Frontier Strategy Group

10 Emerging Market Events to Watch in 2014

2014—Tomorrow's Opportunities Won't Be Won With Yesterday's Playbook

Every year multinationals fail to plan for major external events that impact their performance. Why would 2014 be any different?

While executives in emerging markets can't predict the future, they can plan for events that create business risks and opportunities. What if all companies had built contingency plans in the event of a housing bust and financial crisis in 2007? What if strategic planning departments had used frameworks that suggested the emerging-markets financial crisis of 1997 was imminent— in 1996?

2014 could be a year to remember for similar reasons, in that the business environment we have documented in our strategic planning assumptions is not the one we will likely be living in by year's end.

Emerging markets continue to underperform, exposing political volatility in countries such as Brazil and Turkey, and financial vulnerability in countries such as China. Most mature economies are muddling through at best. Too many regional and country leaders at multinational companies are hoping to do the same, enshrining optimistic expectations about their markets' growth and stability into their 2014 plans.

The key events that will impact multinationals in 2014

In this white paper, Frontier Strategy Group analysts have selected the ten most important potential events that could significantly disrupt business performance in the coming year.

These events are not built into the 2014 planning assumptions of the vast majority of our more than 200 clients. If they occur, companies will withstand the impact only if they have made preparations in advance, or are very lucky. The best prepared could achieve a moment of breakout overperformance while competitors flounder.

Our Methodology

Addressing Blind Spots in the Culture of Corporate Planning

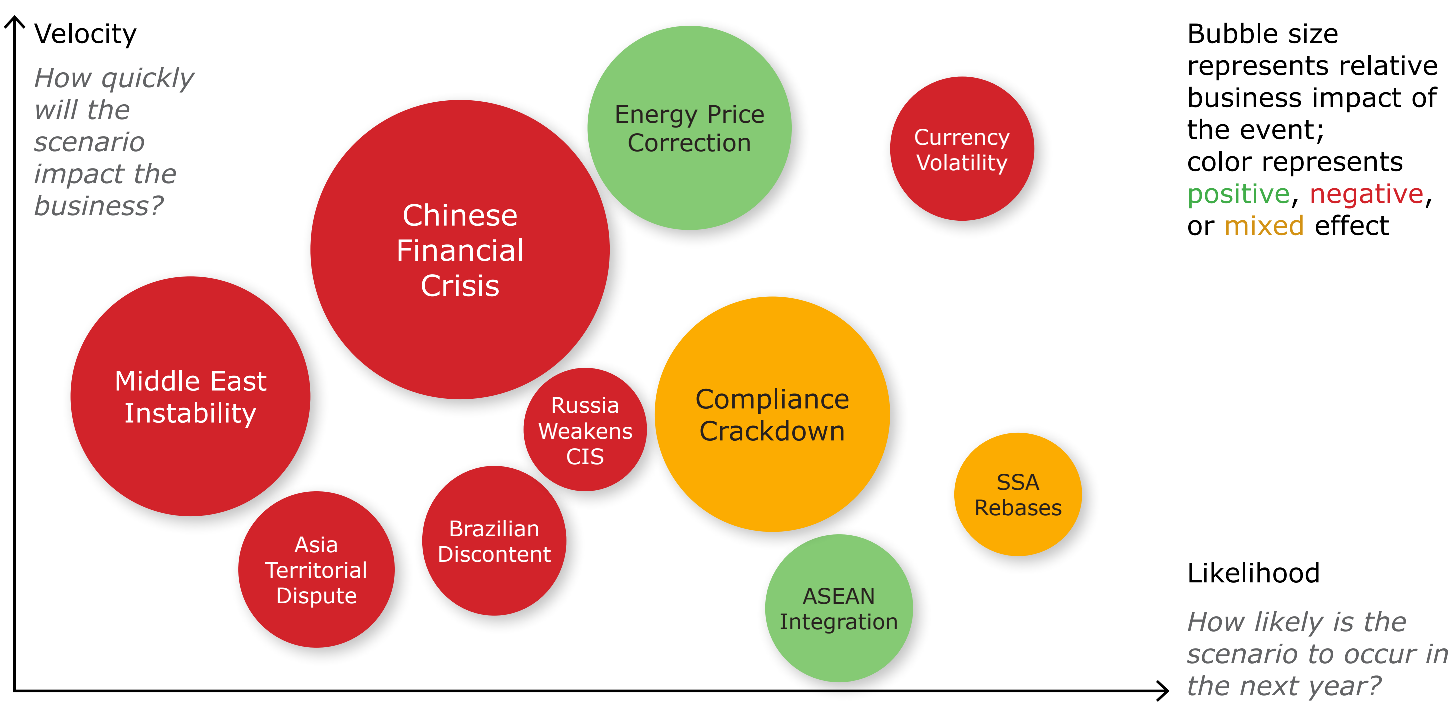
As companies expand their international footprints, their business performance is increasingly influenced by macroeconomic and geopolitical events outside familiar markets. Frontier Strategy Group identifies and tracks the leading indicators of global events that could impact multinationals' performance.

Corporate strategic planners and in-market executives invest significant time in discussing the macro situation during the strategic planning process, but usually focus on developing a baseline assumption as a basis for setting sales targets. Typical corporate culture is much less rigorous about identifying and monitoring potential events that could overturn their best-laid plans.

Focusing on Events That Could Make or Break Business Performance

This report identifies and prioritizes potential events in terms of their likelihood of occurrence, potential business impact, and how quickly the event would impact the business. We selected five global events that, if they occur, would disrupt plans down to the local level anywhere in the world, and five region-specific events that would have disruptive effects primarily in the region. The events are listed in order of likelihood.

Most of the events we highlight are downside risks from the base-case assumptions of our clients, but some could provide upside opportunity for those who are positioned to take advantage. Some are quite probable (e.g., escalating currency volatility) and will have consequences that are relatively easy to predict. Many are unlikely (e.g., comprehensive war in the Middle East), but if they occur, their effects could be disastrous for the unprepared.



Bubble size represents relative business impact of the event; color represents positive, negative, or mixed effect

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Event #1 | Currency Volatility

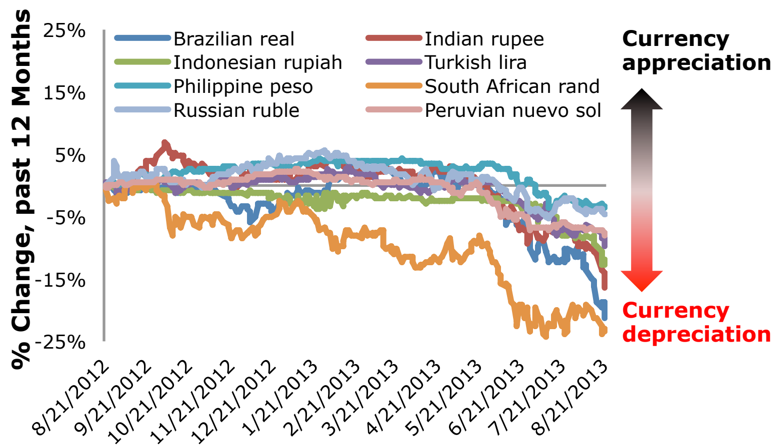
Likelihood High
Velocity High
Impact Medium

In 2012, currency volatility cost US-based, publicly traded companies more than $50 billion, and a similar loss is estimated for 2013. In mid-2013, speculation about a tapering of the US Federal Reserve's quantitative easing program of bond purchases triggered capital flight from emerging markets, causing a wave of devaluations. Continued uncertainty about monetary policy is likely to cause an extended period of higher-than-normal currency volatility.

For multinational companies, frequent bouts of currency volatility would hinder business planning and complicate expectation-setting between local operations and the corporate center. Companies relying on traditional export models endure particularly negative consequences from sudden devaluations. As emerging markets' currencies depreciate, sales figures reported in dollars, euros, or pounds erode. Take South Africa, for example, where the rand depreciated more than 20% against the US dollar in 2013. Even if a US-based company grew rand-denominated sales by 10%, headquarters would perceive a 10% decrease—and likely an underperforming country manager.

Currency Volatility Will Persist Through 2014

Emerging-Market Currency Devaluations vs. USD, Aug '12 – Aug '13



That said, well-prepared executives could find a silver lining. Multinationals that have effectively localized assets, and therefore aligned cash flows into one currency, have been clear winners. Even with emerging markets cooling, these companies are able to grow by capturing share from competitors whose imported products appear much more expensive when a local currency devalues.

Many of FSG's clients are actively exploring further localization in emerging markets. Besides capturing share and being closer to customers, localizing in an environment with a depressed currency can dramatically reduce costs.

Currency volatility cost US-based, publicly traded companies more than $50 billion in 2012

Event #2 | Compliance Crackdown

Likelihood High
Velocity Medium
Impact High

As economic growth slows, emerging-market governments are more likely to crack down on corruption and increase enforcement of regulatory compliance. Governments will act as a populist response to deflect domestic criticism about the economy, to protect local champions, or simply because local standards have improved and companies have not kept up.

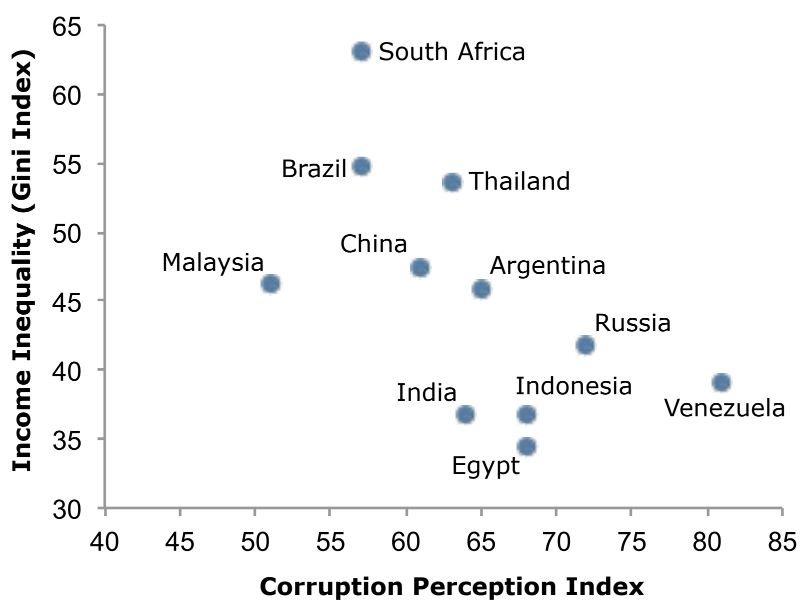
Western companies are easy targets for emerging-market governments. Of the 500,000 corruption investigations in China between 2000 and 2009, 64 percent involved foreign companies. Recent high-profile investigations of Western multinational like GlaxoSmithKline (which saw drug sales plummet 61 percent in the third quarter) indicate they remain prime targets.

Large fines stemming from violations hurt earnings as well as brand value. Investigation costs alone cost millions of dollars, even for smaller matters. Multinationals are also subject to double jeopardy, as local violations will prompt companies' home regulators to follow up on claims about violations.

High-profile investigations will increase risk perception at headquarters. As a result, even companies with best-in-class compliance practices may find it more difficult to make the case for resources to invest in emerging markets.

In this environment, it is more important than ever to build robust compliance plans and corruption prevention practices into any plans for emerging-market investment. The era of assuming that business practices are inherently "looser" in emerging markets and that one can operate in ethical "gray areas" without consequence is coming to an end.

Markets Prone to Corruption Crackdown



64 percent of corruption investigations in China involved foreign companies in 2000-09

Event #3 | Energy Price Correction

Likelihood Medium
Velocity High
Impact Medium

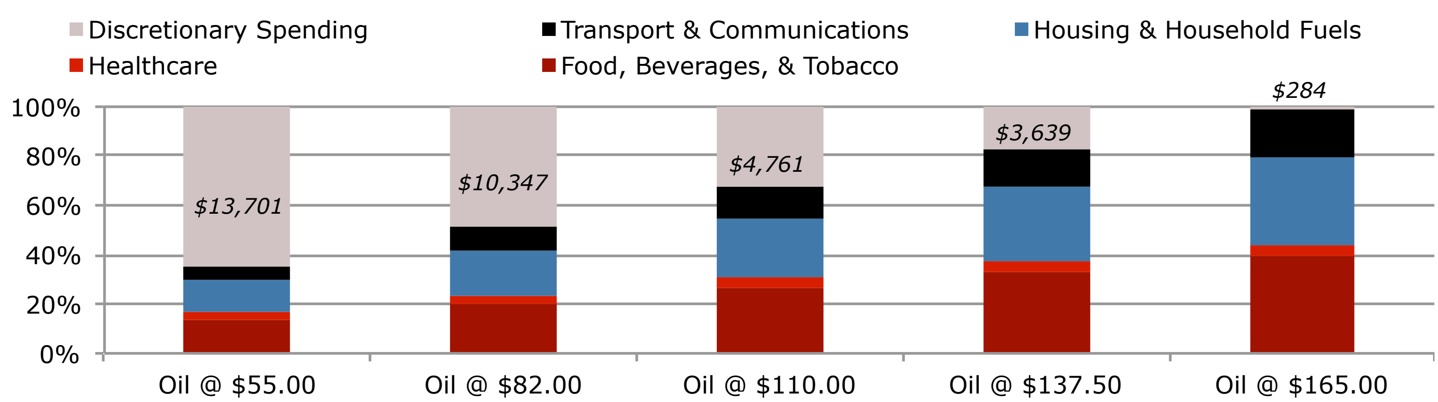
Energy trades at a premium because of political risk in the Middle East, but underlying fundamentals suggest much lower pricing. Energy prices are supply driven, so even small increases in global supply can help push down prices. In the past, 5% moves in OPEC production have driven oil prices up or down by 50%. If political risk dissipates as Iran and the West work toward détente, and fracking technology adoption accelerates, energy prices will drop sharply—much more than most corporate planners assume.

Cheaper energy has the potential to unlock consumer spending for hundreds of millions of households across emerging markets. Energy composes a huge portion of wallet share for emerging-market households, and lower costs represent a generational opportunity for households to enter the consumer class. In some economies, a 20% decrease in energy prices could translate to a 100% increase in discretionary income, leading to huge benefits for consumers and the companies selling to them.

Cheap energy would also mean trouble for some of the world's oil producing countries that have failed to invest in other revenue generating activities—countries such as Russia, Venezuela, and potentially Saudi Arabia.

To prepare for a new energy environment, companies should reprioritize their international market portfolio and review customer segmentation to include a larger consumer class. Companies should also reassess supply chains and organizational footprints, as geographic distance would incur lower costs than it does today.

Oil Prices Disproportionately Affect Emerging-Market Consumers



A 20% reduction in oil prices can increase an emerging-market household's discretionary income by more than 100%

Event #4 | Chinese Financial Crisis

Likelihood Medium
Velocity High
Impact High

China's banks look very similar to US banks before the 2007 bust. They are thinly capitalized and make risky loans in an environment of slowing growth. If markets lose faith in the Chinese banking system, it could lead to a cascading liquidity crunch and rapidly deteriorating growth across the globe. Additionally, the Chinese government is limited in its policy response, because bailing out the banking system could alienate the middle class.

China's broad capital ratios are low at only 6.4%, and non-performing loans are beginning to creep up as the economy cools and speculative real estate projects go bust. As a result, banks are not always comfortable lending to each other, reflected by interbank rates that soared to more than 18% intraday over the summer of 2013.

Managers in the region often believe that "China is different," or that the government's track record of competence guarantees that any economic transformation will be managed with a steady hand. 30 years of Chinese history promotes confidence, but a broader view of economic history would argue that it is prudent to prepare for a worst-case scenario.

The US government entered the financial crisis with the world's reserve currency and an unlimited balance sheet, and the best outcome it could manage was the worst recession since the Great Depression. The Chinese government lacks these advantages and would have to juggle its response to an economic crisis with a much more ambitious domestic policy agenda. As a result, the government's approach—and effectiveness—to dealing with a crisis is extremely difficult to predict.

Companies should resist complacency and develop contingency plans to think through the effects of a banking crisis on system liquidity and business operations—everything from cash flows with local partners to simply ensuring that products reach market. Companies that are prepared to mitigate these potential disruptions will ultimately capture market share as competitors struggle to get goods to market or react to a Chinese crisis by pulling back investment.

Contingency plans should also be formulated at the global level, as the impact of a financial crisis in China would reverberate worldwide. Ripple effects would stunt growth in China's key trading partners, particularly commodities producers in Latin America and Africa.

The shadow banking system has grown to an estimated 60% of China's GDP in 2013

Event #5 | Middle East Instability

Likelihood Low
Velocity Medium
Impact High

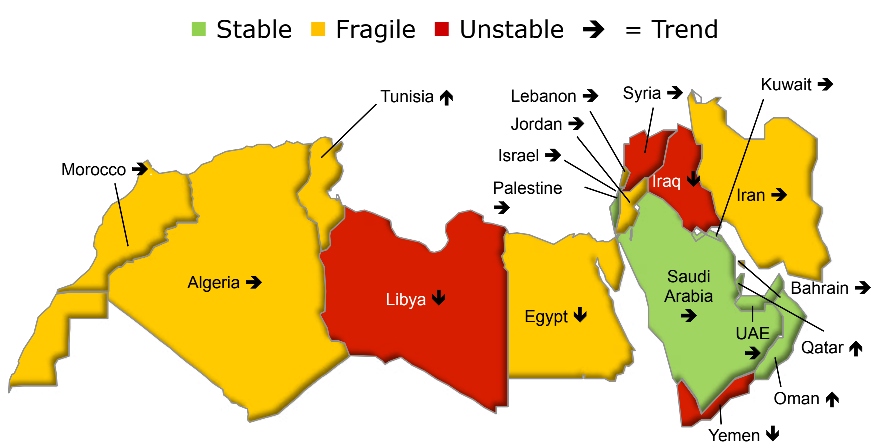
Horrific violence and political upheaval in the Middle East dominate headlines worldwide. Local executives, however, know that civil conflict in Syria or international tensions with Iran have little impact on business results—only 14% of the region's economic output originates in markets that FSG considers unstable.

Regional managers are more focused on selling into prosperous Gulf states than obsessing about doomsday scenarios. Thus, the baseline scenario for most companies' operations in the Middle East and North Africa (MENA) is steady income but relatively limited growth potential.

Broader regional instability would have greater impact on global planning assumptions. Sectarian violence in Iraq or Syria, labor unrest in the Gulf, a botched royal succession, and pre-emptive action by Israel against Iran are all real possibilities at any moment, each of which could spark a broader sectarian conflict that could draw Saudi Arabia or Iran into open confrontation. Direct conflict would cause energy prices to spike and disruption in major shipping lanes.

Instability impacts only 14% of MENA's GDP

2014 Political Forecast



To be clear, FSG considers a downside scenario in the Middle East to be less likely than our positive Energy-Price Correction scenario. But it would be a larger and less predictable disruption to plans, and therefore should be considered in any global scenario planning effort. At a minimum, companies should develop contingency plans for bursts of supply chain disruption and energy price increases.

Only 14% of MENA's GDP comes from markets that FSG defines as currently unstable

Event #6 | AFRICA
GDP Rebasing Intensifies Competition in Africa

Likelihood High
Velocity Medium
Impact Low

When Nigeria rebases its GDP, sometime around the new year, its economy will grow 40–60% on paper, becoming the largest economy in Sub-Saharan Africa, larger than South Africa. Rebasing GDP brings forward the base year from which growth is measured and expands the scope of economic activity that is captured in statistics. Massive industries, such as mobile telecommunications and Nollywood, Nigeria's famous film industry, will be counted in government data for the first time.

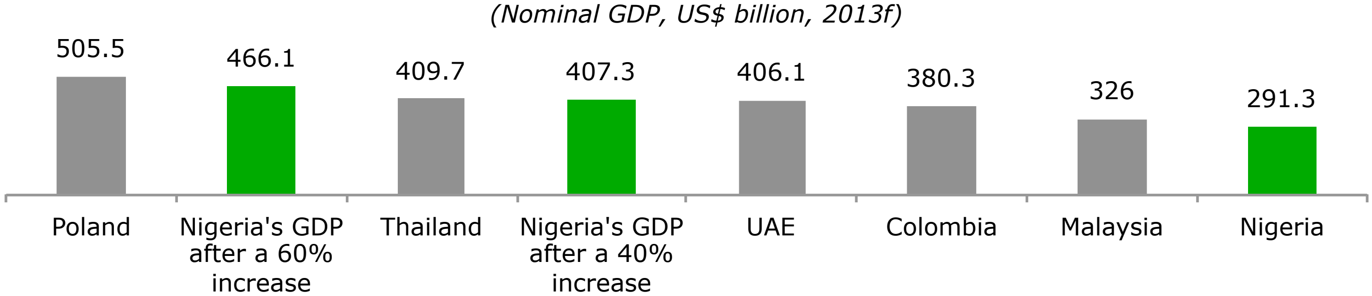
As a result, Nigeria will become too big to ignore, even for companies that have long thought of Africa as too poor or unstable for large-scale investment. Following Nigeria, as many as 25 African countries will undergo the same process in the next three years, attracting attention from corporate headquarters and increased foreign investment across the continent.

Multinationals without a meaningful presence in the region should consider accelerating entry and expansion plans to get ahead of new competitors. Few companies already operating in Africa will see an immediate change on the ground, as the one-time uptick in growth reflects statistics catching up to reality. But inbound capital will change the competitive environment over time and may well accelerate overall growth.

Companies that do business with African governments will see near-term improvement in their market opportunity. Larger GDP numbers will drive down debt-to-GDP ratios. Governments plan to use lower debt ratios to make the case for more favorable credit ratings and ultimately lower borrowing costs. Governments will then leverage lower borrowing costs into increased debt issuance to fund local projects.

Sub-Saharan Africa Will Instantly Appear Wealthier and More Mature

(Nominal GDP, US$ billion, 2013f)



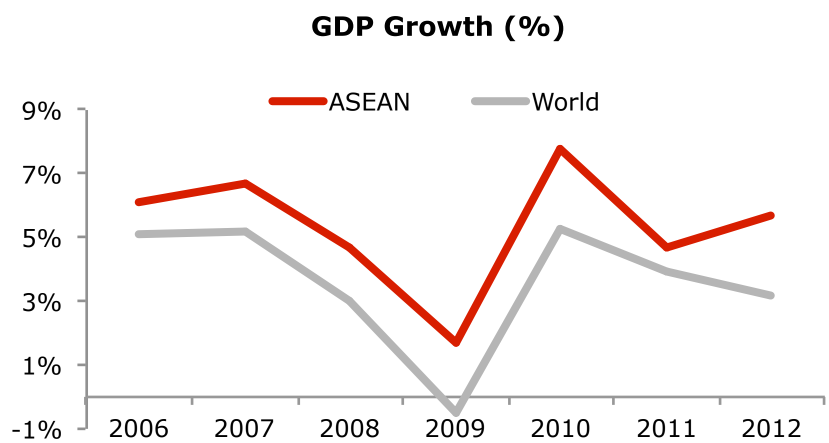
Overnight, Nigeria will officially become the largest economy in Sub-Saharan Africa

Event #7 | SOUTHEAST ASIA
ASEAN Integration Accelerates

Likelihood High
Velocity Low
Impact Medium

Southeast Asia has long been seen as a collection of second-tier countries in an Asia-Pacific portfolio dominated by China, India, and Japan. A push for integration among the members of the Association of Southeast Asian Nations (ASEAN) is changing that calculus. The ASEAN Economic Community (AEC) will knit together 10 growing countries into a single market in terms of free-flowing goods, services, labor, and capital. If progress meets or beats the announced timelines, MNCs will be able to pursue numerous unsaturated growth opportunities with much more scalable cost structures.

Pending agreements could add US$ 1.9 trillion to the global economy by 2025, providing multinationals with numerous opportunities to grow. Additionally, the AEC will not just lower trade barriers and tariffs. It will also bring infrastructure improvements, strengthen intellectual property regimes, harmonize investment laws, and allow for the easier movement of capital and skilled labor.



Multinational companies are increasingly diversifying in Asia to allocate more resources toward ASEAN. The region's growth can offset some of India's missed expectations and China's market saturation. Given this, a reassessment of the investment balance across the Asia portfolio is a necessity.

The ASEAN Economic Community is expected to add US$ 1.9 trillion to the global economy by 2025

Event #8 | EURASIA
Russian Stagnation Weakens CIS Performance

Likelihood Medium
Velocity Medium
Impact Low

Multinationals see significant growth opportunity in the Central Asian and Eastern European countries composing the Commonwealth of Independent States (CIS). Their dominant strategy is to use more established operations in Russia as a hub for CIS expansion. However, there is a significant chance in 2014 that Russia will have a deleterious effect on regional strategy, rather than a beneficial one.

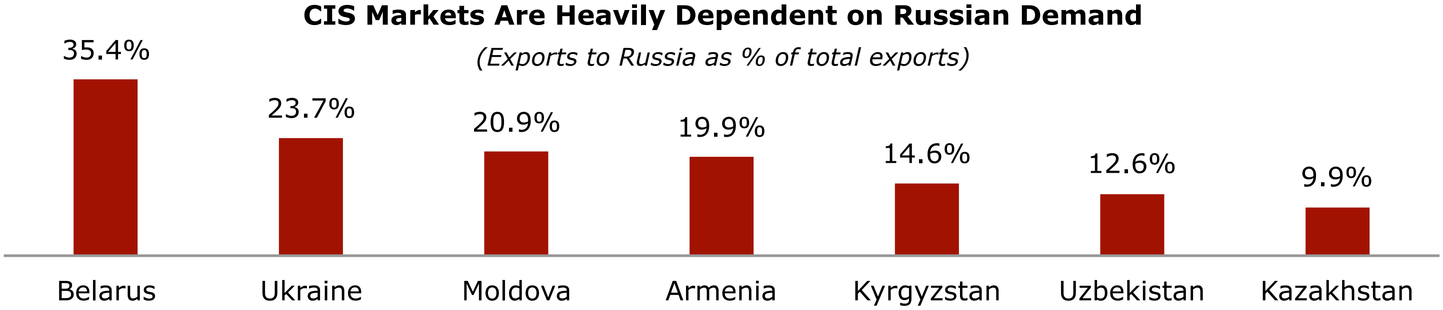
Russia's economy is large enough to qualify as a must-have market, but its lack of dynamism (less than 3% GDP growth in 2013) disappoints expectations. Continued stagnation is a baseline expectation for 2014, but the Russian government's dependence on energy revenue creates a massive downside risk. Our Energy Price Correction scenario would be good news for multinationals globally, but a disaster for Russia—oil prices at US$ 80/bbl would plunge Russia into recession.

Given the deep connections between Russia and CIS economies, a downside scenario for Russia would stifle the more promising growth stories of major markets such as Kazakhstan and Ukraine. Russia is the principal export market for many CIS states, and remittances from CIS nationals in Russia drive consumer spending in their home countries. The financial systems are intertwined as well, with extensive cross-ownership among banks in the region, and Russia supports cash-strapped CIS governments with attractive loan packages.

Business plans for Russia, Eastern Europe, and Central Asia should take into account the potential for a Russian recession to depress exports and industrial output throughout the CIS. Without the ability to diversity risk within the region, companies need to hedge the downside risk of a Russian slowdown with upside potential elsewhere in their global portfolio.

CIS Markets Are Heavily Dependent on Russian Demand

(Exports to Russia as % of total exports)



Remittances from Russia to CIS countries totaled US$ 18 billion in 2012

Event #9 | LATIN AMERICA
Brazilian Discontent Rises Again

Likelihood Medium
Velocity Low
Impact Low

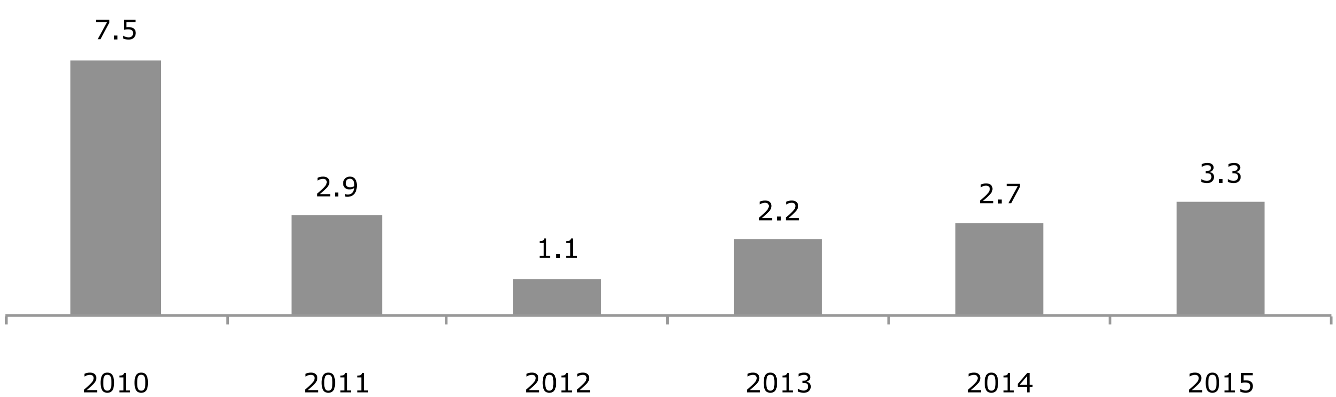
While the Brazilian government spends billions on the 2014 World Cup and 2015 Olympics in a bid to burnish its international image, the country's nascent middle class continues to be frustrated by the stalled progress of improvement in public services. Upcoming presidential elections could trigger a resurgence of the protests last seen in June 2013. Those protests costs local retailers alone more than US$ 660 million, and could reach higher numbers in 2014, as the election will be the most potent opportunity to date for the middle class to express frustration about the direction of public policy.

If protests re-emerge, companies will struggle with reduced productivity and supply chain disruptions. Extended middle-class protests would create a difficult environment for policymakers to purse structural reforms to the infamous "Custo Brasil," the array of labor costs and regulatory burdens that elevate the cost of doing business in Latin America's largest market.

Now is the time to reframe the case for investment in Brazil from a "capture growth in the BRICS" story to a long-term play with near-term challenges. Companies need to make commitments that they are comfortable holding for years before realizing major bottom-line returns, and accept the possibility of a frustrating business environment into the foreseeable future. With eyes wide open, executives can craft a Brazil strategy that will withstand any bursts of political instability.

Brazil's Economy Will Grow Below Its Potential During The Forecast Period

(GDP (US$bn, %YOY)



Protests in June 2013 cost local retailers more than US $660 million

Event #10 | EAST ASIA
Asian Territorial Disputes Escalate

Likelihood Low
Velocity Low
Impact Medium

Geopolitical tension is on the rise in Asia Pacific, threatening regional stability and economic growth. 2013 has seen flashpoints across the region as leaders in China, Japan, and North Korea stoke nationalist fires to shore up domestic support. China has been most active in exercising long-unresolved territorial claims, causing friction with neighboring countries. Nationalist rhetoric in Japan has damaged the brand of Japanese companies, especially in China, diminishing trade between Japan and Asia by 3.9% in 2012 alone, the first decrease in three years. North Korea continues to be a source of uncertainty as it seeks international attention and members of the inner governing circle jockey for influence.

The intensification of any one of these geopolitical disputes would dampen trade, causing countries and companies to miss growth targets. Critical global supply chains would be disrupted as well, raising the cost of manufacturing and shipping in the region. Widespread conflict remains unlikely in 2014, but companies should ensure that their plans are resilient against the potential impact of targeted policies such as trade embargoes or increased tariffs.

Trade between Japan and Asia fell 3.9% in 2012, marking the first drop in three years.

Interested in Learning More?

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ABOUT FRONTIER STRATEGY GROUP

Frontier Strategy Group (FSG) is the leading decision support partner to senior executives in emerging markets. We understand that senior executives in charge of emerging-market businesses cannot afford to make mistakes. FSG empowers our clients to make the right business decisions and outperform in markets filled with uncertainty.

Three Keys to Outperformance:

1. **Unique Perspective** – We partner with 2,500+ senior executives on an ongoing basis and have a deep understanding of their distinct priorities, management cadence, and workflow
2. **Unrivaled Expertise** – We exclusively focus on emerging markets and have specialized, regional expertise, analysts on the ground, and access to a network of industry and government experts
3. **Disruptive Model** – We excel where traditional information service providers fall short in emerging markets by employing a subscription model with tailored support for your evolving priorities