lingering after-effects of the global crisis will prevent a quick return to potential growth. The recovery will, however, be more robust in most emerging markets.

Real GDP growth (per cent)

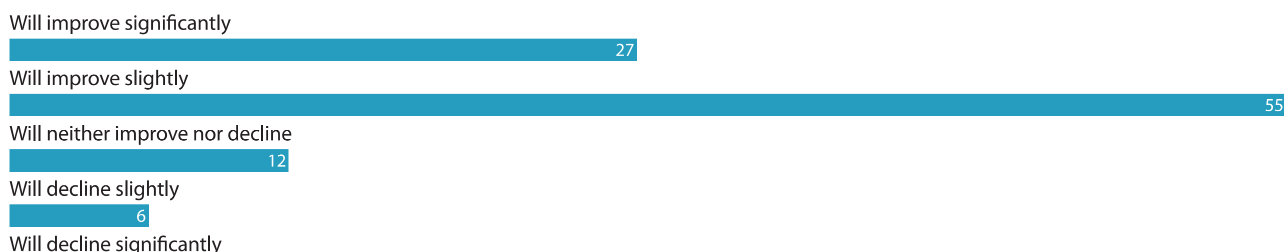
	2007	2008	2009	2010	2011
World (purchasing power parity exchange rates)	5.0	2.8	-1.4	2.7	3.4
World (market exchange rate weights)		1.7	-2.6	1.8	2.3
OECD	2.7	0.6	-3.7	1.1	1.4
Non-OECD	8.7	6.1	1.8	4.9	5.9
Developing Asia	9.7	6.4	4.5	6.0	6.9
Eastern Europe	7.3	4.7	-5.7	1.5	3.5
Latin America	5.5	3.9	-3.4	2.4	3.4
Middle East and North Africa	5.8	6.0	1.0	4.3	4.4
Sub-Saharan Africa	6.3	4.5	-1.7	3.1	4.9

Source: Economist Intelligence Unit.

Caution over the short term…

The survey results also reflect a cautious optimism about the near-term prospects for the global economy. The vast majority of companies (77 per cent) expect the prospects for the global economy to improve in 2010-11 (far more than the 44 per cent who said this in UKTI's 2008 survey), but only a small minority (15 per cent) of the survey respondents expect a "significant improvement" (compared with only 9 per cent in 2008). When asked about prospects for their key sectors, 23 per cent of companies expected a significant improvement and 55 per cent a slight improvement in 2010-11; and this is roughly in line with how respondents saw their own prospects.

How do you view your company's business prospects in your main emerging markets in 2010-11, compared with the past year?
(per cent respondents)



Source: Economist Intelligence Unit.

There is somewhat greater optimism about the recovery prospects for emerging markets. The vast majority of surveyed executives expected positive growth in their emerging markets businesses in 2010-11, as was the case in 2006-08, albeit more modest: whereas 25 per cent of companies reported that they enjoyed annual average growth in sales of more than 25 per cent in their main emerging market locations in 2006-08, only 16 per cent expected this for 2010-11.

There is greater optimism about the recovery prospects for emerging markets. The vast majority of surveyed executives expected positive growth in their main emerging markets businesses in 2010-11.

Expected change in annual sales in main emerging market business locations
(per cent of companies)

	2006-08	2009	2010-11
Growth			
25 per cent and above	25	8	16
15 per cent to 24.9 per cent	21	13	20
5 per cent to 14.9 per cent	25	30	34
0.1 per cent to 4.9 per cent	22	27	23
Contraction			
by up to 4.9 per cent	4	12	5
4.9 per cent to 14.9 per cent	1	5	1
15 per cent and more	2	5	1

Source: Economist Intelligence Unit.

When asked to what extent they believed that emerging markets business depends on an economic recovery in Western markets, just under half (47 per cent) of survey respondents answered to a “limited extent”, and 42 per cent said to a “great extent”. Only 7 per cent said that it had no impact and 3 per cent that their business actually benefited from weakness in Western markets. This would suggest that firms are divided over whether emerging market economies have effectively decoupled from the developed world.

UK investors appear to be more cautious than other investors about the outlook for both the global economy and their own sectors, and this may reflect the country’s large GDP contraction, and could conceivably serve as a catalyst for more trade and investment interest in emerging markets to mitigate pressures at home. By contrast, West European companies (other than from the UK) appear to be more optimistic than their counterparts in other developed countries about the outlook.

The bruising experience of the 2009 recession may be dampening previous investor enthusiasm about emerging markets. Only a small percentage of companies (14 per cent) said that they planned to relocate a significant part of an existing business or business functions from developed countries to emerging markets over the next two years. Just over a quarter of companies (27 per cent) planned to relocate "some back office functions". A clear majority of executives (55 per cent) said that they expected that there would be no shift or only a negligible shift in their business operations from developed countries towards emerging markets; an additional 3 per cent planned to relocate operations back to developed markets. By contrast, in the UKTI 2008 survey, a smaller proportion, 48 per cent, had said that they had no plans to relocate operations to emerging markets.

The highest proportion of respondents who said that they will relocate a significant share of their existing business from developed countries to emerging markets over the next two years were from the manufacturing sector (20 per cent). This compares with 8 per cent from the energy and natural resources sector and 14 per cent from the services sector.

...gives way to longer-term optimism

Firms are more bullish about the longer term, and see a greater proportion of future revenues coming from emerging markets in five years' time. Almost 60 per cent of companies expect to derive more than one fifth of their global revenues from emerging markets in five years' time—almost double the current proportion of 31 per cent. However, this is markedly less positive than views expressed in UKTI's 2008 survey, in which 67 per cent believed that one fifth of global revenues would come from emerging markets—and within just three years. A precise comparison is difficult, but this suggests that respondents, although still optimistic, are taking a more sober view of the relative importance of emerging markets, at least over the medium term.

Interestingly, companies from Western Europe appear to be focussed on emerging markets over the longer term than their UK and US counterparts. More than 21 per cent of West European companies expect over half of their revenues to originate from emerging markets in five years' time, compared with only 13 per cent of US and 10 per cent of UK companies.

Proportion of revenue derived from emerging markets (per cent of companies)

	Now	**In 5 years' time**
Under 5 per cent	30	11
5 to 20 per cent	39	31
21 to 49 per cent	13	34
50 per cent and above	18	24
Total	**100**	**100**

Source: Economist Intelligence Unit.

These forecasts in the wake of the global crisis have prompted new strategic thinking about the future position of emerging markets in company growth projections and organisational structure. In the case of GSK Consumer Healthcare, India is now one of its top four markets globally (along with the US, the UK and Germany). "The slowdown has, firstly, caused the global company to become more involved, more appreciative about [emerging markets'] unique characteristics, and more willing to develop products specifically for them. Country offices are now being given more flexibility and a wider time horizon to build these markets," says Mr Sen, the company's Executive Vice President. He notes a change from the earlier pattern in which global headquarters tended to use products created for developed markets in emerging ones as well, and to hold country offices accountable for maintaining a fixed ratio of sales volume to profits. "This slowdown, in contrast to that of the late 1990s, shows global HQs taking emerging markets seriously as long-term investments. They understand that something fundamental has changed, and do not want to lose the opportunity", he says.

> "This slowdown, in contrast to that of the late 1990s, shows global HQs taking emerging markets seriously as long-term investments. They understand that something fundamental has changed, and do not want to lose the opportunity, whatever the odds."

Mr Bhasin of Genpact explains how the company's business portfolio has already begun to shift decisively towards emerging economies, and to view them as markets and not just global delivery locations. Genpact will thus begin to establish a wider range of operations in the emerging world, including sales, marketing and other functions, as these markets reach a given level of maturity. This shift has been quickened, but not triggered, by the recession. "Expansion in these markets will not be driven by labour arbitrage, but by the success and relevance of our offerings," says Mr Bhasin.

Asia is the future investment region of choice

Where are the future growth opportunities to be found over the longer term? China, India and other Asian destinations are heavily favoured investment locations over the next five years (45 per cent of respondents cited China, 43 per cent India and 35 per cent other Asia). The Middle East and North Africa (MENA) was in 4th place (32 per cent), ahead of Central and Eastern Europe (30 per cent), Russia (28 per cent), Brazil (28 per cent) and other Latin America (25 per cent). Until recently, the prominence of MENA might have been surprising ahead of more traditional high FDI recipients from Eastern Europe and Latin America. Developing Asia, which already receives more FDI than other emerging market regions, is likely to see this advantage persist and widen. Strong Asian growth prospects and, to a lesser extent, continued cost advantages (the two factors also cited in our survey as the most important reasons for investing in emerging markets) will continue to be among Asia's main attractions.

The geographical spread is also reflected in the next tier of non-BRIC emerging markets. Half the top ten are in Asia, and no single country appears from Central and Eastern Europe. Notably, last year's UKTI report ranked Ukraine and Poland 4th and 7th respectively as top future investment locations; this year they have slipped to joint 15th. Also, the number of respondents selecting each new market is lower than in 2008, suggesting a return to the traditional emerging markets.

Beyond the BRICs
Which of the following emerging market countries are you considering entering over the next five years?

2009 rank (2008)	Country	No. respondents (of 513)
1 (1)	Vietnam	38
2 (3)	United Arab Emirates	26
3 (2)	Mexico	21
4 (8)	South Africa	18
5 (13)	Malaysia	17
6 (5)	Indonesia	16
7 (6)	Singapore	15
8 (12)	Turkey	15
9 (23)	Philippines	13
10 (10)	Saudi Arabia	12
15 (4)	Ukraine	10
15 (7)	Poland	10

Source: Economist Intelligence Unit.

Finally, investors in emerging markets must become more aware of intensifying competition from local players. Although 46 per cent of respondents said that their main competitors were subsidiaries of Western multinational companies, a majority were local players: 25 per cent small and medium-sized companies; 22 per cent emerging market multinationals; and 7 per cent state-owned companies. In the longer-term, the landscape will undoubtedly include many more globally expanding emerging market multinationals once recovery sets in, a trend that began in earnest before the crisis, and will resume strongly in the future. Moreover, the growing role of the state, coupled with stimulus policies designed to help local operators, may favour local players (see case study, *Origo Sino-India*).

ORIGO SINO-INDIA: BEWARE LOCAL COMPETITION

CASE STUDY

UK-listed Origo Sino-India, a private equity investor, is taking a long term view on China. When the financial crisis struck, reducing trade flows and drying up liquidity in established markets, Origo seemed equipped to deal with the resulting prolonged delays in investment deals. But into the vacuum came competition from hundreds of Chinese fund managers that seemed ready to dole out easy cash to any fast-expanding firm. Local investors had been present pre-crisis, notes Chris Rynning, Origo's CEO, but the government stimulus package and unprecedented lending by state-owned banks designed to minimise the effects of the global crisis have played a big role in the recent upsurge in their activity. "Even more money is going to be raised in the next few months," he says. "We anticipate that many young and skilled Chinese fund managers will start investing in a range of competitive sectors. What is more, they are much better equipped to deal with local businesses than foreign investors." According to Mr Rynning, "three years ago these local funds would be operating with capital between RMB300 million (US$44 million) and RMB500 million; they now work with four times that amount."

Where has this left Origo? The firm has shifted away from indebted industries, and increased investments in asset-backed sectors such as agriculture, mining and renewable energy, including lucrative, low-cost water purification and desalination businesses. This strategy fits with the Beijing government's recent drive to clean up the environment and improve China's public health system. In Origo's view, any water-related investment opportunity in China, which has scarce water reserves but growing agricultural and urbanisation needs, is worth the risk. Investors such as Origo are keen to follow the government's lead in these areas, and clear environmental policies makes doing business easier.

Government support may provide new opportunities, but there are other threats for the foreign investor to consider: the tested model of deploying foreign technologies into China, for example, is also changing, according to Mr Rynning. Chinese managers are increasingly considering local options: "If the technology is not home-grown, it is much more difficult to deploy than, let's say, ten years ago," he notes.

CONCLUSION

- Emerging markets have outperformed their counterparts in the developed world, but the picture of a booming developing world outpacing the crisis-ridden OECD would be misleading. Times are tough in most emerging markets too.

- Only China and India, admittedly the two biggest emerging markets, have performed well, and even then far below levels achieved in previous years. But for Western companies still able to invest and expand abroad, the relative strength of Asia in particular remains a compelling prospect. Other emerging regions may have to wait for a more robust upturn in the global economy before pre-crisis returns can be resumed.

- For those firms not concerned only with quick profits, the development of a longer-term emerging markets strategy seems well advised. Executives might enjoy a rosier long-term future if they are prepared to stay the course; and many are—through a combination of new product development, corporate restructuring, cost cutting and by tapping into government stimulus programmes.

- Positioning for the upturn, however, also requires a shift in corporate thinking. When the dust settles on the current economic crisis, emerging markets, especially China and India, will assume a significantly larger place in the strategic view of international companies.

UK Trade & Investment

UK Trade & Investment is the government organisation that helps UK-based companies succeed in the global economy.

We also help overseas companies bring their high quality investment to the UK's dynamic economy – acknowledged as Europe's best place from which to succeed in global business.

UK Trade & Investment offers expertise and contacts through its extensive network of specialists in the UK, and in British embassies and other diplomatic offices around the world. We provide companies with the tools they require to be competitive on the world stage.

For further information please visit www.uktradeinvest.gov.uk or telephone +44 (0)20 7215 8000.

The Economist Intelligence Unit

The Economist Intelligence Unit is the business information arm of The Economist Group, publisher of The Economist. Through our global network of 700 analysts, we continuously assess and forecast political, economic and business conditions in nearly 200 countries. As the world's leading provider of country intelligence, we help executives make better business decisions by providing timely, reliable and impartial analysis on worldwide market trends and business strategies.

Solutions for Business

Funded by UK Government

A range of UK Government support is available from a portfolio of initiatives called Solutions for Business. The “solutions” are available to qualifying businesses, and cover everything from investment and grants through to specialist advice, collaborations and partnerships.

UK Trade & Investment is the government organisation that helps UK-based companies succeed in the global economy, and is responsible for the delivery of the two SfB products “Developing Your International Trade Potential” and “Accessing International Markets”.

We also help overseas companies bring their high-quality investment to the UK’s dynamic economy – acknowledged as Europe’s best place from which to succeed in global business.

UK Trade & Investment offers expertise and contacts through its extensive network of specialists in the UK, and in British embassies and other diplomatic offices around the world. We provide companies with the tools they require to be competitive on the world stage.

For further information please visit www.uktradeinvest.gov.uk
or telephone +44 (0)20 7215 8000.

Whereas every effort has been made to ensure that the information given in this document is accurate, neither UK Trade & Investment nor its parent Departments (the Department for Business, Innovation and Skills (BIS), and the Foreign & Commonwealth Office), accept liability for any errors, omissions or misleading statements, and no warranty is given or responsibility accepted as to the standing of any individual, firm, company or other organisation mentioned.

The paper in this document is made from 50 per cent genuine waste pulp and 50 per cent ECF pulp from sustainable forests. The inks are vegetable oil-based and contain resins from plants/trees and the laminate on the cover is sustainable, compostable and can be recycled.

Published September 2009 by UK Trade & Investment
© Crown Copyright.
URN 09/1245