CHAPTER 1
Introduction

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Money and business have gone global, so it's important for an executive to have an international perspective. A growing part of the world economy is represented by the emerging markets (see Figure 1.1)--a collection of 156 poor countries in various stages of development. Accounting for 84 percent of the world's population and 76 percent of its land mass, they are an important adjunct to the dominant economies of the United States, Japan, and Western Europe, and they attract considerable interest from multinational corporations, investors, and financial institutions. However, Westernized participants must be cognizant of the unique business environment that emerging markets signify. Developing countries are extremely diverse in language, politics, and culture, yet patterns of business behavior and circumstance are recognizable. The purpose of this book is to educate the reader about these commonalities and provide prospective investors with a foundation that supports a practical decision-making process.

UNEVEN PLAYING FIELDS

Emerging markets are difficult places for Westerners to do business. Besides the myriad risks associated with any economic venture, the foreign corporation or financial institution seeking to operate in these markets walks into a tough game. Investments and imports from wealthy countries are subject to special restrictions, taxes, and red tape that preserve local oligopolies and limit foreigners' profits. This makes a "joint" venture with a local partner--who knows the right buttons to push and the right officials to groom--de rigueur. Even then, the outsider must pay close attention to what's going on, lest additional impediments interfere with the profit objective.

My experience collecting on a defaulted loan is illustrative. In 1988, the International Finance Corporation (IFC) invested $13 million in a Mexican pulp mill, of which $10 million was a loan and $3 million was in common stock. The controlling stockholder in the business was Grupo Industrial Durango, S.A. (GID), a regional concern that conducted a sizeable paper and packaging business. By 1991, pulp prices had plummeted, rendering the project uneconomic, and Celulosa y Papel de Durango, S.A. (Celpap) stopped payments on the loan. Pursuant to a support agreement, GID was required to "backstop" the loan, but it backed away from the obligation, citing a technicality in the legal documents.

In the United States, a commercial lender in a similar position would have accelerated the loan, taken control of the project, sold the assets, and sued GID for whatever losses occurred. However, the sponsor's support obligation was under local jurisdiction. Under Mexican law, the process of foreclosure takes 6 to 12 months, and the mechanics of a subsequent liquidation require years. Furthermore, Mexican jurisprudence had few precedents in the interpretation of debt support agreements, and the IFC feared a local judge would simply void the entire arrangement, even though similar supports were widely accepted elsewhere.

As part of the influential World Bank (which includes Mexico as both shareholder and borrower), the IFC should have been immune to legal discrimination in a backwater town like Durango, but my superiors refused to stake the IFC's political capital on a $10 million investment. If an agent of the World Bank can't get a fair hearing in Mexican courts, I wondered, how are multinationals going to fare?

The IFC had been in on-again, off-again negotiations with GID for several years. When IFC's foreclosure threats rang hollow, GID realized it was in the driver's seat, and offered few concessions. IFC decided a new face might move things along, and I was asked because of my ability to negotiate in a variety of situations. This businessman's first impression of the dusty mining town of Durango was full of surprises. The town was located in the Sonoran desert and, as I learned later, the area's dry, stark scenery made it a popular filming location for old cowboy movies. But what a strange place to put a pulp mill! Shouldn't it have situated in a wetter climate, with forests and trees? Later, in a moment of candor, one GID official told me the federal government, through misguided policies and pork-barrel politics, pushed jobs to Durango by building a $200 million paper plant nearby. This white elephant was the pulp mill's only customer.

Situated in an area lacking forests and water supplies (paper factories use a lot of water), the facility operated at a loss for years. Eventually, the Mexican government privatized the plant in one of its suspicious auctions, and GID bought the assets for pennies on the dollar. Substituting waste paper as the principal raw material instead of pulp, GID put the facility into the black, but in doing so, the pulp mill lost its customer.

When I arrived at GID's headquarters, information that we had requested weeks before was unavailable or missing, and GID's executives assigned to the negotiations forgot how to speak English, complicating matters and forcing me to translate for IFC's technical expert. During a tour of the pulp mill, we noticed that key pieces of equipment were missing. Since the equipment weighed several tons, we concluded that GID removed it to raise cash, obviously in violation of the loan agreement.

Negotiations went nowhere, and I returned to Washington, convinced that the IFC had a total loss on its hands. A few weeks later I met a Chase Manhattan banker at a hotel in Monterrey, Mexico. The bank had syndicated two large loans for GID, and he let slip that the company was filing for a $200 million initial public offering (IPO) on the New York Stock Exchange. After some detective work, I discovered that Morgan Stanley & Co., the white-shoe investment banking firm, was leading the IPO. The fact that GID, a marginal operation at best, attracted top-tier financiers, like Chase Manhattan and Morgan Stanley, puzzled me, but when investors are hungry for emerging market paper, I suppose it's the banks' job to feed them.

My calls to the Morgan Stanley executive leading the transaction went unanswered, and the IPO filing moved through the regulatory process of the Securities and Exchange Commission. When I finally connected, this executive gave me the brush off, and shortly thereafter, the company started its "road show." My leverage was strongest when GID had no recourse, so I waited until U.S. institutional investors had reviewed the deal. At the last hour, I notified the company and Morgan Stanley, in writing, that the IPO prospectus didn't include a description of the IFC dispute and the resultant potential for litigation. Knowing that few institutions would put money into a company that had welched on a World Bank obligation, GID sent a $6 million settlement package across my desk two days later.

The IFC made a partial recovery of its joint venture investment, but the average foreign investor faces rough treatment when things go wrong. Emerging markets lack the legal infrastructure for workout situations, and courts lean heavily toward local interests. Financial regulators and local legislatures show little inclination toward leveling the playing field for outsiders.

UNREALISTIC TERMS

This cold reality clashes with the developing nations' stated desire for foreign investments, which

can bring jobs and progress. The countries want outside monies, but only on their own terms, which are usually unrealistic from the Western point of view. For example, after the spectacular economic crashes in Asia, the local business owners were often broke, yet they refused to sell out to cash-rich multinationals. Their asking prices prevented a buyer from ever realizing a decent rate of return. Hundreds of Western executives hit the ground running, looking for deals, but the vast majority came up empty-handed.

Unilever PLC, the giant food company, amassed an $8 billion war chest in 1997 to make acquisitions in emerging markets. In 1999, it returned the money to shareholders, citing a lack of "acquisition targets that would create value at their current prices." Ford, Lucent Technologies, Chase Manhattan, and others spent considerable time looking for Asian acquisitions, only to return empty-handed. Ted Teng, president of Starwood Hotels' Asian group, summed up the problem, "There is a huge value gap between what buyers (foreigners) are willing to pay and sellers (Asian owners) are willing to take."

My experience drumming up new investments for the $1.8 billion AIG-Asian Infrastructure Fund was similar. In Thailand, the few large firms that weren't technically bankrupt presented regulatory problems, since foreigners were prohibited from owning more than a 25 percent interest in any company operating in 30 key industrial sectors. In South Korea, corporate managers clung to the belief that the drop in asset values was temporary--delaying meaningful negotiations--even as their companies fell into insolvency. In China, the government allowed foreign power project sponsors to lose all of their investments when things went wrong, but the upside, when things went right, was capped at 12 percent to 14 percent. Finding worthwhile investments wasn't easy, as the locals were wary of being exploited by outsiders.

Inexperienced Western firms jump at the chance to buy into a promising emerging market and accept one-sided terms from the local establishment. Such transactions represent an expensive education. China, Russia, and Indonesia--to name three countries--are the graveyards for billions of dollars of Western investment. Just recently, Coca Cola, the big soft drink company, took a $400 million write-down of its Russian assets. Starry-eyed executives who think they are going to make easy money should avoid the developing world.

SEVERE MACROECONOMIC FLUCTUATIONS

To say the value of an emerging market investment is subject to macroeconomic fluctuations is an understatement. Following the hype that saw Western money flood into these countries, there occurred massive currency devaluations and financial crises that rotated through Latin America, Asia, and the former Soviet Union. In U. S. dollar terms, the stock markets of numerous countries dropped by 70 percent or more, a decline not seen in the United States since the Great Depression. Real estate and operating asset values experienced similar declines in these countries. In each case, the transformation from a promising market to an economic basket case was amazingly swift. Facing imminent bankruptcy and a shortage of time, the affected governments didn't settle for the gradualist solutions favored by central bankers. Instead, they received massive bailouts, courtesy of the IMF, World Bank, and G-7 community, whose leaders worried that the daisy chain of catastrophes might attach itself to the financial centers of New York, London, and Tokyo.

Blue-chip banks, investment houses, and operating companies were caught in the maelstrom, sacrificing tens of billions of dollars in the process. Losses were concentrated among the private sector, since sovereign obligations were backed by the multilaterals and G-7 nations. Few of the so-called emerging market "experts" employed by Western banks envisioned the train wreck. Indeed, most had been tireless promoters of the various developing countries up to the day before their respective crashes. Several of the markets eventually bounced back and a portion of the losses

were reclaimed. But the damage had been done, and the crises sharply illustrated the risk vis-à-vis safer developed countries, such as the United States and Germany.

These financial upsets were just one part of a long line of dislocations. Such "boom-and-bust" cycles were well-established (see Figure 1.2), and the question remained whether continued integration with Western investors made these poor countries more susceptible to breakdowns, or less. The bailout packages provided damage control and prevented national defaults, thus shielding Western investors from greater loses. But this protection encourages more risk taking in the future. The IMF received pressure from the U.S. Congress to discontinue the free insurance policy. As a meager example of its new resolve, the IMF denied a bailout in late 1999 to Ecuador, a small South American nation, forcing it to default on its debts. By late 2000, however, it was business as usual, as the IMF structured multibillion bailouts for Argentina and Turkey.

From this discussion, it is clear that an emerging market investment contains more pitfalls than a similar commitment to a "developed country." This doesn't mean you should avoid these markets, but it recommends a degree of study, preparation, and caution that is greater than one exercises in a Western setting. Later on in Chapters 4, 7, and 10, we'll discuss methods to manage that risk, as well as the appropriate rates of return for such investments in Chapters 6 through 9.

MULTIPLE OPPORTUNITIES

Despite the dangers that Western companies, banks, and portfolio investors face in the developing nations, there remains a fascination with these exotic locales. The growth potential of the largest of these economies seems endless. In India, a nation of one billion people, only 2 percent of the population has a phone, and only 1 percent own a car. Most Indians are too poor to afford these products, but imagine the increase in demand with a sustained improvement in the economy. Computers sold to an additional 1 percent of the population would provide sales volumes of $20 billion!

On the supply side of the equation, emerging markets are attractive export platforms for multinationals. The wage-and-benefit packages paid to workers are far less than the compensation for similar work in the developed nations, and health, safety, and environmental regulations are either poorly enforced or non-existent. For example, rather than pay an American worker $6.00 per hour to make processed food, Sysco outsources this task to Sigma Alimentos, a Mexican firm that pays its employees $1.00 per hour and then exports the product to the United States. Sure, Mexican productivity is lower and shipping expense is higher with the Mexican tie-in, but the wage differential ensures a benefit to the U.S. company.

My visit to a major textile plant, near Medellin, Columbia, was a stark introduction to the primitive working conditions found in many developing nations. Antiquated equipment in the weaving and dyeing process spread noxious fumes around the plant, and few workers wore protection. Polluted air spread throughout the neighborhood, unfiltered by the plant, and workers casually dropped industrial waste on open grounds outside the site. Chemical-rich effluent then went untreated into the local water table. Trips to factories in Eastern Asia presented decrepit surroundings that were reminiscent of an Industrial Age sweatshop. Local employers are becoming enlightened, but correcting these problems costs money they either don't have or don't care to spend.

In natural resource industries, like oil and gas, timber and mining, emerging markets represent new areas of exploration. With remote locales and rudimentary infrastructures, the developing country's resources are expensive to extract, but the alternative for the multinational is to explore Western sites that have either been picked-over or are subject to stringent environmental laws. That's why less and less oil exploration is being done in the United States. Already, Mexico, Venezuela, and

Nigeria, three emerging markets, supply 19 percent of U.S. oil needs, and the Central Asian states near the Caspian Sea will be major suppliers by 2010.

Like big corporations, portfolio investors have several ways to play the emerging markets. Sophisticated institutions can open local brokerage accounts and buy securities directly from the local exchange. Proxy securities called Global Depository Receipts (GDRs) or American Depository Receipts (ADRs), trade on the NYSE and NASDAQ. Telefonos de Mexico and China Unicom are two of the most active issues on the exchanges. Alternatively, investors can buy the securities of multinationals active in the developing world. Coca-Cola, for example, derives 50 percent of its unit volume from developing economies. For those who want to spread their bets on many firms, a variety of mutual funds are available, including country funds, regional funds, and industry-specific funds.

THE EMERGING MARKET QUANDARY

Faced with a wealth of seeming opportunities, corporations, institutions, and individuals are presented with a quandary. Venture into the emerging markets--with each investment possibility accompanied by a special set of risks--or ignore 84 percent of the world's population. It is not an easy choice.

In the 1990s, corporations and individuals made huge sums in the United States, as the domestic economy took off. A large number of these participants never gave a thought to going overseas, where customs and languages are strange; and, frankly speaking, it's harder to do business. More importantly, people don't like to lose money, and the emerging markets show no guarantee of a good investment return. From 1990 to 2000, for example, the IFC investable index provided a compound annual rate of return (in US$) of 6 percent. The comparable return of the popular S& P 500 index was 19 percent, with less price volatility, no political risk and little currency fluctuation.

On the other hand, risk taking is part of a forward-looking business profile, and staying close to home is not always a good long-term move. A sensible strategy is striking a balance between the rich, developed markets and the poor, developing countries. As you examine their relative economic firepower, you'll see that even the largest emerging markets are destined to be niche plays. For example, the economy of Poland, with 39 million people, is equal to the economy of the state of Maryland, with a population of 5 million, while India (population, 1 billion) has less gross domestic product than California.

Narrowing Your Focus

U.S. companies and investment funds focus their efforts on the 12 largest emerging markets, which collectively represent 73 percent of the segment's GDP:

Argentina	Poland
Brazil	Russia
China	South Africa
India	South Korea
Indonesia	Thailand
Mexico	Turkey

These 12 larger economies are sensible places of entry for the newcomer. Other Western firms have paved the way and a certain infrastructure is established for foreigners to do business. By consulting Western banks, law firms, and companies with operations there, a multinational can

assemble a team to plan an entry and implement it. Including local lawyers and consultants, the team is familiar with the bureaucratic red tape, regulatory obstacles, requisite political and business connections, and legal formalities. In this way, the foreigner doesn't "reinvent the wheel" and thus avoids wasting time and money. Remember, playing by these rules doesn't guarantee a successful market entry or thriving supply platform--even when your product line is superior or your cost structure is lower than the local competition. Frequently, a good business plan needs something "extra."

Beware of Differences

Dispatched by an American consulting firm to open a Buenos Aires office, a Latin friend of mine was frustrated in securing consulting contracts from local utilities, despite his company's superiority over the domestic players. After nine months of coming up empty--with nothing to offer headquarters by way of explanation--he consulted a business official at the U. S. Embassy. "Oh, you want to win contracts!" said the official, "you'll need to see so and so; he's an American and he's been here 20 years." My friend met with the intermediary, and afterwards, his firm started winning contracts. At 10 percent to 15 percent of the contract value, the intermediary's price was steep. A large portion of his fee was paid out in questionable commissions, but my friend was finally able to show revenue for the executives back home.

For the portfolio investor, the larger stock markets have a semblance of order, although they've a long way to go before approaching the New York Stock Exchange. The big stocks trading on these exchanges have an acceptable amount of activity, so investors can move in and out them without upsetting the price, but abuses that have been largely wrung out of the American system--insider trading, phony accounting, and front running--are still prevalent. As you proceed to the smaller stock markets, liquidity, fairness, and transparency diminish further, and speculative elements dominate securities trading.

SUMMARY

Emerging markets represent the bulk of the world's population but only a fraction of its economic output. Many of the markets are attractive export platforms, and a smaller group of large states offer opportunities for in-country sales growth. Moneymaking opportunities in the emerging markets involve special risks that are not prominent in United States or Western European deals.