

Lauder Global Business Insight Report 2009:

# FIRST-HAND PERSPECTIVES ON THE GLOBAL ECONOMY



# INTRODUCTION

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## First-hand Perspectives on the Global Economy

In this special section, students from the Joseph H. Lauder Institute of Management & International Studies report on companies and industries that they analyzed during a summer immersion program in 12 countries around the world.

Their articles offer a window into the changing global economy, including the rise of Chinese and Egyptian companies in the telecommunications sector, the promise of Brazilian technology in the field of organic plastics, the challenges of the hostile takeover market in Russia, the continuing reluctance of the Japanese government to welcome foreign investment, and the dilemmas facing the Mexican oil industry. Other articles look at corporate social responsibility and renewable energy sources in China, new trends in the French luxury goods sector, and entrepreneurship in Brazil, Mexico and Germany.

Taken together, the 13 articles offer perspectives on a range of dynamic economies and identify existing opportunities for conducting business within specific cultural, political and institutional contexts. The articles are part of the Lauder Global Business Insight program.

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## Huawei Technologies: A Chinese Trail Blazer in Africa

Walk into a bookstore in Beijing and you will find shelves filled with books about Huawei Technologies. As one of China's fledgling multinational companies and a major force in the international telecommunications equipment industry, Huawei is rewriting the rules of competition in a global industry. Moreover, it is the first non-state-owned Chinese company to successfully expand its operations internationally, some observers say, and it has become a model for other Chinese companies and a source of national pride.

Despite the challenges facing the global economy and the telecommunications industry, Huawei achieved contract sales of \$16 billion, representing a 45% year-over-year increase, with approximately 72% of its revenues coming from international markets. In less than a decade, Huawei has penetrated almost every market around the world, investing heavily in its business and technology product lines, which includes fixed networks, mobile networks, data communications, optical networks, software and services, and terminals.

“Huawei is currently the number three global company in wireless networks and number two in fixed line and switches.”

—Ren Zhenfei, Founder and CEO, Huawei

According to an industry insider, Huawei segments the telecom equipment industry into three major categories: Internet switches, fixed line networks

and wireless networks. “Huawei is currently the number three global company in wireless networks and number two in fixed line and switches,” says founder and CEO Ren Zhenfei. “But Huawei’s goal is to become number one in all three segments.” Its competitors include both well-known European and American companies, such as Alcatel-Lucent, Cisco Systems, Nokia Siemens Networks and Ericsson Telephone Co., as well as lower-cost Chinese competitors such as ZTE Corp.

Huawei currently serves 270 operators in about 100 countries, including 35 of the world’s top 50 telecommunications companies. As of March 2007, Huawei had more than 83,000 employees worldwide, of whom 43% are engaged in R&D. The company reports that it dedicates at least 10% of its revenues to R&D and is now the fourth largest patent applicant worldwide, with more than 20,000 applications filed by 2007. Last year, Huawei won 45% of all new Universal Mobile Telecommunications System and High Speed Packet Access contracts, making it the top supplier in this area. Huawei is also now one of the top three suppliers in the global GSM market; by the end of 2007, it had shipped base stations with total capacity of 700,000 carrier frequencies, serving more than 300 million GSM users worldwide. (GSM is currently the most popular second-generation standard for mobile phones.)

It is hard to understand Huawei’s success without considering its humble origins and distinctive corporate culture. In 1988, Ren, a former People’s Liberation Army (PLA) officer, founded the company as a third-party reseller of telecom devices in Shenzhen, China. Five years later, Huawei achieved its first breakthrough when it launched its C&C08 digital telephone switch, which had the largest switching capacity in China at the time. By initially

deploying in small cities and rural areas, the company gradually gained market share and made its way into the mainstream market. From 1996 to 1998, Huawei experienced exponential growth, coinciding with the boom in China's telecommunications industry. After winning its first overseas contract in 1996 with Hong Kong's Hutchison-Whampoa, Huawei expanded to Russia and Africa. In Africa, Huawei began operations in 1998, starting in Kenya, and has now become the largest CDMA product provider in the region. During the same year, Huawei hired IBM consultants to gain expertise in management strategies in a concerted effort to learn industry best practices.

## First, the Countryside

As a follower of Mao's thought, Ren has drawn much inspiration from the PLA's military strategy – reflected in Huawei's business strategy, organization and corporate culture. For example, Huawei has relied on a well-known Maoist strategy of first focusing on seizing the countryside, then encircling and conquering cities. Huawei followed this strategy, achieving its first breakthrough in 1993 when it aggressively marketed its digital telephone switches in smaller towns before expanding all over China. Later, Huawei utilized this same strategy by first targeting the underserved markets of Russia and Africa before moving into Europe.

Military culture is also epitomized in Huawei's rigidly hierarchical organization, where emphasis is placed on hierarchical management rather than on individual employees, who are viewed as easily replaceable foot soldiers. Like that of many other East Asian firms, Huawei's corporate culture relies heavily on rhetoric and propaganda. The introductory article of Huawei's basic law reads: "Love for our homeland, fellow citizens, work and life is the source of our cohesion; responsibility, creativity, respect and solidarity represent our company's quintessential culture."

Other aspects of Huawei's culture are characteristically Chinese. Resilience and hard work, qualities valued in traditional Chinese culture, are emphasized at Huawei as a way to gain competitive advantage. Another classic East Asian trait, putting the group before the individual, can also be seen. Huawei expects its employees to place their personal lives second in order to serve their company loyally. Its approach to business, referred to as "the way of the wolf," is characterized by reliance on instinct, extreme resilience and employees' willingness to cooperate and sacrifice

themselves for the sake of the pack.

Huawei's strong identity, however, has not prevented the company from adopting Western tactics. In the mid 1990s, most Huawei managers were sanguine about the prospects of the firm. However, Ren was aware that Huawei had severe growth limitations, mainly due to the lack of organizational expertise and the absence of a viable long-term strategy. He set out to change the company into a solutions provider. By 2000, when the communications industry slowdown was noticeable, Huawei was already in the midst of a restructuring process that gave the firm its competitive edge against local rivals.

According to an industry insider, "Ren recognized that the best way to overcome Huawei's limitations was to learn from leading Western companies." Thus, from 1998 to 2003, the company hired IBM for management consulting services, modeling itself after the American company. Under IBM's guidance, Huawei significantly transformed its management and product development structure. Ren prioritized R&D and supply chain management by adopting IBM's Integrated Product Development (IPD) and Integrated Supply Chain (ISC). After discovering Huawei's return on investment in R&D was one-sixth that of IBM, Ren stipulated mastery of IBM's IPD methodology. Furthermore, Huawei adopted ISC since supply-chain performance was far below potential. According to *The World of Huawei*, Huawei's on-time delivery rate in 1999 was only 50%, compared with 94% for competitors; annual inventory turnover was 3.6%, compared with 9.4% for competitors. Adopting ISC entailed winning over suppliers and partners, many of whom had little appetite for Western management practices.

While working with Huawei, IBM was completing its own strategic change from a hardware vendor to an IT solutions provider. Ren drew from IBM's experience, also realizing that the future of Huawei was not in manufacturing what others invented, but in creating excellence in both research and service. This strategy, which may be conventional for leading Western firms, is unusual in China. Although Huawei management possessed vision before hiring IBM, it was through the experience, insight and methodologies gained from working with IBM that Huawei managed to adopt new management practices and become a global player.

Nowhere is Huawei's presence and strategy more evident than in Africa, a continent it entered for the first time in 1998, where it successfully dispelled the

“made in China” image of low cost and low quality. Beginning in the 1990s, Huawei shifted its role from a manufacturer to that of a complete solutions provider. Today, Huawei creates some of the most sophisticated telecommunications equipment in the world and, according to the company, is “not making it cheaper — it’s making it better.” Armed with its combination of a corporate culture marked by Communist roots and leading Western business practices, Huawei has executed a strategy composed of superior pricing, customer service and brand awareness to penetrate and dominate the African market, one in which few multinationals have been successful. Huawei has established a reputation as the preferred low-cost, yet high-quality mobile network builder. Its sales in Africa had topped \$2 billion across 40 countries by 2006.

According to the former head of Huawei’s operations in West Africa, Wilson Yang, Huawei’s profit margins in Africa can be up to 10 times greater than those it realizes in China. Huawei manages to achieve tremendous margins while still pricing itself only 5%-15% lower than its major international competitors, Ericsson and Nokia. Furthermore, Huawei is cautious not to price itself too low so that it will not be seen as yet another low-cost Chinese provider. In contrast, Huawei’s main Chinese competitor in Africa, ZTE, consistently prices 30%-40% below European competitors and, consequently, its products are perceived as being of inferior quality.

Huawei’s pricing methodology can also be traced back to its experience with IBM, a company that helped Huawei learn the importance of turning R&D into cash and of approaching product development from both technical and business angles to ensure investment returns. This represented the transition for Huawei from a low-cost volume competitor to a value-added leading enterprise.

### **Learning from the Master**

Another factor behind its African success is its attention to superior customer service. In 2000-2001, Huawei faced a confluence of challenges: IT investment dried up, profit margins shrank and the market faced oversupply, leading profit growth to evaporate. IBM consultants stressed increasing profits through better supply-chain management, stronger R&D and more integrated corporate structure. However, Huawei was also learning a key strength of IBM: unparalleled service. Ren appreciated the value of this concept under looming adversity. Unmatched attention and commitment

to service eventually came to dominate the firm’s global strategy.

Indeed, superior service was a distinguishing feature of Huawei’s business model in Africa and its core competitive advantage. Yang explains how this aspect of Huawei’s business model ultimately led to global growth: “Three years into its Africa experiment, Huawei still had only 20 employees on the ground and very few contracts. However, our existing clients noticed the unparalleled responsiveness of management and personnel. We brought a Chinese attitude to both work ethic and relationship building in Africa. The result was that clients soon realized they could rely on Huawei 24 hours a day, seven days a week. We emphasized close relationships to foster that reliability and soon began to realize collateral benefits. All of a sudden, our reputation for superior service and higher quality gained us introductions to decision makers in new markets, faster network building and advanced notification of competitive bids. This enhanced Huawei’s ability to price safely below the competition.”

Huawei is also using its business in Africa as a training ground for establishing itself as a global brand through three distinct channels: policy, local investment and marketing. Huawei leverages its resources and products to connect with developmental policy throughout Africa. In May 2007, at a forum held in conjunction with the 2007 annual meeting of the African Development Bank Group (ADB), Huawei set out a vision for Africa that is centered on “bridging the digital divide and enriching the lives of Africans.” Huawei prides itself on giving back to the African community; one of the ways it does this is through donating educational communications equipment to schools.

Huawei has begun to establish regional training centers in African countries such as Nigeria, Kenya, Egypt, Tunisia, Angola and Guinea. By August 2004, Huawei had invested more than \$10 million dollars into its Nigerian training center. Recently, Huawei opened a new training facility in South Africa, its fifth training center on the continent. There is a sixth center currently being built in Angola. The company now provides training for up to 2,000 people annually. Such local investments by Huawei help bolster the local economy with job creation and localized management while improving the company’s image in the eyes of local consumers, businesses and potential partners.

Huawei is asserting its brand potential in Africa by means of smart marketing strategies and “going

green,” including optional use of solar and wind energy. It actively promotes its GSM base stations as among the most eco-friendly in the business, claiming that it cuts energy usage by 47% compared to regular towers. By the end of 2007, Huawei reported that it had deployed more than 100,000 green base stations, which saved 570 million kilowatt-hours, or 170,000 tons of coal.

Huawei Technologies has built a world-class enterprise, reaped tremendous profits in Africa over the last 10 years and is contributing to growth in Africa. In China, domestic media have heralded Huawei’s success as a model for other Chinese companies trying to transform themselves from domestic entities into global players. Huawei has already profitably penetrated the European market, winning major contracts and servicing prominent clients such as Vodafone and Telefónica. As Huawei leads the way for home-grown Chinese corporations, the challenges its leaders face going forward include maintaining its growth and transferring the lessons learned in Africa to Europe and North and South America, all of which represent both enormous profit potential and new strategic challenges.

*This article was written by Christine Chang, Amy Cheng, Susan Kim, Johanna Kuhn-Osius, Jesús Reyes and Daniel Turgel, members of the Lauder Class of 2010.*





## How the Environment for Foreign Direct Investment in Japan Is Changing – for the Better

Described as “the most closed investment market in the developed world” by European Union trade commissioner Peter Mandelson, and ranked last by the Organization for Economic Co-operation and Development (OECD) as a target for foreign direct investment among major economies, Japan has developed a reputation for being resistant to foreign investment and extremely hostile to the practices of foreign financial investors.

Despite the support shown by elected officials for increasing FDI in Japan, foreign investors still face a substantial amount of bureaucratic red tape.

But contrary to Japan’s reputed aversion to foreign capital and Western investment practices, Japan’s volume of M&A transactions increased at a compound annual growth rate of 13.9% between 1996 and 2006, foreign ownership in companies listed on the Tokyo Stock Exchange rose to 28.0% of market value and, after years of lackluster economic performance, polls of the Japanese population now indicate a belief that foreign investment can help the moribund Japanese economy. This article will examine the general environment for foreign investment into Japan, recent high profile investments that have encountered resistance, and specific strategies Western investors have employed to successfully avoid or ameliorate resistance to foreign investment.

Investment rates into Japan trail those of other major economies. Despite its rank as the world’s second largest economy, Japan’s inward FDI rate is surpassed several times over by those of individual European countries. However, keeping with successive government administrations’ goals of doubling the level of foreign direct investment in Japan at five-year intervals or faster, Japan has been narrowing “the FDI gap.”

Gross capital inflows to Japan increased to their highest level in 2006, and foreign capital invested in Japan reached \$107.6 billion that same year. M&A volume and value have also shown a long-term upward trend, and domestic and foreign private equity firm buyout activity has increased disproportionately quickly compared to overall M&A, demonstrating an increased openness to Western forms of financing. M&A activity is expected to increase further still with new legislation allowing triangular mergers with foreign entities, which has been characterized by the Japan External Trade Organization as “a systemic change that will very likely promote M&As of Japanese companies by overseas companies.”

Continuing reforms to bring down the firewalls between retail and investment banking, and relaxing regulations for acquisitions within the pharmaceutical industry, among others, make a compelling case that the government is genuinely trying to facilitate both domestic and foreign M&A activity.

Despite the support shown by elected officials for increasing FDI in Japan, foreign investors still face a substantial amount of bureaucratic red tape, particularly with respect to protected industries. FDI is principally governed by the Foreign Exchange



and Foreign Trade Control Law, which specifically prevents foreign investors from acquiring a majority stake in Japanese companies within industry sectors classified as closely related to national security and public safety. This includes industries as diverse as aeronautics, defense, nuclear power generation, energy, telecom, broadcasting, railways, tourist transportation, petroleum and leather processing.

Foreign investors intending to make direct investments in certain industries must file with the Japanese Ministry of Finance as well as the respective ministry governing the specific industry of the investment target. If issues are found in relation to the investment, either the Ministry of Finance or the industry-specific ministry has the authority to issue an official recommendation to revise the investment plan or to put a complete stop to the acquisition. Industry-specific regulations that, for example, limit foreign ownership to one-third for airline and telecom companies, further constrain foreign investors.

## Blocked Investments

Steel Partners and TCI provide two examples of take-over bids for Japanese companies meeting with intense resistance on multiple fronts. Steel Partners is a U.S.-based buyout/activist fund and the largest shareholder of several sizeable Japanese corporations. Steel Partners has imported its U.S. activist investment model to Japan and has shown a willingness to question publicly the strategy of current management at its investment targets and to litigate disagreements.

As a result of Steel Partners' posture, the firm's take-over bid for household-brand Bulldog Sauce met with resistance from the media and Japan's legal system. The court to which Steel Partners appealed a failed injunction to prevent Bulldog's poison-pill strategy stated: "[Steel Partners] pursues its own interests exclusively and seeks only to secure profits by selling companies' shares back to the company or to third parties in the short term, in some cases with an eye to disposing of company assets.... As such, it is proper to consider the plaintiff an abusive acquirer."

The battle between London-based TCI fund and Japanese power provider J-Power has also become a test of Japan's eagerness for foreign direct investment. TCI began attracting media attention in Japan by acquiring shares of J-Power in 2005. After applying for approval to increase shareholdings to 20%, TCI met a wall of resistance:

J-Power management cautioned that TCI could cut maintenance and investment costs in nuclear plants, and the Japanese media relayed sensationalist warnings about the potential for "blackouts." The result: The Japanese government blocked the investment.

As evinced by the prior examples of Steel Partners and TCI, loud public investor agitation has not produced a track record of success for foreign investors. However, there are numerous counter-examples of smoother direct investment involving foreign and Japanese companies – including Renault's investment and subsequent turnaround of Nissan, and Citigroup's January 2008 purchase of Nikko Cordial, Japan's third largest brokerage. The Nikko Cordial acquisition, born from a seven-year joint venture, was carried out quietly with a minimum of public attention and, according to Citigroup executives, has thus far been beneficial to both parties.

A number of influential business leaders interviewed for this research contributed their views on Japanese resistance to foreign investment and how it can be avoided or overcome. Several themes consistently recurred:

### **Select acquisition targets that won't elicit**

**resistance:** Leaders of foreign funds making investments in Japan consistently counseled that it was important to avoid conducting business in a confrontational manner. But more importantly, they said, investors would be wise to select investment targets that will not elicit opposition. The management team of real estate investment group Merchant Capital partially attributed both its and Merrill Lynch's successful avoidance of resistance to the fact that they invested in an asset class that lacks the emotional or regulatory resistance of private equity or activist-shareholder investment. Masanori Mochida, president and representative director of Goldman Sachs Japan, went further and cautioned against Westerners making any type of active investment in Japan.

**Show sensitivity to the local culture:** Among both Japanese and Western investors interviewed, the foreign fund most consistently mentioned was Steel Partners. The activist-shareholder role Steel Partners adopts is entirely practical from a shareholder-value centric view, but their non-collaborative approach (not disclosing their post-investment plans or objectives to the management teams of target companies) and confrontational style (seeking injunctions against their targets) have

been perceived as tone deafness by other investors in Japan. Far more savvy is Citigroup's approach, which has been so delicate in its integration of Nikko Cordial that employees at the branch level are largely unaware of any change of control, according to Brian McCappin, head of Fixed Income and member of the Executive Committee at Nikko Citigroup.

**Negotiate as equals:** A large number of investors targeting Japan, as well as Ray Yamamoto of GCA (Japan's largest independent M&A advisory firm), emphasized the necessity of dealing with potential acquisition targets and investment targets as equals. This extends from the lip service of sometimes describing acquisitions as "mergers" to the culturally specific and highly formalized Japanese convention of having only counterparts of the same title and responsibility level meet with each other.

**Avoid headcount reductions to the highest degree possible:** Several issues lie at the root of Japanese resistance to foreign investment. But for the general public, raised on the ideal of lifetime employment, perhaps nothing is more central to opposition to foreign investment than the fear of American-style cost-saving through headcount reduction. Indeed, in our poll of Japanese attitudes towards foreign investment, this was what Japanese citizens feared the most about foreign ownership of Japanese companies. Manabu Yamamoto, a managing director at Cerberus Japan, echoed the words of other interviewees when he stated that they do not view headcounts as a variable cost when examining Japanese companies. In his seven years at Cerberus Japan, Yamamoto has never seen his firm implement layoffs. Takeshi Kamiya and Ryosuke Kawashima, consultants in Bain's private equity advisory practice, caution that any fund that seeks to cut costs through a headcount reduction strategy would find it difficult or impossible to consummate future deals.

**Keep out of the public eye:** Interviewees noted that the level of sensationalism in the Japanese press towards foreign investment has died down over the past decade. But investors also uniformly agreed that keeping investments and transactions out of the media should be a priority. GCA's Ray Yamamoto largely credits his eight successful takeover defenses against the Murakami fund (a Western-style, Japanese activist fund) to the attention he was able to generate in the media.

**Make a commitment to this specific geography:**

According to Richard Folsom, cofounder of Advantage Partners (the PE firm which has completed the most deals in Japan), the only firms that have succeeded in making direct investment in Japan are those demonstrating a complete commitment to the country. Folsom suggested that localizing to Japan, creating a deal-sourcing network and acquiring processing capabilities in Japan required such a large investment of resources that funds only partially focused on Japan (e.g., pan-Asia funds) would inevitably begin looking at other geographies that are more welcoming to FDI and provide faster consummation of deals.

The satirist Peter Finley Dunne's oft-repeated criticism of Japan after Commodore Perry's military/trade mission, which opened Japan to the West, has rung true for almost 200 years: "Th' trouble is whin the gallant Commodore kicked opn th' door, we didn't go in. They come out." However, there is clear cause to be optimistic that, as foreign investors' capital and investment practice more fully adjust to Japan, and as Japanese attitudes and policies become more accepting of foreign investment, foreign capital will increasingly "go in."

*This article was written by Stephen Hibbard, Forest Shultz, Lilian Wouters and Jan Zelezny, members of the Lauder Class of 2010.*



## The Sichuan Earthquake and the Changing Landscape of CSR in China

Multinational corporations have embraced the concept of corporate social responsibility (CSR) and have introduced global policies to ensure best practices in every market. In China, however, firms that had operated under the perception that international CSR doctrines could be simply applied cookie-cutter style received a rude wake-up call in the aftermath of the May 12, 2008, Sichuan earthquake.

This massive earthquake, measuring 7.9 on the Richter scale, not only left 70,000 people dead and five million homeless, but also forever changed the landscape of CSR in China. The scale and timeliness of aid response by both domestic and multi-national corporations crafted Chinese attitudes towards companies to an unexpected degree. Firms doing business in China can learn from the public's reaction following the disaster, and can incorporate tailored CSR principles into their core strategy for the Chinese market.

In the days and weeks following the Sichuan earthquake, many MNCs pursued a global CSR policy in line with their international standard. While some multinationals pledged cash, many others pledged a combination of cash, equipment and services. Domestic firms, by all accounts, out-donated multinationals. By May 20, Chinese companies had donated more than US\$645 million in cash and goods. The popular perception was that international firms' relief contributions not only did not match those of local Chinese companies in terms of scale or timeliness, but also were not commensurate with their presence in the Chinese market. Chinese consumers quickly seized upon this disparity by openly attacking major MNCs, calling for a boycott of their products and publicly condemning companies that donated too little. For

multinational companies used to operating under a global CSR framework, the ensuing consumer backlash came as a shock.

*This massive earthquake, measuring 7.9 on the Richter scale, not only left 70,000 people dead and five million homeless, but also forever changed the landscape of CSR in China.*

The Chinese public soon gave these affected MNCs the nickname of "international iron roosters." The term refers to a bird that will not give up a single feather, and its usage highlights the perceived stinginess of these international firms. The list of "iron roosters," first appearing on May 14 included the following notable MNCs: Samsung, Nokia, Coca Cola, McDonald's and KFC. In the face of such negative publicity, many MNCs responded quickly. Nokia increased donations on May 17 from 3 million RMB to 10 million RMB (US\$430,000 million to US\$1.43 million) and Coca Cola raised donations from 5 million RMB to 17 million RMB (US\$710,000 to US\$2.4 million). Despite these additional donations, "iron-rooster" MNCs continued to face angry consumers throughout China, resulting in severe public backlash, including protests at several McDonald's and blockades at KFCs throughout Sichuan province and the rest of China.

On May 27, the affected multinationals met with the Chinese Ministry of Commerce (MOC) to discuss response efforts to both the earthquake and the

publicity aftermath. More than 40 companies attended the meeting, originally intended to include only 10. To address the lack of transparency related to contributions, the U.S.-China Business Council began recording donations of its member companies — which were sent to the Ministry of Foreign Affairs (MFA), the MOC, and the media — and published them on its official website.

Though sensing the need to move quickly to avoid further negative publicity, many MNCs were hampered in their movements by overseas corporate offices that simply referred to corporate global CSR policies. Nokia, for example, donated 3 million RMB (US\$430,000) and 5,000 mobile phones immediately after the quake, yet ranked second on the initial “iron-rooster” list. With the backlash intensifying, the vice president of the Chinese office of Nokia, Xiao Jieyun, flew to Finland to request additional donations from the home office. Management in Finland, however, noted that the company’s contribution was equal to those following similar disasters in Indonesia and Myanmar, and questioned why China should be an exception. Only after showing the “iron rooster” list to home officials and describing the severity of the situation in China did Xiao gain approval to increase company contributions.

Local firms soon found that CSR crises in China do not depend on the nationality of the firm. Despite its positive image in a notoriously corrupt industry, VanKe, China’s largest real estate development firm, met with immediate criticism from netizens (Internet users) in response to chairman Wang Shi’s initial pledge of only two million RMB (US\$290,000) and his insistence that company employees donate no more than 10 RMB each (US\$1.40). Wang apologized with a second donation of 100 million RMB (US\$14.3 million) on June 6, admitting his comments and actions had affected the brand image and share price negatively. He committed not only to elect a spokesman to avoid similar situations in the future, but also to “resign immediately, if VanKe’s performance suffers because of my personal comments.”

On the other hand, firms that acted quickly and generously enjoyed an extremely favorable public response. Wang Lao Ji, an herbal tea soft drink, quickly became one of China’s most well-known and highly esteemed brands after its parent company, JDB, donated 100 million RMB on May 18. After the news was released, enthusiastic netizens encouraged others to purchase the drink, comparing Wang Lao Ji’s generosity to that of rivals’ miserliness (e.g.,

Coke and Pepsi). By May 24, demand for Wang Lao Ji was so high that JDB struggled to fill the shelves of China’s groceries and restaurants.

In general, domestic firms that contributed generously were singled out by Chinese netizens, who encouraged their compatriots to use only these brands. Local firms and their contributions were glorified in the following widely spread message, proliferated through text messaging and online BBS (electronic bulletin boards) postings: “In the future, drink Wanglaoji (100 million RMB), save your money at the Industrial and Commerce Bank (87.26 million RMB) ... drive Geely cars (10 million RMB).”

The response described above was fueled in large part by feelings of nationalism. According to Scott Kronick, president of Ogilvy PR China, “The whole event was indicative of a sort of social contract that Chinese consumers have made with corporations. They look to the business community in addition to the government for support in times of need.” As foreign companies see profits from China grow, Chinese locals demand an increasing obligation to Chinese society. The perceived failure of multinationals to respond quickly to the disaster perpetuated the belief that foreign companies exploit China without giving back.

The unique nature of CSR in China has cultural roots. Historically, China has been shaped by Confucianism, which values family first before support for the wider community. In addition, the communist ethos and state ownership of resources from the mid-20th century prevented accumulation of wealth and, to some extent, reduced the need for private philanthropy. Hence, Western philanthropic traditions, from volunteerism to philanthropic magnates, have not been as common in China. Currently, no meaningful charitable sector exists to effectively mobilize and support disaster relief efforts in times of crisis. Therefore, aid and relief efforts are coordinated primarily by the government and jointly funded by the public and private sector, suggesting that the corporate sector plays a significant role in modern day Chinese philanthropy. Moreover, as the Confucian ideal of righteousness over profit guides how the public views donations, companies donating too little relative to their means are seen to value profits over morality.

CSR initiatives in China are also affected by word-of-mouth to a greater extent than in other markets, and this effect has been magnified as Internet use has rapidly increased. As Internet public relations firm CIC’s founder and chairman Sam Flemming

notes, “the world wide web now serves essentially as an amplifier, vastly increasing the reach and influence of the word-of-mouth conversations on brands that previously took place offline. The migration online has not only increased the potential readership of comments on brands to some 250 million Chinese netizens; these comments are also now archived, so that they are rarely forgotten and can be easily referenced again later.” Nonetheless, the spread of the Internet is also true outside of China. What is unique to the country, however, is that there is a notable lack of a trusted traditional media to which Chinese consumers can turn for reliable information. Therefore, the role of electronic bulletin boards in China has taken on astounding importance, with users more numerous and more active than in other countries. For companies looking to develop their CSR policies in China, they have to be very careful about how they market their initiatives online.

China’s important young market, a cultural propensity to link CSR and company image, and a highly vocal and active online population make CSR critical in China. Accordingly, MNCs may need to rethink their approach in China, where CSR and company performance may be more closely aligned than in other countries. MNCs need to recognize that a thoughtfully developed CSR strategy is not merely conducive to doing business in China: It’s a precondition. Three key factors are crucial to formulating an appropriate CSR strategy in China.

The first element involves organizational structure and processes. CSR requires creating the right escalation mechanisms and organizational reporting lines. Many MNCs in China were hamstrung by bureaucratic red tape and simply could not react as quickly as many local companies. Samsung, for instance, donated 30M RMB (US\$4.3 million) to the Red Cross within three days of the earthquake — by which time they were already being publicly disparaged as an “iron rooster.” MNCs need to have well-established escalation mechanisms as a core part of their CSR strategy, perhaps with a set of decision criteria to determine whether a particular event can be rushed to senior management for urgent consideration.

Second, MNCs must understand the cultural context. Companies must realize that they are expected to give, and failure to do so can result in serious public relations damage. Due to the necessity of prompt action in times of crisis, it may be prudent to have set aside a predetermined budget for CSR issues. Moreover, companies should

expect to make their donations public. As shown above, companies that donated discreetly risked being mistakenly accused of not donating. Some MNCs took to posting a live tally of their employee donations on their websites.

Last, as Internet word-of-mouth plays such an important role in China, companies should pursue a highly active online brand management strategy, including tracking online opinion and working to stem any PR issues before they become disasters. As Flemming notes: “Tracking online opinion not only allows a company to react quickly when an online public relations crisis is brewing — such as Carrefour in the recent Sichuan earthquake — but also helps the company identify key online stakeholders. These stakeholders, who are sometimes simply fans of the brand, can be very helpful in managing the company’s brand online.” Online PR companies have been working with both multi-nationals and Chinese firms to avoid PR disasters and harness the power of the Internet, and are a good option for companies doing business in China where online image management is of critical importance.

Corporations have been forced to reevaluate their assumptions of how to do business in China. Facing the force of the public’s reaction after the Sichuan earthquake, company executives need to equip themselves with a well thought-out strategy for confronting CSR issues, as well as a policy to harness the collective power of netizens. In implementing these measures, MNCs may find it beneficial not only to allocate a greater amount of their marketing budget to CSR efforts, but also, given the importance of first-mover advantages, to allow local managers more autonomy to act quickly in response to future situations. As Scott Kronick remarks: “CSR is in many ways the future of public relations [in China]. Companies would do well to acknowledge this new reality.”

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## Renewable Energy in China: A Necessity, Not an Alternative

What role does renewable energy play in the world's fastest growing economy? We have all heard about China's prowess as an economic power, but not what its growth means for the country's energy needs in the coming decades. China's burgeoning consumption rate, its increase in heavy industry exports and a construction boom that has led the Chinese to nominate the "crane" as their national bird have fuelled a massive and increasing appetite for energy — intensified by the government's balancing act of not imposing energy constraints while also seeking more energy sources.

Some predict that China will need up to US\$3.7 trillion in investments to fuel this growth. Its energy use grew by 8.4% in 2007 compared to overall world demand growth of 2.4%. Clearly, exploring alternative energy sources is not a luxury based on environmental concerns, but an absolute necessity to simply provide enough energy for China. According to Yang Fu Qiang of the Energy Foundation, if China uses only traditional energy sources, "it simply will not have enough energy capacity for its population."

The [Chinese] government's goals have been ambitious — one provision in the law requires 15% of all energy consumed in China to be renewable by the year 2020.

Renewable energy in China, therefore, is not an alternative to traditional fuels, but rather an

additional supplement. China has fed its growing energy demands for years through coal and oil, and it will certainly continue using those sources at similar levels. Given that coal currently makes up 76% of China's primary energy production, oil makes up 13% and renewable energy only 8%, the government's plan is to increase renewable energy's percentage contribution so that the absolute amount of energy generated can continue to rise.

So what has the Chinese government done to encourage renewable energy development? Chinese leaders — from those in the central government to those at local levels — have worked for years to address China's rising energy needs. This initiative is particularly challenging given that power generation from renewable sources is expensive to implement and cannot yet produce at levels high enough to replace traditional energy sources. Despite these difficulties, the Chinese government has made a strong statement in its intention to integrate renewable energy into China's national energy plans for the 21st century, most notably in the Renewable Energy Law of 2006. The government's goals have been ambitious — one provision in the law requires 15% of all energy consumed in China to be renewable by the year 2020.

Given that target, which groups in China are ultimately going to lead the charge in developing renewable energy? In terms of funding and investments, the public and private sectors will both play a role. However, the extent to which the Chinese government is driving investments for renewable energy is astonishing. Because of profitability challenges, private investment is currently more focused on specific areas within renewable energy technology — for example, equipment manufacturing rather than energy production. As

a result, China's renewable energy sector is being driven primarily by public-sector spending to meet the goals set by the central government.

## Massive Reserves of Cash

Although traditional Western views do not generally identify the government as the most qualified driver behind cutting-edge technological innovation, Chi Zhang, chief Asia economist at BP China and a leading expert on renewables, notes that the Chinese government has a massive reserve of cash to fund the renewable energy initiative not necessarily driven by profitability or private-sector participation. Concerns regarding consistently loss-making state-owned energy companies represent a very Western point of view, he adds. He believes that companies in China must be seen as part of the entire government system rather than as individual commercial entities. This is because the Ministry of Finance "balances the books" for unprofitable companies by funding individual losses at the end of the year. As a result, the government is not particularly concerned with ongoing losses at the individual company level, according to Zhang.

He elaborates on China's ability to fund the renewable energy initiative: "Western countries are efficient, but not always effective. In China, you do not need to worry about efficiency [or lack of money]; you only need to worry about effectiveness." Thus, the Chinese government has the funds to attack the energy issue with brute force and push towards the development of renewables. Given that the Chinese government-led effort is clearly very different from initiatives in many Western countries, it is important to understand China's challenges from a different perspective.

China's renewable energy policies target three areas: hydro, solar and wind. In terms of potential, China's hydro energy future seems almost infinite. Already the global leader in hydro electricity, the country's bountiful landscapes of rivers and streams present an untapped resource that will shape the face of its energy future. Currently, China's hydro energy represents 23% of the nation's growing electricity consumption and is second only to coal-generated electricity. Within this vast "green" promise, hydro energy is classified into two sources: small hydro plants, which produce 25 megawatts or less annually, and large hydro plants, such as the 3 Gorges Dam in Hubei, the world's largest hydro-electric power station.

In China, small hydro plants include more than 43,000 stations scattered across the country. The

preponderance of these plants is directly related to transmission system needs and governmental tax policies. Although the large hydro plants can generate huge amounts of energy, the current electricity transmission systems prevent efficient transmission to rural countryside villages. As a result, the Chinese government fosters the development of small hydro plants in rural areas through tax incentives and relaxed constraints on bank loans. This environment encourages private companies to invest in the construction of small hydro plants, which then become the major source of small hydro funding. Joint ventures — such as the Manasi Number One Hydropower Project in Xinjiang, a province in Western China — are opportunities for private companies like Xinjiang Tianfu Thermal Power and the Tokyo Electric Power Company to build small hydro power stations.

In contrast, large hydro plants are few in number but provide 67.5% of the country's hydro electricity. The construction of these large hydro plants is largely state-driven. According to Zhang, "only the Chinese government has the ability to build large hydro stations because only the government has the resources required to move people from their homes." It follows that the financial backing behind large hydro stations is also government-driven. For example, the financing for the 3.5-GW Ertan Dam Hydropower station in Sichuan province involved substantial equity from three government entities. In addition, several Chinese hydropower projects are also taking advantage of the opportunity to sell Certified Emission Reductions (CER) Certificates to third parties in accordance with the Kyoto Protocol. With plans to open at least 13 major hydro power plants by 2020, it is clear that large hydro will constitute a majority share in China's renewable energy progress.

In order to meet its 2020 goals, experts estimate the total required investment at US\$127.8 billion for large hydro and US\$38.8 billion for small hydro. For large hydro, the government will have to continue to provide direct investment. For small hydro, the government must encourage private investment. Utilizing this government-driven, mixed-financing solution will be crucial in reducing state fiscal pressure. Encouraging the continued growth of localized power generation will also compensate for the inefficiencies in the current Chinese power transmission systems.

Though hydropower remains the capacity leader in China, solar energy stands out as the fastest-growing clean-energy sector. The solar industry

is expected to grow 40% per year over the next four years. However, some experts are quick to note that this growth will be less profitable than other areas of clean energy. Shawn Kim of Morgan Stanley Research believes that, "Solar offers a more compelling long-term growth opportunity than wind but at lower returns."

Accordingly, despite mammoth growth prospects, solar energy within China remains an unsustainable energy source given its dependence on government subsidies. The current cost per watt of solar energy ranges between \$3 and \$4, while the approximate cost of traditional coal energy is as low as \$1. Despite these cost challenges, investors are still betting on Chinese solar equipment manufacturing companies. "Solar remains one of the most promising areas of clean energy for investors today," Kim observes.

As a reflection of this high potential, 10 Chinese solar module manufacturers have been listed on the public markets within the past five years. These companies have been the driving force behind solar in China and have seen the most financial success. Beginning with Suntech's IPO on the NYSE in December 2005, China has seen a series of module manufacturers' IPOs on global markets, including Trina Solar in 2006 and Yingli Green in 2007.

In addition to profitability challenges, solar power faces a number of other difficulties. Limits in the global supply of silicon, a key ingredient in module manufacturing, remains one of the greatest challenges facing solar energy today. As such, wafer manufacturers are feeling pressure from module manufacturers to become more cost-effective. Kim sees the industry moving forward, but only through continued innovation: "Cost reductions through new technologies or increased efficiency should continue to spawn new areas of demand over the coming decade." Many photovoltaic (PV) wafer manufacturers will likely struggle with this inevitable technology shift.

Just as the government plays a crucial role in financing hydropower, it has also committed substantial funding to solar. The need for continued technological innovation means that investment in China's solar energy is expected to total US\$55.9 billion over the next 15 years. In 2007, the National Reform and Planning Commission launched an initiative to further the development of Chinese solar power with a 10 billion RMB (approximately

US\$1.46 billion) funding commitment.

As China's energy needs continue to grow, government spending and private investment in solar energy manufacturing will continue to fuel technological advances. For private investors, profitability and the ability to connect energy generation to state power grids will continue to be significant obstacles. Despite the challenges solar energy faces and the ongoing need for government subsidies, experts predict that private investment in solar manufacturing, coupled with government-financed solar innovation, should remain strong.

## Going with the Wind

With costs comparable to traditional sources of energy such as oil and gas, wind is seen as the most commercially viable clean energy source in China. Given that current installed wind capacity ranks second largest in Asia and fifth largest in the world, China has been aggressive in exploiting its vast wind resources. By 2020, the country is estimated to have an installed base of wind power totaling 100GW. This substantial growth is due primarily to abundant resources, a strong technology base and, most importantly, heavy government involvement.

The Chinese government has enacted a number of laws encouraging continued wind development. For example, China's Renewable Energy Law of 2006 requires power grid companies to buy all output of local registered renewable energy producers. This has been instrumental in creating an extensive market for wind power. Provincial governments have also been quick to incorporate clear targets for wind power generation capacity in their five-year plans, ensuring the continued growth of China's wind power sector.

On the investment side, wind power is a hot spot for renewable energy investors with the overall required investment estimated at US\$91.1 billion by 2020. Investment is currently dominated by the "Big Five" state-owned power companies and the private players connected with them. These groups will need to face several challenges, including those regarding technical transmission and unpredictable pricing policies.

The division of investment from the public and private sides is determined largely by each group's tolerance for sustained losses. For many government-linked investment groups, developing wind energy at a loss is viable since they can potentially make up their investment over the next five to



10 years. Chinese wind farms help state-linked companies fulfill renewable energy quotas and secure generation resources for the future. Because wind power is expected to contribute 10% of China's electricity by 2020, these public investors can sustain current losses with the promise that they will eventually turn a profit. However, for most private investors the risk is too high to profitably fund wind power in China.

As state-owned enterprises are driving the growth of wind generation capacity, the turbine manufacturing sector is also experiencing a boom. In terms of wind power equipment manufacturing, the sector is dominated by major foreign and JV manufacturers who have established a strong base in China. With the explosive growth in demand for wind power, the wind turbine industry is currently operating at full capacity and cannot keep up with demand.

At the same time, local firms are growing steadily in this market. These local firms are expected to have a competitive quality product at a 10% to 20% lower price compared to foreign rivals. The government has had a role in specifically encouraging the local turbine manufacturing sector. The current Chinese policy aims for 70% of China's wind turbines to be produced locally. Therefore, China-based manufacturers remain one of the most attractive investment opportunities. Despite small "pockets" of opportunity for private investors, it is clear that in wind energy, as in other renewable energy technologies, the Chinese government continues to be the driving force behind development funding.

The Chinese government has the funds and willpower to fuel the renewable energy investments necessary to reach its 2020 goal of 15% percent of energy consumption regardless of whether the private sector participates or not. As the rest of the world comes to terms with China's massive energy needs and corresponding initiatives, it is important to recognize that the Western economic framework for analyzing the energy industry and companies may not apply in China. Multiple priorities for the Chinese government hinge on resolving the energy crisis, including China's energy needs, social stability and environmental concerns. Therefore, the government will continue to push its agenda of making renewable energy a substantial portion of China's overall energy consumption.

As China continues its path as a global economic powerhouse, its massive investments in renewable energy present an unprecedented opportunity for the development of sustainable technologies.

Although these initiatives are largely for pragmatic reasons rather than environmental concerns, the coming decades of investment, both public and private, should yield global benefits. The future for renewable energy in China is bright, primarily because it is a necessity, not an alternative.

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## French Luxury Foods Firms Bet on Innovation While Preserving Tradition

Each year Fauchon, one of France's most celebrated luxury grocers, dresses up its best-selling éclairs to be launched in their *haute couture* collection of the season. The autumn 2008 collection features 34 individualized éclairs in an extravagant display of premium foods photographed in the style of the best high fashion catalogues. Meanwhile, Parisians, expats and tourists alike line up at the celebrity Paris bakery, Poilâne, to buy the famous *miche*, a loaf of bread that is still made by hand and whose recipe has not changed since the bakery was founded in 1932.

The battle for the luxury goods consumer has intensified, bringing the trade-off between innovation and tradition front and center.

Innovation is becoming a clear market trend as French luxury goods companies, long seen as the guardians of centuries-old tradition and quality, face the pressure to change. Today's market realities — the maturation of the European marketplace, the consolidation of key industry players, and the increased focus on East Asia's growing economies and newly affluent consumers — have forced these firms to reconsider their strategy and reinvent themselves. The dramatic global economic slowdown has added to increasing pressure on companies in the luxury space. With market leaders like LVMH losing as much as 40% of their value in less than a year, and a scarcity of financing for small- and medium-sized businesses, many analysts

predict that 2009 will be one of the worst years on record for the luxury goods industry.

The battle for the luxury goods consumer has intensified, bringing the trade-off between innovation and tradition front and center. This article evaluates the approaches of two celebrated names in French luxury food: Fauchon, a luxury grocer, and Poilâne, a family-run bakery, with different historical approaches to the changing economic landscape. While Fauchon has continuously sought to reinvent itself as the paragon of French luxury food, Poilâne has gone to great lengths to keep its original concept unchanged. The historical success of these two approaches is explored, as are the benefits and risks from pursuing these strategies in a bid to stay relevant in the toughest luxury market in decades.

Estimated to be worth US\$220 billion (€64 billion) the comprehensive luxury goods industry includes products and services ranging from *haute couture* fashion to perfumes, champagne and other consumer products. An important part of this industry is the luxury foods market, a sub-sector whose offerings include high-end gourmet restaurants, rare and exotic produce, and intriguing gastronomic creations such as *Joconde* éclairs that bear the eyes of the Mona Lisa. *World Archaeology* defines luxury foods as those "that are widely desired because they offer a refinement or qualitative improvement of a basic food.... [They are an] indulgence and a status indicator." Consumers reach for these extravagant goods in pursuit of perceived high quality and contribution to a luxury lifestyle.

The French luxury industry accounts for an estimated US\$14 billion of the US\$500 billion in annual exports from French companies. Despite

forming only 2.8% of the country's exports, luxury foods are a symbolic industry within France. The future of the industry is widely discussed throughout the country, particularly in the context of recent economic reforms implemented by French president Nicolas Sarkozy, designed to increase the international competitiveness of the French economy among its neighbors.

Such reforms, meant to deal with the market-shifting effects of European unification, are simply one contributor to the changing landscape of the French luxury foods industry. For many companies, the trouble had already begun at home. Recent studies of the luxury foods industry within France conclude that, domestically, French firms that have historically prospered in their home market are challenged by two recent trends. First, "pure-player" firms focusing on one luxury foods product are becoming increasingly present, eroding the market share of companies such as Fauchon that provide a diverse product range.

Second, traditionally mass-market retailers such as Monoprix and Carrefour are diversifying into the luxury foods market, thereby reducing foot traffic in retail stores owned by luxury foods companies. In the face of these encroachments on market share, many French luxury foods companies have decided to pursue a two-pronged strategy already common among their cousins in luxury fashion: brand innovation and increased presence in new international markets to take advantage of increased buying power overseas.

### 'Fauchon on Your Lips'

Fauchon's flagship store in Paris is a pilgrimage destination for luxury foods aficionados. Located in Place de la Madeleine, it is, according to some, a more popular tourist destination than the famous church that lends its name to the square. Founded in 1886 by pushcart grocer Auguste Fauchon, the house of Fauchon has achieved a fine balance of innovation and tradition for over a century. Thanks to an exclusive contract with Air France, it became the first French food company to regularly import luxury foreign produce to France. In the 1970s, it was also one of the first French luxury foods companies to explore international expansion through a joint venture with the Japanese department store Takashimaya, selling apple-flavored tea in Japan.

Fauchon has experienced both the ups and downs of being a hallmark of French luxury foods in a

global arena, lessons pertinent to weathering the current recession. During the 1990s, in an attempt to boost profitability, Fauchon entered the mass-market retail space and began distributing to supermarket chains such as Carrefour. The result was lukewarm. As prices were slashed by as much as 20% and new product lines designed for the mass-market were rolled out, the company faced criticism over brand equity dilution. Ignoring claims that it was spreading itself too thin, Fauchon followed a tried-and-true approach by increasing its foreign presence, a move financed by a private equity consortium that acquired Fauchon in 1998.

At the time, lead financier Laurent Adamowicz commented to French newspaper *Le Monde* that, "This is the best brand in the sector.... In the United States, everyone recognizes the [Fauchon] name, although its products aren't sold in the market." The acquisition proved less successful than expected. The revenues of three new New York stores were disappointing, and their start-up costs contributed significantly to Fauchon's losses in 2003 and 2004. By 2004, Fauchon started reporting heavy losses, with sales of €0 million generating an operating loss of €0.3 million.

Following these struggles in the 1990s, experts agreed that Fauchon needed a new wave of rejuvenation that would also preserve the company's core competencies. When Michel Ducros, an icon in the luxury foods business in France, acquired a majority stake, reinvention became a priority. Ducros recruited a dynamic new chief executive, Isabelle Capron. A veteran of the French public relations and advertising space, Capron's mission focused on developing a two-part strategy — first, re-centering the brand on its traditional strengths and, second, using this new brand to consolidate market share in France while increasing market share in fast-growing international markets.

Fauchon's successful brand reincarnation was a careful balance between venerated tradition and the *avant garde*. The new management wanted to establish Fauchon as a "luxury good reference" and to implement a comprehensive advertising and store redesign accordingly. Renovation of Fauchon's two stores at Place de la Madeleine was completed in 2005, achieving an ultra-modern look that the newspaper *Les Echos* noted "transgresses the visual codes" of the 120-year-old brand. Borrowing from the aesthetic of its successful French cousins in *haute couture*, the Fauchon storefront look is more akin to Chanel or Dior than to the pastry-shop style

of its next-door competitor Hediard. Its advertising campaign is highly eroticized, with widespread circulation in high-fashion magazines such as *Vogue* centered on the concept of “Fauchon on your lips.” In one stroke, Fauchon was able to distinguish itself from the competition.

The second part of the investment strategy focused on international expansion and differentiation. To reinforce Fauchon’s preeminence in France and export it to growing markets in Japan, China, Korea and the Middle East, Ducros made a simple press statement: “We have to move fast.” The new, ultra-chic store concept was exported to all of Fauchon’s international locations, comprising 36 countries with 451 points of sale. At the top of this export strategy was China, where in 2007 Fauchon opened its largest retail space in Beijing. “Today, luxury is made in the West and sold in the East,” Isabelle Capron comments. “From now on, Asia is the principal source of growth.” Still, Capron is clear on what it is she is selling, telling *Les Echos* that “Our partners abroad ask us for France, France and France.”

Fauchon’s rebranding and internationalization campaign has borne fruit. Sales for 2006 were €8 million, representing a 21% organic growth over the previous year. Its net loss shrank to only € million in 2006; and in 2007 Fauchon executives expected the company to return to profitability. Recently published figures indicate Fauchon currently draws 60% of its sales from outside of France, and expects this figure to reach 80%. The future, while uncertain, looks relatively bright. Fauchon’s focus and reinvention have come at the right time. Being the market leader in its category, Fauchon commands a formidable presence in markets that continue to grow. In countries like China, it will continue to attract an expanding aspirational consumer class. At home, Fauchon is re-polishing its customer focus by providing an ever-changing, innovative, unique customer experience. A range of price points allows Fauchon to capture an increasing share of a mature European market — from the student who buys a € éclair to the large-scale corporate accounts.

Amid a constantly shifting market both at home and abroad, Fauchon’s rebranding campaign has helped it remain relevant and return to profitability. Its recipe for success in the future is to remain ahead of its customers and continue to surprise them. In that sense, its new motto, “Fauchon takes you away,” is right on point.

## FedExing One Million Loaves

Not all French luxury foods brands have undergone radical changes in order to remain competitive. In contrast to Fauchon, Poilâne, a Parisian high-end bakery, has not strayed far from its product, location, advertisement or management structure since its founding 76 years ago. Retaining its position of market leadership in a niche market has helped it successfully grow its presence and weather more than one economic downturn in the past. Its story provides a second successful approach to managing innovation and tradition.

Specializing in bread and simple pastries, Poilâne is most famous for a round, two-kilogram sourdough country bread referred to as a *miche* or *pain Poilâne*. When Lionel Poilâne died in a helicopter accident and his Harvard-bound daughter Apollonia Poilâne took over, France appeared relieved that Poilâne would continue to be family-run. Celebrated in France, Poilâne continues to operate under the watchful eyes of its clients who value its small, family-owned identity. With its unassuming storefront, neutral product colors and lack of advertisement, Poilâne quietly embraces tradition. Within the context of companies that are considering internationalizing with a fresher brand image, Poilâne’s solid embrace of its traditional French food house identity and family roots is a different kind of innovation.

Perhaps due to its emphasis on tradition, Poilâne stands as a success story in French luxury foods today. According to *Businessweek*, sales have grown steadily in recent years from €11.6 million in 2001 to €15 million in 2007. Relying on word of mouth in lieu of advertising, Poilâne has also succeeded in growing its customer base both within and outside of France. Currently 20% of the company’s output is shipped abroad, including half a million loaves that are sent via FedEx to customers and resellers around the world.

Perhaps Poilâne is one of the lucky companies that, due to their well-established market niche, do not need to innovate to survive. In fact, any change to the Poilâne image may cause more damage than good. As Jacques-Henri Bourdois, managing director of the Association Syndicale des Moyennes Entreprises Patrimoniales (ASMEP), a lobbying group for medium-sized French companies, has suggested in *Fortune* magazine, “Poilâne has become a great brand name, but it remains a niche market. Apollonia can continue to grow within this

niche. But is it reproducible, expandable, [and] franchisable on an industrial, international scale? That's possible, but if so, it would lose the authenticity that has been its strongest attraction."

Yet, like others in the luxury foods industry, Poilâne is facing competition, in particular from mass market retailers such as the Pain Paul bakery chain, whose rapid growth has had industry experts like Steven Kaplan commenting in the *International Herald Tribune* on its "tentacular reach." In the face of this competition, Poilâne's current strategy has been to remain focused on its traditional niche brand. As Apollonia Poilâne also stated in the *Tribune*, "I have no competitors." It may turn out that Poilâne does not require the financing to fund a bold global expansion or entry into new markets. Moreover, its loyal customers are unlikely to change the purchasing habits they have followed for decades. But it remains to be seen whether this strategy will continue to garner success for the company.

The French luxury goods industry is at a crossroads. For years, it has enjoyed a market perception as a leader in quality, coupled with a growing consumer base both at home and abroad. However, the current economic crisis has brought sharply into focus the trade-off faced by luxury businesses: Falling consumer confidence, stagnant incomes in the West and ever-increasing competition have all added pressure to adapt and change, or succumb to failure. Our case studies of French luxury foods show that the most important strategy for luxury goods businesses is protecting competitive advantage at all costs — whether it is the excitement of continuous innovation, in the case of Fauchon, or Poilâne's number-one position in a niche market. In addition, Asia as a consumer center has created new challenges but provides a much-needed lifeline and an expansion strategy that will no doubt be replicated in other emerging luxury goods markets.

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## Out of Africa: The Egyptian Telecoms Challenger

By all measures, the mobile telecommunications industry is rapidly approaching critical mass. More than 50 countries have a greater number of cell phone subscriptions than people. The U.S., with more than 270 million cell phone subscriptions (nearly 90% market penetration), has one of the lowest per capita subscription rates in the industrialized world. Global mega-firms such as Vodafone, Telefónica and T-Mobile now compete for dominance in an ever-shrinking list of countries that have yet to go wireless.

“In this industry being the first-mover is everything.”

—Hassan Abdou, CEO of Weather Investments II

In this rapidly evolving industry, one Egyptian company is proving that it is never too late to go global. After consolidating its presence in Africa, South Asia and the Middle East, Orascom Telecom Holding (OTH) is now prepared to take some developed markets by storm. OTH, founded by Egyptian billionaire Naguib Sawiris, has experienced an impressive rise to world-wide prominence as the result of some extremely bold ventures. While the company initially lacked significant experience, it quickly learned the rules of the global telecoms game and then broke them with aggressive entry into such hostile operating environments as Iraq and Zimbabwe. The lessons learned from these experiences have helped transform OTH from an Egyptian domestic service provider to a global incumbent, serving more than 74 million subscribers worldwide.

According to Hassan Abdou, CEO of Weather Investments II (the parent holding company of OTH), becoming a dominant world player was not originally part of OTH's strategy. However, first-entry into emerging markets soon became a defining feature. When asked about the value of the first-mover advantage, Abdou stated that in this industry “being the first-mover is everything.” While this is certainly no secret, it raises the question of how far one is willing to go to secure this type of advantage. In the case of OTH, the answer is simple: anywhere, even North Korea. In partnership with the North Korean government, OTH has launched that country's first commercial mobile telephone network. How did an Egyptian mobile service provider end up in North Korea? The story, like so many tales of antiquity, begins on the banks of the Nile River.

When the Egyptian government announced its plan in 1997 to issue a second license for mobile phone operations in addition to the government-owned license, Naguib Sawiris recognized the opportunity. However, despite his substantial personal and family holdings, he had no experience as a telecoms operator. So he enlisted the support of France Télécom in a competitive bid against Vodafone. He lost. Undeterred, Sawiris simply bought the government-owned company along with its license. That was the beginning of Mobinil, the network that has, according to Abdou, “enabled OTH to build a track record ... [from] which it could branch out and bid legitimately for other licenses in other countries.” OTH wasted little time in doing so and, by 1999, had expanded into nearby Jordan. A year later, OTH simultaneously entered 11 different sub-Saharan African nations. While costly, this strategy of rapid expansion marked OTH's emergence as a global player.

## Unsatisfactory Negotiations

The strategy was simple: to be *the* telecommunications provider to Sub-Saharan Africa. Sawiris envisioned a broad expanse of contiguous OTH coverage across the heart of the African continent. Mounting regulatory constraints imposed by tempestuous governments ultimately hampered this effort, but the rapid expansion into sub-Saharan Africa left OTH not only with the dubious prize of a struggling Zimbabwean operation, but also with a newfound appreciation for the importance of understanding the political environment of business. Sawiris and the rest of the OTH leadership are quick to admit that they were unprepared for sub-Saharan Africa, stating that their holdings in this region generated 10% of company revenues but took 95% of their management resources. They had already set up shop but then had to negotiate regulatory terms that would allow consumers to purchase phones. These negotiations rarely reached a satisfactory conclusion and, as recently as May 2008, Sawiris called “on African governments to reduce the taxation and regulatory burden on mobile users so we can maximize the positive impact of this investment.”

In addition to regulatory woes, OTH also encountered meager average returns per user in the smaller sub-Saharan nations due to limited population concentrations with little money to spend on mobile phone service. Abdou suggested that, in hindsight, “a better strategy might have been to focus OTH resources on large population centers, such as Nigeria, rather than on numerous small countries.” Major regulatory challenges, limited profitability, and growing debt led OTH to sell off the majority of its sub-Saharan telecommunications operations as 2006 approached. The firm streamlined operations and focused on its networks in Tunisia and Algeria, where operations were more profitable. This decision to prioritize its core African operations proved efficient for OTH as its Algerian network alone (popularly known as Djezzy) currently accounts for roughly half of all OTH profits.

Next on OTH’s agenda was Iraq. Reeling from the U.S.-led invasion and spiraling into a bitter insurgency, the country was certainly not the most ideal investment environment in 2003. With the nation in ruins, OTH unveiled its most successful enterprise to date, the *Iraqna* network. Translated as “our Iraq,” the brand became a symbol of solidarity in the midst of national crisis. Moreover, OTH’s policy of hiring local labor and management gave the brand a local image and offered OTH a competitive advantage in the crowded telecoms

marketplace over rival Vodafone. Where the British firm had developed a globally consistent brand name and logo, OTH now had a collection of local brands, each of which had a unique national appeal to its customers.

As the expiration of its Iraqi license neared, OTH faced the decision of whether or not to continue operating in the ravaged country. Although the venture had been wildly profitable, deteriorating security conditions had taken their toll on management. OTH employees endured threats, attacks and kidnapping at the hands of insurgents. At one point, 75% of OTH’s employees in Iraq were security guards. Despite this, Sawiris wanted to continue operating the *Iraqna* network. The decision to sell the network came only after OTH’s license expired. In the bidding cycle that ensued, OTH set a hard limit on what it was willing to pay for the new license. When the price exceeded this limit, OTH recognized that the time had come to walk away. According to Abdou, OTH sold the *Iraqna* network for \$1.2 billion in 2007, a 350% return on its investment. With proven success in building, operating and divesting a network in such a hostile environment, OTH now headed east to take advantage of one of the few remaining untapped telecoms markets.

Since the first-mover advantage is of such value to OTH, it has invested \$400 million to establish the first commercial cellular network ever launched in North Korea, dubbed Koryolink. In lieu of a licensing fee, Sawiris devoted some of his private capital to North Korean development projects in exchange for a 25-year operating license with a four-year exclusivity clause. On December 15, 2008, a year after opening its North Korean headquarters on the top three floors of the 103-story Ryugyong Hotel in Pyongyang, OTH announced the commercial launch of CHEO Technology.

This new subsidiary is a 75/25 joint venture between OTH and the North Korean state-owned Korea Post and Telecommunications Corp. “We are making history in a country that is developing and opening up in a remarkable way,” noted Sawiris. As a further expression of confidence in the economic prospects of North Korea, OTH opened Ora Bank in Pyongyang the following day. The new financial institution, also a joint venture with an existing government enterprise, will process Koryolink subscription payments and handle remittances from abroad. Despite Sawiris’ faith in these investments, to what extent North Korea will open its economy remains to be seen. Regarding Koryolink, a report from the Korean Central News Agency on the network launch

“provided no details on the terms of service, the types of phones it might accommodate or who would be able to utilize it.” At present, North Korean citizens face restrictions on purchasing and owning cellular phones and are not permitted to make international phone calls. This fact alone was enough to dissuade other potential entrants from seriously considering North Korea.

When asked to explain what led to the decision to invest in such an isolated and foreboding telecommunications environment, Abdou argued that “with no competition and no licensing fees, it was a golden opportunity for OTH.” The venture, he added, “is, in fact, relatively low-risk when compared to the potential reward. In most other countries, the licensing fees are a significant portion of the initial investment, but in this endeavor there was no such cost.” Should the country open up to international business in the future, OTH will be years ahead of potential competitors, with its only investment being the fixed cost of developing and maintaining the network.

### Entering North Korea

From the perspective of a company that is willing to accept risk and stake a claim in one of the world’s few remaining telecoms greenfields, the timing and circumstances of entry into North Korea are as good as they are ever likely to be. Abdou estimates the potential value of the North Korean telecoms market at \$3 billion to \$5 billion. If the market does hit that target during the company’s exclusive license period, OTH stands to reap a huge return on investment, one that would rival the landmark Iraqi venture. With everything in place for success, OTH is now waiting for the inscrutable course of North Korean politics to run in its favor.

In an interview with CNBC Europe earlier this year, Sawiris stated that “the world is coming to an end when it comes to mobile telephones, so the opportunities are very scarce. You really have to go wherever you get a chance and [North Korea] is one of the last.” This realization has coincided with a cultural shift at OTH. After the sale of *Iraqna*, the work environment at OTH changed. The entrepreneurial spirit that had characterized the company during its period of rapid expansion was replaced by a more conservative mood as the company matured in its business approach, internal systems and size.

However, the entrepreneurial spirit, tempered by experience, lives on in another part of OTH, Telecel Globe. With a management team of three, the new entity is designed to be lean and cost-conscious. Its goal is to develop a localized entry strategy for small to medium emerging markets. Telecel Globe has lately acquired networks in Burundi and the Central African Republic, and is rumored to be searching out markets as far-flung as Mongolia and Cuba.

According to the OTH website, “We believe that by positioning ourselves as the primary provider of communication services, we are shaping the future of the markets we serve.” Once a late-coming emerging market operator, OTH has now turned itself into a global telecoms innovator. With its recent foray into banking, OTH plans to pioneer mobile tele-banking. Abdou explained the potential of this new business on OTH’s Pakistani Mobilink network as follows: “Half of our profits come from Algeria, but half of the subscribers are in Pakistan. With 35 million subscribers in Pakistan alone, if even 1% of our subscribers take advantage of [mobile tele-banking], that’s 350,000 customers.”

Through its trials in Africa, Iraq and North Korea, OTH has established itself as the upstart emerging-market service provider. While Telecel Globe scours the world for the last remaining patches of greenfield, OTH has now entered the developed North American marketplace through acquisition of a Canadian network, Globalive Communications. In an industry with rapidly diminishing room to accommodate late-comers, OTH grew up quickly and has elbowed its way to global prominence, where it now stands ready to shape not only the local markets in which it operates, but also the future of the telecoms industry worldwide.

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## Hostile Takeovers: Russian Style

On August 1, 2006, one headline dominated business news around the world: A Russian court had declared Yukos, one of the largest private oil producers in the world, bankrupt. Soon, its CEO and founder, Mikhail Khodorkovsky, saw his company's assets sold off for a fraction of their value to the state-owned Rosneft Oil Company and found himself behind bars, charged with tax evasion. The downfall of Yukos has unofficially become known as the most sensational example of high-end corporate raiding in the history of the post-Soviet economy.

According to some estimates, approximately 70,000 Russian companies a year become targets of raider attacks. Billions of dollars in assets are tied up in complex legal schemes, which some have dubbed "a new wave of property repossession." Despite certain similarities between corporate raiding and Western-style hostile takeovers, the unique Russian version of the phenomenon uses tactics that are possible only because of certain peculiarities of the Russian legal and administrative environments.

While the concept of corporate raiding in Russia has been around since Soviet economic liberalization began in the early 1980s, its methods have evolved continuously. In the mid-1990s, reports of AK-47 wielding masked men storming the headquarters of up-and-coming companies, seizing assets and forcing owners to sign a variety of property transfer documents were all too common. Since the financial default of 1999, however, tactics of raiders and their agents have become much more sophisticated. These days, the most common scenario involves an interested party placing an order with a raiding team for the takeover of a target company. Raiders typically start by acquiring a minority share in the target firm and using this share to initiate frivolous lawsuits against the target. The raiders then use a

complex game of legal arbitrage to compromise the company's operations and drastically devalue its stock. These actions result in possible bankruptcy and almost certain takeover by the raider.

According to some estimates, approximately 70,000 Russian companies a year become targets of raider attacks.

With the gradual sophistication of the raiding process, raider teams have become an institution of the Russian marketplace. Some raiding teams are independent intermediaries, similar to external consulting groups. Other firms originated as corporate division departments of the oligarchs' giant investment funds and currently cater to the entire marketplace. The most infamous are the raiding teams that are subsidiaries of large holdings and financial institutions. These teams possess operating knowledge and familiarity with the marketplace not unlike that of investment banking professionals in leading Western institutions. Their expertise highlights one of the end goals of the raiding process: to provide an alternative to legitimate M&A.

### Color-coded Teams

These raiding teams are commonly divided into "black," "grey" and "white" firms based on the degree of illegality of their tactics. "Black" raiders are known for the blatant use of criminal force, as was done in the mid-1990s. "Grey" raiders utilize milder forms of criminal activity, relying largely on

judicial bribes. “White” raiders are most similar to their Western counterparts and use tools such as organized strikes and unplanned inspections by regulatory officials.

The legality of the raiding methods used in each instance is not clear-cut. Even if, in some cases, the particular tactics of Russian corporate raiders could be considered legitimate in the West (e.g., share buy-back), the manner of execution could be illegal (e.g., extortion of existing shareholders). The main methods of raiding include falsification, greenmail, forceful takeovers and share buyout.

Raider tactics differ greatly. Falsification includes the creation of fraudulent property ownership documentation, forgery of signatures and bribing of judges and governmental officials. This type of “grey” raiding occurs, for instance, when raiders bribe a court to file a lawsuit against a targeted company. While the lawsuit may be fictitious, it can result in a legal “arrest” of all outstanding shares of the company and deprive the executive board of its decision-making power. A company whose shares are “under arrest” cannot undertake significant business transactions or human resources decisions, or obtain financing. Galina Krylova, a Russian lawyer who has worked extensively with victims of raiding, states that the consequences often force “the owner to sell the operations to the attackers for a fraction of their actual value. Or, the lawsuits simply continue until the company is bankrupt.”

“SMARTS” Group, for example, is a Russian telecom company that fell victim to raiders using falsification, among other tactics. The raiders obtained a minority share of the company and subsequently disrupted shareholder meetings. By filing legal claims against “SMARTS,” the raiders succeeded in paralyzing the company’s operations via the court system. In order to undermine the company’s defensive measures, the raiders filed multiple identical lawsuits in regions far from the company’s location. The raiders obtained jurisdiction in those regions by entering into false contracts on behalf of the company with local citizens. The legal proceedings have dragged on for two years and continue still.

Another victim, Hermitage Capital Management, was the largest international portfolio investor in Russia, with \$4 billion invested. In a scandal that began in December 2005, Hermitage accused Russian police of attempting to defraud the company of hundreds of millions of dollars. Russian

police confiscated key documents, which were later changed and falsified and used to file lawsuits against the company’s subsidiaries.

Greenmail is a quasi-legal raiding method that utilizes psychological attacks. Similar in nature to greenmail used by Carl Icahn and others in the U.S. in the 1980s, this tactic employs a small group of raider-controlled shareholders who irritate the management until the latter agrees to repurchase the shareholders’ stock at a significant premium. The means of concentrating these shares may not be entirely legal, and the tactics of influence are far less sophisticated than in the West. In one instance, a particularly reluctant board member of a targeted company received a coffin — complete with flowers — as a birthday gift, likely a quite persuasive gesture.

Forceful takeovers are frequently combined with fraud tactics. For example, a group of armed mercenaries may storm into the offices of the target company and set up a fictitious CEO. Police often provide fraudulent paperwork; judges, acting on bribes, validate those documents. Violent takeovers, prevalent in the mid-1990s, have become less common due to both changes in law enforcement and further development of anti-takeover laws.

Togliatti Azot, a victim of a forceful takeover, is a giant chemical factory in Russia’s Samara region, 600 miles east of Moscow. According to deputy director Sergei Korushev, in September 2005, dozens of men dressed in camouflage and carrying automatic weapons stormed into the administration building. The attackers were members of OMON, Russia’s paramilitary police, and detectives from Moscow. They seized financial documents that they claimed were evidence of crimes committed by the management. The police later charged the general director and CEO with tax evasion and fraud. The company supposedly owed \$150 million in back taxes. The head of the plant, Yuri Budanov, claimed that the police investigations were instigated by rival companies with influence over local politicians.

Another, less sophisticated, forceful takeover involved Specialist Electrical Equipment, a small Moscow company that manufactures fire-safety equipment. One day in November 2004, the raiders used their muscle to simply lock the employees out of the premises and take over the company. The owner was ousted, and the company’s valuable property in Moscow was sold off. All that is known about the raiders is that they were linked to a firm registered in the British Virgin Islands.

Share buyout, the most Western of the tactics used by raiders, often uses “grey” methods. In the U.S., a hostile takeover occurs when an acquirer buys out a company, often at a premium, despite management’s opposition. In Russia, a raiding syndicate that obtains a controlling share of a target company typically forces a secondary equity offering without the consent of the other shareholders. In this way, the raider dilutes minority interests and retains majority control of the company and the newly issued shares. The dilution of the minority stake reduces the bargaining power of the remaining shareholders, often forcing them to sell off their shares.

## Closed Auctions

Many unique factors in the post-Soviet environment have enabled asset-acquisition via raiding. The legacy of decades of a planned economy is the lack of an established framework for private-property ownership. In the late 1980s, most of the Soviet Union’s industrial capital was sold off in closed auctions at prices hundreds of times below market value. These auctions concentrated a vast amount of capital in very few hands, thereby laying the foundation for oligarchic industrial ownership at a time when Russia lacked a legal framework for the protection of property rights. Due to the widespread familiarity with — and contempt for — the nature of these first-wave acquisitions, the notion of private property in today’s Russia enjoys little respect. This, in turn, facilitates corporate raiding.

Another factor that enables raiding is the lack of sophistication in Russia’s emerging financial markets, which produces two effects. First, local investors’ inexperience with complex financial instruments clears the way for schemers to manipulate stockholders and illicitly acquire their financial assets. Second, inexperience limits local investors who could otherwise purchase adequate financial instruments in more mature markets. In part owing to the financial crisis of 1999, the Russian stock market trades primarily on the blue chip stocks of the country’s corporate giants and not on the stocks of mid-cap companies. Moreover, since the notion of transparent and accountable corporate governance remains in its infancy in Russia — a situation perpetuated by operating inefficiencies and complex tax evasion schemes — potential buyers are deprived of the ability to accurately gauge the value of firms. Given the low level of corporate transparency, raiding offers a quicker, cheaper and more effective alternative to legal M&A processes.

In addition, the legal environment has helped clear the way for corporate raiding. Sergei Volfson, a lawyer at Dewey & Leboeuf’s Moscow office, confirms that Russian legal judgments are not based on precedent, and judicial opinions are not made publicly available. The few legal decisions that have been published recently have been too laconic to offer much guidance to lawyers or contribute meaningfully to the predictability of the law. As judges who have no legitimate legal reason for their rulings are not forced to reveal their thinking, it is much more difficult to identify judicial corruption. Corporate raiders use corruption to their advantage in order to obtain favorable court decisions and falsified legal documents.

Forum shopping, the strategic selection of a forum for a lawsuit based on favorable law and judges, is commonplace in Russia and enables raiding teams to compromise their targets more easily. In the U.S., legal forum availability is limited by jurisdictional requirements. In Russia, plaintiffs can bring the same lawsuit simultaneously in multiple — often remote — local courts in the hope of obtaining at least one favorable verdict or injunction. For the defendant firm, the barrage of identical lawsuits represents an enormous cost and greater exposure to potentially unfavorable decisions, damaging its operations and thereby forcing it to capitulate to the raiders’ demands.

The practice of law itself in Russia remains largely unregulated. Russian lawyers do not face the same rigorous examination requirements as their Western counterparts prior to commencing their practice. Furthermore, the Russian legal system lacks effective methods for reprimanding attorneys engaging in malpractice. In the U.S., for example, Rule 11 of the Federal Rules of Civil Procedure sanctions lawyers who turn in false documents to the court or initiate frivolous lawsuits. In Russia, no such similar sanctions exist.

While debate may continue regarding the exact causes of corporate raiding, its effects on the Russian economy are clear and negative. The widespread extent of raiding, which harms thousands of successful businesses every year, significantly compromises the overall economic growth of the Russian economy. Often, raiders dismantle the targeted companies and sell off their assets. As a result, any long-term economic value from the target company’s operations is lost. Even if the firm survives, the crippling effect of the raiding process may render it unprofitable.

The threat of raiders significantly impedes future business growth by undermining the incentive structure for business development in Russia. As Galina Krylova notes: “There is no pattern by which companies get targeted [for raiding]. Any successful, well-functioning company will get targeted, sooner or later.” An environment in which businessmen have to worry about developing an operation that is too profitable simply does not promote growth, especially in an emerging economy such as Russia.

Moreover, corporate raiding significantly reduces foreign investment flows into Russia. The chief economist of the Moscow branch of a major international investment bank stated that it is his “distinct impression from conversations with international clients that corporate raiding in Russia is a concern that adds to the overall murkiness of the Russian market.” Public Joint Stock Offering regularly warns investors that the Russian legal system and legislation, as well as “inconsistencies between federal laws ... gaps in the regulatory structure ... [and a] lack of an independent judiciary” create an uncertain environment for investment and business activity.

The consequences of raiding and the publicity that raiding has garnered have raised awareness of the need for effective defensive methods. A carefully designed corporate structure remains one of the most effective tactics. Daniel Coppel, also an attorney at Dewey & LeBoeuf’s Moscow office, argued that creating offshore holding companies for Russia-based entities can be a useful measure to evade attacks because such a move introduces judiciary precedent and increases the difficulty of becoming a minority stockholder and obtaining company documents. Moreover, designing joint venture agreements between Western and Russian partners that include an anti-dilution provision — to ensure that the original investments are unchanged over time — can protect a company from raiding attacks.

Nicolai P, a small business owner in Moscow, acknowledged that raiding has spurred companies to adopt creative defenses, such as obtaining multiple registrations for the same company. “When you begin to suspect a raider attack, the assets of the company can be quickly transferred to a parallel company under a different registration,” said Nicolai. One long-term approach advocated by others is to take the company public and make it as transparent as possible. Greater transparency makes it more difficult for raiders to raise false charges against the company.

None of these strategies is foolproof. Indeed, raiders have taken over companies with every one of the aforementioned defenses in place. Krylova states that, in the end, “the only real preventative measure is to have very good political connections.” The last few years have witnessed the rise of a variety of anti-raiding firms in Russia that offer protective services. However, because no individual method of protection can guarantee security, Russian businesses are looking to the government for more systematic solutions to raiding. Many believe that the eradication of corruption is a prerequisite to successfully combating corporate raiding. Possible government measures include the development of an investigative unit specifically dedicated to tackling corporate raiding and the establishment of a government agency that would inventory all outstanding shares of public companies and record changes in their ownership.

Others place hope in recent legal reforms, particularly those addressing jurisdictional issues. Three years ago, the Supreme Court of the Russian Federation proclaimed that courts of common jurisdiction cannot rule on cases of corporate arbitrage, many of which are raider-instigated lawsuits. The requirement that arbitrage cases be filed only in the location where the defendant company is incorporated will deprive raider firms of the ability to file multiple identical suits, a key tool in the takeover arsenal. Many experts claim that coupling these measures with reforms establishing effective punitive measures for legal and judicial malpractice may prove a highly effective method of preventing frivolous litigation.

Nevertheless, many remain skeptical about the proposed reforms and the changes already adopted. “Increased political will” is the only long-term solution to the raiding problem, according to Krylova. She and several other lawyers state that Russia has adequate corporate laws, but that they are not well-enforced: “[W]e have wonderful laws but they only apply to a select few.” Only strong support on behalf of the government for the anti-raiding laws and campaigns can put a stop to this profitable business activity.

Over the last 20 years, the Russian economy has experienced large fluctuations. The unique combination of post-Soviet infrastructural loopholes and rapid market liberalization has spawned widespread corruption and made activities such as corporate raiding extremely profitable. Proponents of anti-raiding measures currently focus on engaging the government in ending

corruption. However, the future of raiding remains unclear. Many believe that bribery has engrained itself so deeply in the Russian mentality that the development of independent and accountable agencies to support an efficient market will remain impossible. Others, however, continue to be optimistic that soon Russians — including raiders — will seek greater stability in the market in order to protect their rights and “rightful” property.

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## Franchising in Germany: A Stepping Stone Toward Entrepreneurship

Germans are widely considered to be risk-averse, and Germany is hardly the first country one associates with entrepreneurship. “The entrepreneurial culture is much more advanced in the U.S.” than in Germany, according to Walter Grassl, partner at Munich-based venture capital fund Munich Venture Partners. For typical middle-class Germans accustomed to long-term employment in their field of training, entrepreneurship is often seen as complex and overly fraught with risks. Franchising, however, represents a means of avoiding many of these risks.

Traditionally, independent German businesses have been based on the technical and engineering expertise of their founders, rather than on the novelty of their business models.

The concept of the visionary, risk-taking entrepreneur is far less developed in Germany than in many other countries. Traditionally, independent German businesses have been based on the technical and engineering expertise of their founders, rather than on the novelty of their business models. The great powerhouses of German industry, as well as the *Mittelstand* stock of small- and medium-sized enterprises, which in many ways forms the backbone of the German economy, are strongly focused on engineering and other technical sectors.

The quintessential examples of German entrepreneurs include Werner von Siemens, who started his industrial empire in a small workshop in

Berlin; Robert Bosch, who opened a workshop for “precision mechanics and electrical engineering”; and Carl Zeiss, who founded his namesake company as a workshop for precision mechanics and optics. Each of these entrepreneurs focused his life on a developing company that bore his name and remained true to the core competencies upon which it was grounded. The idea of the serial entrepreneur focused on the process of launching new businesses and discovering new ideas across a range of industries has traditionally been far less common.

As Germany’s structural unemployment continues to grow, the government has increasingly sought to encourage growth in entrepreneurship. It recognizes franchising as a means of facilitating entrepreneurship by mitigating the risk would-be entrepreneurs must take on. Hartmut Schauerte, Germany’s Federal Secretary for Small and Medium Enterprises (SMEs), praised the commitment of the franchise sector in a speech at the 30<sup>th</sup> anniversary celebration of the Deutsche Franchise-Verband (German Franchise Association), saying that “to start up one’s own business through a proven business idea is becoming the mentality of entrepreneurs, which is strengthening German SMEs.”

The latest data from the German Franchising Association for the year 2007 shows that there are more than 900 franchisors and about 55,100 franchisees in the country, with 441,000 employees and a total turnover of €1.5 billion (\$52 billion). This represents 300% growth over the last decade, starkly contrasting with 25% growth in GDP in the same period. In per capita terms, Germany employed around 5.4 people in a franchise per 1,000 inhabitants. By comparison, the United States employed around 37 people in a franchise per 1,000 inhabitants in 2007, according to a report from PricewaterhouseCoopers.

A shift in the hierarchy of sectors within the German economy has supported the growth of franchising. As the growth rate of engineering-oriented businesses in Germany has slowed, franchising has emerged as a key way for business starters to access the faster growing service sector. According to a Deutsche Bank research paper by Uwe Perlit, titled "Franchising in Germany Coming of Age": "One reason for this has been that business in veteran franchising sectors like fast food has continued to expand at good rates, while inroads have also been made into lucrative new segments such as wellness." Based on the same research, services have accounted for more than 50% of the growth in franchises, and are expected to expand at a 7% annual rate to contribute €10 billion to German GDP by 2015.

### Finding Work in New Sectors

Over the last decade, franchising has increased from 1.0% to 1.6% of German GDP, and the number of employees in the sector has doubled. In contrast, general employment rose by only 4% during the same period. The increase in self-employed workers remained lower than the increase in the number of franchisees (2.6% vs. 8% per annum), which lends credence to the prospect that franchising offers a feasible alternative for Germans to own their own businesses.

Helping unemployed Germans find work in new sectors would provide huge benefits to the economy. In 2007, Germany had an employment rate of 69%, slightly above the average of 67% within OECD countries but far behind leading nations such as Switzerland, Norway, or Iceland, with a rate of 75%. Approximately 22% of German jobs were part-time, and 56% of unemployed Germans seeking a job in 2007 had been doing so for over a year. By this metric, Germany was ahead of only Slovakia among European countries.

According to Deutsche Bank projections, the franchise sector's growth rate is likely to outstrip GDP growth in the medium term, although it probably will not reach the 11% annual rate of the last decade. Within the franchising sector, the greatest growth is expected in the health, education and environmental services sectors. The retail, restaurant and catering segments are considered largely saturated and are not expected to yield explosive growth.

In his article, "Franchising and the Choice of Self-employment," Patrick J. Kaufmann, a marketing

professor at Boston University, describes the relationship between purchasing a franchise and its financial and business benefits. Franchising offers the opportunity to expand in a much wider range of sectors. In addition, franchisees are more likely than independent business owners to operate in sectors in which they do not have previous experience. This suggests that franchising provides a means of increasing the flexibility of an economy. This is of particular value in Germany, where workers often have specialized training that results in high structural unemployment as entire industrial sectors contract.

Dietmar Wahnelt, a franchisee in the Munich restaurant chain Münchner Suppenküche (Munich Soup Kitchen), provides an example of how franchising can help the German entrepreneur enter a new sector. Up until last year, Wahnelt had spent his entire life in Spelle, a small town in north-western Germany. He completed eight years of vocational training to obtain the title of Industrial Master at a large oil refinery near his hometown, where he worked for 26 years, ultimately serving as a supervisor. Eventually, Wahnelt became disillusioned with working in a large corporation, mainly due to the inability to work independently and the overnight shift-work he was often required to perform. During this time, he pursued some small part-time business ventures. By the summer of 2007, his frustrations had reached a head and he decided to pursue his entrepreneurial aspirations full-time.

Based on his passion for cooking, Wahnelt targeted the restaurant business. Rather than starting out completely on his own without any experience, he decided to utilize the franchise model. After investigating a number of opportunities via various franchising organizations, he became interested in Münchner Suppenküche, a small chain of restaurants in Munich that focus on healthy soups. The idea of serving healthy, affordable and convenient meals was highly appealing to Wahnelt, and he became the third MSK franchisee in the summer of 2007. Working with the German Franchise Association, which compiles franchising offers on its website and provides consulting services to potential franchisees, he came into contact with the Münchner Suppenküche franchisors.

Münchner Suppenküche aims to differentiate its products through the use of fresh, natural ingredients. The company uses no preservatives and received "Bio Certificate" organic food certification in 2007. In addition to daily specials, international soups and home-style soups designed to evoke memories of home-cooked meals, the menu

includes entrees ranging from Argentinean meat soup to artichoke soup à la Provence to vegetable curry. Franchisees determine prices within a range set by the group, generally less than € per soup. The company has also recently begun to sell broth with instructions so customers can make their favorite soups at home.

Franchisees invest between €5,000 and €15,000 to open a new location, of which €2,800 comprise a one-time start-up fee. Franchisees receive an equity stake of about €5,000 in their restaurants. Restaurant operators sign a 10-year contract with the company and have an option to extend the relationship. Ongoing costs include a franchise fee of 4.5% of monthly net sales and an advertising and brand fee of 1.5% of monthly net sales. Münchener Suppenküche restaurants usually begin to achieve positive operating results after about six months.

Franchising offers risk-averse German entrepreneurs like Wahnelt a clear template to follow as well as operational support for their businesses. Franchising programs typically offer formal and informal training opportunities, along with company best practices and established supplier contracts. Structured support from franchisers is the key value proposition to many risk-averse entrepreneurs and can facilitate new business creation despite cultural distaste for uncertainty.

Wahnelt was attracted to the franchising model by the opportunity to gain expertise from the Münchener Suppenküche's central organization as he started his restaurant and further training as he operated it. The franchise reduced uncertainty by supplying a fixed model within which to operate. The company's central organization provided marketing, public relations and process optimization — freeing Wahnelt from key business tasks with which he was most unfamiliar.

### **Soup in Large Quantities**

In the case of a soup restaurant, operators are faced with the challenge of providing perishable soup in large quantities to consumers who visit restaurants primarily during short periods each day. Wahnelt's Münchener Suppenküche location serves the vast majority of its customers between 11:30 a.m. and 2:30 p.m., with some additional sales on cool winter evenings. Consumer demand for a wide range of soups makes the task more complicated.

Participation in the Münchener Suppenküche franchise allows franchisees like Wahnelt to

source their soups from the centralized kitchens of the group, which are located in Munich, and to incorporate products from local markets. Münchener Suppenküche uses a proprietary system to cool and package the soups in five-liter sealed containers. The process, which is difficult to replicate — in part because it requires a seamless refrigerated delivery chain — allows the soups to be stored for at least 16 days, accommodating the uneven demand of lunchtime customers.

Centralized procurement and proprietary technology help franchise entrepreneurs reduce risk. Not only do the measures cut costs, but they also remove opportunities for error. Financial risk sharing further encourages hesitant entrepreneurs, lowering the necessary personal investment and cutting the potential for losses.

The benefits of franchising, from operational advantages to financial backing, become particularly relevant in a risk-averse culture like Germany. The certainty provided by the franchise structure appeals strongly to would-be entrepreneurs who would benefit from the independence of entrepreneurship but hesitate to accept the incumbent risk. The German example shows how franchise models can unlock entrepreneurial potential and illustrates how a franchise can serve as a tentative first step for aspiring entrepreneurs who might not otherwise have the stomach to launch their own businesses.

As a new business owner, Wahnelt has benefited from the Münchener Suppenküche's brand recognition in Munich, where it has operated for 26 years, and has received positive press coverage — both in the local press and in foreign publications from the U.S. to Japan, including *The New York Times'* travel section.

After less than a year running his Münchener Suppenküche franchise, Wahnelt is already finalizing plans for an independent restaurant modeled on his own culinary concepts. Building on Münchener Suppenküche's emphasis on light and healthy fast food, Wahnelt has designed a "vitamin bar," where customers can choose healthy alternatives such as curry soups, salads, fruits, vegetarian sandwiches, and, of course, the whole complement of Münchener Suppenküche's soups. "I want to offer colorful and healthy food to enhance the experience of my customers," says Wahnelt. This new concept builds upon many of the features that first attracted him to the Münchener Suppenküche franchise but brings them a step further with a fuller complement of healthy food choices.



Franchising is a powerful tool for promoting business ownership and entrepreneurship in Germany. By mitigating some of the risks inherent in starting a new business, franchising facilitates the jump to business ownership and, as in the case of Dietmar Wahnelt, can serve as a stepping stone towards independent entrepreneurship. As Germany makes the transition to a more service-oriented economy, this model of business ownership will prove to be a powerful tool in helping Germans achieve broader levels of prosperity.

*This article was written by Gokhan Afyonoglu, Marcos Contreras, Sean Meyer, Thomas Rose, and Christoph Weber, members of the Lauder class of 2010. Marcos Contreras acknowledges a graduate fellowship from the Fundación Pedro Barrié de la Maza.*





## The Brazilian Bioplastics Revolution

The production of plastics from renewable sources constitutes the next frontier in the search for ways to mitigate our dependency on oil and reduce our environmental footprint. The country at the forefront of these tantalizing developments, however, is not commonly perceived as being a technology powerhouse. Brazil is leading the way in this industry after decades of research and commitment to a technology based on sugarcane ethanol. The technology has proven to be environmentally sustainable and potentially capable of changing the way we manufacture everything, from personal care products to automobiles.

Since plastics are a fundamental material in modern life, making their production more sustainable can have an important positive impact on the environment. Annual plastics consumption worldwide has increased twentyfold since the 1950s, reaching around 150 million tons. It has been estimated that producing 1 kg of the most common plastics requires the equivalent of 2 kg of petroleum for energy and raw material, and releases approximately 6 kg of carbon dioxide. Green plastics could

leading petrochemical and plastics producer in Latin America, the development of bioplastics will not just contribute to the prevention of global warming and the depletion of petroleum resources; its recyclable nature will also impact on waste management in urban areas and unlock the potential to revolutionize the cycle of energy production and usage in all aspects, creating a self re-enforcing cycle of producing, recycling and reusing.

Green plastics, also referred to as bioplastics, are made from 100% renewable feedstock (such as plant-based ethanol), have the same specifications of petrochemical plastics and are completely recyclable. Bioplastics do not necessarily have to be biodegradable. As Jeffrey Wooster, senior value chain manager at Dow Chemical, the largest producer of plastics in the world, observes: "It really is about carbon emissions," and plastics produced from renewable sources have a net positive carbon footprint. Compared to the production of plastics derived from petroleum, which emits carbon dioxide (CO<sub>2</sub>) into the atmosphere, the production of green plastics actually absorbs CO<sub>2</sub> during sugarcane field photosynthesis. Between 2.1 to 2.5 kg of CO<sub>2</sub> are removed from the atmosphere for each 1 kg of green plastics manufactured.

Leading manufacturers Braskem and Dow agree that recyclable green plastics generally perform better than biodegradable alternatives in sustainability analyses. Biodegradable green plastics are less durable, cannot be easily disposed of because of the need to separate them from conventional recyclable material, and emit methane (a powerful greenhouse gas) when decomposing in landfills. On the other hand, green plastics effectively store the CO<sub>2</sub> absorbed during photosynthesis for extended periods of time as it is recycled and used in different

Since plastics are a fundamental material in modern life, making their production more sustainable can have an important positive impact on the environment.

hold great potential for alleviating these negative impacts. As noted by officials at Braskem, the

ways. At the end of their useful life, green plastics can be burned to recover their energy content.

According to officials at Braskem, the revolutionary aspect of these products is that they are renewable as opposed to biodegradable. In other words, they can be recycled without threatening the process, as would polylactic acid, for example, the most common biodegradable plastic produced from corn-based ethanol. At the end of its usable life, non-biodegradable bioplastics can be incinerated together with other urban waste to generate electricity or other types of energy. Considering the quickly dwindling sites for landfills in urban areas such as São Paulo and parts of Europe, the ability to sustainably incinerate waste and generate energy is also highly coveted.

The technology currently used in Brazil to manufacture green plastics is very efficient. Ethane, the raw material to make plastics, can be manufactured by simply removing one water molecule (H<sub>2</sub>O) from sugarcane ethanol through a dehydration process. In the end, the plastics produced have the same characteristics as conventional plastics derived from fossil feedstocks, such as naphtha or natural gas. Due to their characteristics, sugarcane ethanol-based plastics can compete favorably with conventional petroleum-based plastics and can even be sold at a premium to eco-minded consumers. Although no industry certification yet exists, carbon dating laboratories have been used to certify that the plastics produced are derived completely from renewable sources.

## Plastics from Cornstarch

Brazil is not the only country where bioplastics are currently manufactured. In the United States, the technology has been around for more than a decade, with corn as the most commonly used feedstock. NatureWorks, a joint venture between Cargill and Toijin, already has a plant that can produce 140,000 tons of biodegradable plastics from cornstarch in Blair, Neb. Metabolix, of Cambridge, Mass., is in the process of developing a plant to produce biodegradable plastics made from cornstarch. Also, following its \$8 billion strategy to double revenues from renewable sources by 2015, Dupont partnered with Australia's Plantic Technologies to produce plastics from cornstarch. At the same time, several projects have also flourished in Europe. Innova Films of Britain is building a new plant to produce 28,000 tons of plastic film made out of wood cellulose, while Novamont of Italy has

been manufacturing plastics from cornstarch and biodegradable polyester for more than 10 years.

However, production in these countries is less competitive in terms of cost and concentrated mainly on small-scale projects sponsored by specialized biotech companies. The recent increase in the price of oil has improved the cost competitiveness of renewable plant-based feedstock, particularly in Brazil, and encouraged large traditional petrochemical companies to embark on sizeable green plastics projects.

In June 2007, Braskem announced the successful production of the first internationally certified plastics made from sugarcane ethanol. One month later, Dow entered into a joint venture with Crystalsev, the leading Brazilian ethanol producer, to also produce bioplastics. Both companies have moved quickly to achieve commercial production. Braskem is now building a \$300 million plant at its existing *Triunfo* complex with the capacity to produce 200,000 tons of green plastics per year. Expected to come online between 2010 and 2011, this will be the first facility of its kind to enter commercial operation. At the same time, Dow and Crystalsev are developing the first integrated facility (sugar cane plantation and ethanol mill along with a plastics manufacturing plant) to produce bioplastics. This facility will produce 350,000 metric tons of plastics and is expected to start production in 2011, becoming a key part of Dow's growth strategy in Brazil.

Although the integrated facility will take longer to become operational, it will allow Dow and Crystalsev to take advantage of important synergies in the production process, such as the use of water that results from the conversion of ethanol into ethane and the co-generation of electricity using the byproducts of sugar cane production. Initially, Braskem will invest only in a plant to produce ethane from market-bought ethanol using this material as an input at one of its existing manufacturing plants. "We are pursuing this strategy in order to have first mover advantage in a booming market for environmentally friendly products," says Manoel Carnauba, Braskem's vice president of basic raw materials. Braskem's second bioplastics plant, scheduled to start production between 2012 and 2014, will be a totally integrated facility in order to exploit production synergies.

As a domestic player, Braskem has knowledge of the local ethanol market and good relationships with suppliers. For Dow, entering into a joint venture with Crystalsev was the best way to take

advantage of local ethanol production technology and access feedstock in high quantities. "Crystalsev has a leading edge in this business, a similar culture and compatible objectives, minimizing the risk associated in such a new thing," says Alberto Ulriksen, polyethylene product director for Dow Latin America.

For Dow, the project first emerged as a way to build a plastics asset base in Brazil and ensure access to competitively priced feedstock. "We did not have access to feedstock: We had to buy the ethylene. That's not the Dow model, really. The only way that we found out that we could actually set up in Brazil was via this ethanol feedstock. That was the main reason [for the project]," says Ulriksen. Nonetheless, sustainability goals also played a role in Dow's entry decision. "One of the things that has attracted us very much is the sustainability part because it is breakthrough in terms of carbon footprint and has a high value in the market," Ulriksen adds.

Braskem's venture into bioplastics was not driven by the need to access competitively priced raw materials, but by the opportunity to capitalize on the increased demand for green products. Having achieved cost competitive production of sugarcane-based plastics, Braskem is seeking to achieve product differentiation and to create a niche market for its product. "Braskem is positioning its bioplastic as a premium product that will command a higher price than conventional plastic. This strategy has nothing to do with cost. It has to do with the additional value that the product will bring in capturing CO<sub>2</sub> from the atmosphere and reducing the green house effect," says Luiz Nitschke, Braskem's biopolymer project director based in São Paulo. "Braskem expects its biopolymer [bioplastic] to sell for 50% more than the conventional petrochemical product."

Dow will market its green plastics product under the same brand it uses for its fossil fuel-based plastic resins, Dowlex. Although this brand enjoys high recognition among industrial customers, it is not well known by end consumers. On the other hand, Braskem is working with the marketing departments of companies in the automotive, food packaging, cosmetics and personal-hygiene industries, which can use green plastics applications to profit from the increasing demand for sustainable products. "If Braskem and its partners are able to create marketing value and to communicate it correctly, the product will be profitable regardless of the evolution of oil prices," argues Nitschke. In

September 2008, the company signed a distribution agreement with Toyota Tsusho, the trading arm of the automobile manufacturer, for the sale of its future green plastics production to Asian clients. Braskem also recently announced the certification of another type of green plastics that can be used in the automotive industry.

Braskem has been producing small product quantities at its testing facilities and is already marketing the product using high visibility consumer goods and sporting events. In June 2008, in partnership with Brinquedos Estrela, a leading toy manufacturer in Brazil, Braskem started producing the game pieces for "Sustainable Monopoly," an environmentally conscious version of the popular board game that is being sold in local Wal-Mart stores with great success. In November 2008, the Formula 1 Brazilian Grand Prix winner Felipe Massa received the first bioplastics trophy in the world made with Braskem's green plastics.

As an emerging-market multinational company, Braskem sees green plastics as a way to achieve global leadership. The company's ultimate goal is to become the leading green plastics producer in the world by leveraging its strong production base in Brazil, its first-mover advantage, and a technological edge built over more than 10 years of experience and important investments in R&D. Braskem sees a niche market in developed economies, particularly Europe and Japan, where studies have shown that consumers are willing to pay a premium for sustainable products and environmental regulations mandate the use of plastics made from renewable sources. According to company executives, Braskem has received solicitations for three times the volume it will be producing in 2010, or 600,000 tons. Still, this amount represents only 1% of the global plastics market.

For its part, Dow views its green plastics project in Brazil as one of the many innovative renewable strategies it is implementing around the globe. "This is like a drop in the ocean, but this drop has a greenish bluish color," states Ulriksen, who suggests that green plastics production cannot possibly replace all of Dow's fossil-based production, but it can certainly allow the company to enter the Brazilian polyethylene market. Nonetheless, Dow does not downplay the possibility of using Brazil as an export platform. According to Wooster, "Dow's global distribution channels will always be available to take advantage of foreign markets."

## 'Brazil Chose Us'

Brazil offers an exciting proposition for Dow and Braskem to explore plastics production from renewable resources, as it has a competitive advantage over other countries where it costs more than twice to make the same amount of ethanol. "We didn't choose Brazil, Brazil chose us," adds Ulriksen as a way to describe the attractiveness of Brazil as a platform for the production of plastics made from renewable sources. "Brazilian sugar cane production is a much more efficient way to produce ethanol than growing corn in the United States would be," says Wooster.

Brazil is, indeed, the leading and most efficient sugarcane producer in the world. Sugarcane in Brazil is used as the basic input towards a diverse range of value-added products such as food, biofuels, bioelectricity and, now plastics. Brazil began using ethanol as a fuel as early as the 1920s, gaining momentum during the 1970s oil crisis when the government introduced the ProAlcool Program. By providing tax breaks and subsidies to sugarcane farmers, investment flocked to the industry and large distilleries developed to convert the crop to ethanol, especially in the state of São Paulo. In the 1990s, the government withdrew its subsidies and lifted price controls on ethanol, creating the world's first self-sustaining market. Brazilian ethanol is competitive with gasoline, assuming the price of oil is at least \$40 per barrel.

Ethanol production is often criticized due to its alleged negative impacts on the food supply and the environment. However, these criticisms have no grounding in the case of Brazil. For starters, land is plentiful in Brazil, with ethanol production occupying only 1% of the country's arable land. In addition, approximately 65% of recent sugarcane expansion has taken place in mostly degraded pasturelands. Finally, there is still significant room to increase the productivity of land used for cattle grazing, reducing pressures on land availability for other agricultural uses.

Ethanol production is also far from threatening the Amazon rainforest. Not only has the growth in plantation focused on South Central Brazil, approximately 1,555 miles from the Amazon, but also the climate and land conditions in the Amazon region make the production of sugarcane economically unviable. Contrary to conventional wisdom, ethanol production from sugarcane does not have a negative impact on the production of other

agricultural goods. In fact, the production of both sugarcane and foodstuffs has increased steadily in Brazil in recent years. Brazil's emphasis on transforming sugarcane production into a high-performing and sustainable agribusiness has resulted in the highest ethanol production yields in the world and enabled a parallel increase in the production of other agricultural crops, such as cereals and soybean. On average, the ethanol yield of Brazilian sugarcane is 6.8 thousand liters per hectare, compared to 5.5 thousand for European beet, and 3.8 thousand for U.S. corn. Furthermore, new technologies are expected to significantly increase sugarcane yields in coming years.

The use of leading-edge technology and highly efficient operations at distilleries also means that Brazilian sugarcane ethanol delivers a clear cost advantage. Production efficiencies keep costs low at \$.23 per liter, compared to \$.39 per liter for corn-based ethanol in the U.S. and \$.52 per liter for wheat-based ethanol in Europe. These cost and resource advantages are attracting investor interest in the industry as well as increasing efforts by companies towards using ethanol to create products beyond fuel.

The country currently produces 487 million tons of sugarcane and 22 billion liters of ethanol. In the 2007-2008 sugarcane harvest, Brazilian ethanol production is expected to reach 22 billion liters. Throughout 2008, some 29 new distilleries are expected to come online, while investment in the industry is expected to total \$33 billion through 2012. Dow and Braskem both plan to use around 300 liters of ethanol by 2012 to produce green plastics in Brazil.

As stated by Bruno Pereira, plastic product development manager at Dow, "there is nowhere else in the world where a renewable feedstock, available on this scale, is produced so responsibly," thus confirming Brazil's tremendous potential to become the leading global producer, not only of ethanol, but also of bioplastics. Even with the recent decrease in oil prices, bioplastics production in Brazil remains very attractive due to its cost competitiveness and positive demand drivers, such as increased consumer interest in environmentally friendly packaging and a greater emphasis on sustainability on the part of product manufacturers worldwide.

In the future, consumers will be able to drive cars that not only run on ethanol, but also are partially made from it; consumers will be able to buy

alcoholic beverages in bottles made from alcohol and enjoy sugar candies wrapped in sugarcane plastics. However, there is still a long way to go. It is estimated that the annual global production of green plastics will increase to around one million metric tons by 2011, which represents only about 0.7% of the plastics used today. In fact, the 550 thousand metric tons of bioplastics that will be produced in Brazil by 2012 will meet less than 1% of world plastics demand.

*This paper was written by Rosalía Morales, Daniel Pulido, Summer Ticas, and María Trigo, members of the Lauder Class of 2010.*





## A Major Milestone in the History of Mexican Financial Markets

Improving access to capital inevitably appears as a top policy prescription in any economic stimulus geared towards growing small- and medium-sized businesses. This is no less true in Mexico, where small-to medium-sized enterprises (SMEs) employ half of all workers and account for approximately 70% of GDP, according to figures from the Organisation for Economic Co-operation and Development (OECD). The question that remains, however, is how to implement improved financing and through which institutions.

Despite liberalization of the Mexican banking sector over the past decade, banking service penetration remains low. Mexico's stock market — the *Bolsa Mexicana de Valores* (BMV) — remains an exchange for only the largest companies. As the *Financial Times* recently pointed out, the BMV has “fallen woefully behind” its Brazilian counterpart in terms of generating new listings. Aiming to replicate the successes of small exchanges in other countries, a group of Mexican businessmen under the leadership of founder Salvador Guerrero has established *Negocios Extrabursátiles*, an over-the-counter market designed to spur venture capital funding.

Though a closer look at *Negocios Extrabursátiles* reveals that it remains primarily an online bulletin board for small companies to list investment opportunities, its establishment and development to this point mark a major milestone in the history of Mexican financial markets. The next goals for the market will be to generate more transactions and begin electronic trading. The challenges it will face as it continues to grow demonstrate the underlying difficulties of improving financing opportunities for small- and medium-sized businesses in Mexico.

Mexico has more than 200,000 SMEs, yet the country's banking system does not typically provide these organizations with the financial and advisory support they need to grow and develop. According to Luis de Garate, director of the graduate finance department at the EGADE business school in Monterrey, Mexico, less than a quarter of all Mexican companies receive funding from the Mexican banking system. “Although credit has become more available for businesses,” Garate states, “these loans are [generally] not for investment, but rather for operations.” Almost 60% of companies receive their financial support from private sources — mainly family, friends or personal savings, which severely limits growth opportunities for most entrepreneurs. The BMV, meanwhile, is an inaccessible platform for these organizations. Listing costs are high, and only 20 new companies have been listed over the past five years — including just four IPOs in 2007.

Almost 60% of companies receive their financial support from private sources — mainly family, friends or personal savings.

Recognizing the market potential for small- and medium-sized businesses, Mexico enacted a new Securities Market Law in June 2006 (*Ley del Mercado de Valores*). This legislation was the critical cornerstone that *Negocios Extrabursátiles* needed to launch. The law permits businesses to issue securities without the registration and regulation

requirements typically associated with public offerings as long as they restrict the sale of their shares to a limited number of qualified investors. Participants in the market are able to issue shares, obtain loans and sell companies outright.

*Negocios Extrabursátiles* addresses the lack of formal funding options for private companies by creating an alternative capital market for these businesses. At the first stage in the process, the firm's directors receive notification of interest either directly from a small company or through government agencies involved in supporting small businesses. Unless basic financial statements already exist, *Negocios Extrabursátiles* directs the candidate to an auditor so that current finances can be reviewed and summarized. The business is then listed on the website ([www.negocioextrabursatiles.com](http://www.negocioextrabursatiles.com)) for review by potential investors who have registered with the organization.

### **Increasing the Number of Transactions**

*Negocios Extrabursátiles* has been working hard to generate interest among private investors and venture capital funds. To date, 218 companies are listed, but fewer than 10 transactions have closed. Increasing the number of successful transactions represents the firm's greatest challenge. Although the company generates income through subscription revenue from companies listed — and accounting and advisory firms that advertise on the website — *Negocios Extrabursátiles* will need to generate more income from transaction commissions to remain economically viable in the long term.

*Negocios Extrabursátiles* has two key advantages: its close relationship with the Mexican government and related small business associations, which provide a flow of clients at the correct growth stage; and the pure market logic inherent to small-business growth profiles. Two government organizations, *Nacional Financiera* (NAFIN) and the *Consejo Nacional de Ciencia y Tecnología* (CONACYT), provide a valuable feeder system of SMEs that are ready for the next stage of private capital to fuel their expansion plans. "The great majority of [the listed companies] come from NAFIN and CONACYT," notes Gabriela Basurto, director of financial development projects in the Secretariat of the Interior and Public Credit. The partnership is a symbiotic one: *Negocios Extrabursátiles* gains access to small businesses that are likely candidates for listing, while its government partners help clients receive growth capital and access to institutional investors. Should

the new market prove to be a successful financing alternative, these agencies' goals to foment economic growth and innovation through small enterprise will be more easily attainable.

From a pure market-logic point of view, the market is ripe for success in attracting investors looking for high-potential returns. Small businesses typically have higher growth profiles than larger, more mature companies (though with a concurrent increase in risk). As over-the-counter markets have focused historically on these smaller businesses, they have also had a history of higher average returns relative to other markets. Investors may be enticed by the high return opportunities afforded by this new market. In addition, as more companies list on *Negocios Extrabursátiles*, potential investors can diversify their holdings more readily.

Significant challenges remain for Mexico's young financial market. First and foremost, small businesses in Mexico continue to lack the necessary transparency to attract potential investors. The transparency question is arguably the largest, most challenging problem — not only for the success of *Negocios Extrabursátiles*, but also for any kind of formal financing for small businesses. Much of the problem is the result of the apparent cultural barrier within the companies, which are typically family-owned and unaccustomed to revealing financial data to outsiders.

The passage of the new securities law sought to address this issue by creating a new legal framework for small business transparency. When these companies meet certain defined levels of corporate governance, they receive a specific associated legal designation and become exempt from regulation by the National Banking and Securities Commission (*Comisión Nacional Bancaria de Valores*). Investors in these organizations then receive additional minority shareholder rights and protection — an enticing prospect. As Basurto explained, the law's intention is to encourage investment in small businesses from banks and private investors. Unfortunately, however, few companies have actually attained the legal requirements of transparency. According to Basurto, "Only a minimal number [of companies]" have satisfied the requirements to achieve the designation.

The transparency issue must be remedied in order for *Negocios Extrabursátiles* to be successful. If a greater level of transparency among small businesses does not become more highly institutionalized, investors will continue to shy away from



making significant investments, especially given the higher risk profiles of these businesses.

The second major issue for *Negocios Extrabursátiles* is one of market awareness. With only 218 companies listed, the firm and its government partners must do more to generate awareness — especially within the small business community. Messaging should focus on established companies where transparency is less of an issue, and standard bookkeeping and planning practices are in place.

In addition, *Negocios Extrabursátiles* should move beyond its advertising partnerships with advisory and auditing firms to develop a standard package of accounting and consulting services for new clients. Such an offering might help small businesses that are hesitant or unaccustomed to opening their financials to outside investors, while ensuring a competitive market among advisories to keep the review costs low.

Given the newness of the exchange, *Negocios Extrabursátiles* should focus on working closely with investors and small businesses to finalize a few more investments in order to demonstrate the market's potential. The website currently relies on investors to reach out and connect with potential portfolio companies, rather than making formal outreach to the investor community. Although the exchange currently has almost 100 registered investors, *Negocios Extrabursátiles* does not maintain contact with any of them, nor does it have knowledge regarding their investment interests. The authors of this article, for instance, signed up for the website but have yet to be contacted in the months since registering.

## Unfavorable Tax Laws

Next, there remain certain unfavorable tax laws in Mexico that make investing in public companies preferable to private ones. Under Mexican tax law, investors in privately held companies are subject to a capital gains tax withholding upon the execution of a sale of their investment, rather than being permitted to claim any gains only once on their annual tax returns. This withholding does not apply to investments in publicly traded companies, however, creating a significant difference in the cost of capital between the two markets. According to Basurto, the Mexican government is currently reviewing the BMV exemption, but no immediate action has been declared. If the government were to change the law to make the tax costs equal,

investors might be more willing to participate in the over-the-counter exchange — with a clear trickle-down effect benefitting SMEs.

Finally, *Negocios Extrabursátiles* lacks a secondary trading market, which severely limits the exit opportunities for investors. A secondary market would allow investors to liquidate their investments when desired rather than having to negotiate a complicated private transaction. The firm's ultimate objective, as envisioned by Guerrero, is to open a secondary electronic market for the resale of the shares and the debt that originates in the primary market. "The plan is to have a robust electronic platform by 2011 once we have shown that the primary market can function," Guerrero states. "[W]ithout the secondary market, it will be difficult to attract investors."

*Negocios Extrabursátiles* is addressing a clear market need. With small- and medium-sized businesses representing the largest portion of the Mexican economy, the sector's continued growth and development are critical for the country's economic well-being. Thus far, the commercial banking sector has been unable or unwilling to provide these businesses with the necessary growth capital, and public listings remain an alternative limited to very few organizations. And although wealthy individuals, small venture capitalists and investment arms of large corporations may be able to provide some support, they are neither a scalable option nor a long-term solution.

To date, however, *Negocios Extrabursátiles* has seen little investment activity, and its future outlook is unclear. While both the firm's managers and its government partners should push for greater market awareness, further growth will be hindered if larger structural issues in Mexico are not dealt with, including the culture of financial non-disclosure among small businesses, unfavorable tax laws and an overall unfamiliarity with over-the-counter markets in Mexico.

The extent to which *Negocios Extrabursátiles*, the Mexican government and various government agencies can effectively confront these issues will have a long-term impact on the over-the-counter market concept and small business financing in Mexico. *Negocios Extrabursátiles* could start by defining certain requirements for listed companies, such as dividing them by different levels of governance and transparency — a tactic that has proven successful in increasing market trade in other countries. The firm could also better

communicate its advisory and education services offered through its consulting partners. Given the market's innovative nature in Mexico, even if *Negocios Extrabursátiles* is limited by its size and resources, giving more aid to listing companies may be a necessary first step. All parties would benefit from a stronger hand connecting investors to the Mexican small business community.

At the same time, however, it does appear that the long-term success of *Negocios Extrabursátiles* is contingent on the creation of the secondary, electronically traded market — yet there is currently insufficient activity in the primary market to warrant a secondary platform. This presents a chicken-and-egg-type of problem. Only time will tell whether enough investors will be attracted, incentivized and matched within the market to allow the successful launch of a secondary market. The evolution and development of *Negocios Extrabursátiles* should continue to be watched. Even if it fails, valuable insights will be gained about how financing opportunities in Mexico and in other developing markets can be improved.

*This article was written by Geoffrey Moore, Diego Moreira, Mateus Panosso, Christopher Thornsberry, Gregory Wallace, and Jessica Webster, members of the Lauder Class of 2010.*



## Risky Business: An Entrepreneur's Perspective on the Brazilian Housing Market

Rafael became an entrepreneur when he moved to Brazil about a year ago to work in the country's nascent housing market. Before that, he was a successful portfolio manager at a hedge fund in London where he had been saving his bonuses and waiting for the right moment to strike out on his own.

Rafael identified an opportunity in the Brazilian real estate market, since all market drivers had forecasted a boom in this industry. The economy was growing at a 5.4% rate — thanks to its soaring agriculture, energy and agricultural industries — and was further aided by an escalation in the prices of commodities. Inflation finally seemed to be under control: It had decreased from 19.75% in 2003 to 13% in 2006, the government had been able to absolve most of its foreign debt, and the Brazilian real had appreciated more than 20%.

Brazil was also seeing very positive changes in demographics and income trends, especially in the middle class sector. Under Lula's populist government, redistributive initiatives such as *Bolsa Família* helped fuel the growth of Brazil's middle class as the average income of Brazil's poor went up 9% between 2001 and 2006. For the first time in history, the middle class now makes up more than half of the population. Indeed, it has grown from 44% to 52% over the last six years.

Some of the more exciting enticements for Rafael, however, were the new regulatory changes that were revolutionizing the industry. Since the late 1990s, proactive government policies, such as *Alienação Fiduciária*, have provided an exit strategy for banks in case a borrower defaulted on his/her loan; historically, banks are not permitted to confiscate a person's last asset. Basically, a legal trust could be established in which the bank owns the title of the asset through which the lender holds a lien. Once

the loan is repaid, the lien is removed and the trust transfers the property to the homeowner.

The past few years have seen the success of this structure, so confidence in home mortgages has escalated. Historically, Brazilians have been required to personally finance at least 70% of their homes' value, but in May 2007, banks finally began offering 30-year loans for up to 70% of the homes' value. From a macroeconomic standpoint, real estate lending represented only around 4% of the country's GDP, compared to 15% in Mexico and 18% in Chile. Finally, the government also has tremendous interest in new urban residential development and has backed this claim by promising more than R\$500 billion (US\$230 billion) in new infrastructure to support urban growth. Needless to say, Rafael saw the perfect conditions for a booming middle-class housing sector.

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For the first time in history, the middle class now makes up more than half of the population.

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By this time, Rafael was absolutely convinced about making the move into Brazil's housing sector as an entrepreneur. However, the question he asked himself was: "What angle do I want to take when I enter this market?" It was clear that the demand existed and was expected to grow to 22.6 million units by 2020, given the current conditions. It seemed very attractive to enter on the construction side as a developer since banks were offering attractive construction loans. In 2006 alone, Brazil's nine largest construction companies raised a total of

R\$5.8 billion (US\$3.8 billion) in the capital market. In addition, the conditions were excellent for low-cost prefabricated housing to reach some of the lower middle-class people with steady incomes.

However, considerable barriers made this option unattractive. First, Brazil's developers are very powerful since they are vertically integrated, have deeper pockets and political support, and already own considerable "land banks" for future construction. It would be extremely difficult for Rafael to compete with these players since he had neither the necessary capital nor the right contacts. Second, pre-fabricated housing is a relatively new technology that few Brazilian contractors know how to work with (only a few thousand units are produced per year), and Rafael had no experience in construction.

Rafael then decided to look at the financial side of the value chain because, after all, his background is in finance. Brazilian banks recently began offering long-term loan packages. However, banks lacked experience in this market. Rafael did not have the capital necessary to begin a boutique credit institution like the ones sprawling throughout Brazil, but he knew that he could partner with several banks as an independent broker. With his knowledge of finance, Rafael could make it as an entrepreneur by finding customers who qualified for loans, preparing their loan packages and selling them to banks.

### Positive Signs, at First

Initially, everything was on the up side for Rafael. Almost immediately, he was originating mortgages at a rapid pace, which banks were very keen to acquire. Rafael was also feeling good as interest rates continued to decline and demand for mortgages continued to increase. At the same time, Brazil's economy was growing rapidly: It experienced a net trade surplus in fiscal 2008, the first in its history. During the summer, S&P and Moody's elevated Brazil to investment grade, which Rafael hoped would bring longer-term debt at lower rates while expanding his client base for borrowers.

The only long-term problem Rafael saw was that property prices were escalating rapidly in Brazil's major cities due to the massive land and property buy-ups by the major developers. This would eventually be problematic because it could cause his middle-class client base to shrink as properties rose in value. Rafael's only solution for maintaining a growing client base was to diversify into Brazil's interior cities. Many of these cities — for example,

Curitiba and Vitoria — have been experiencing major growth in the past few years due to the rapid expansion of Brazil's service sectors. Property prices have remained much lower than in Brazil's major coastal cities.

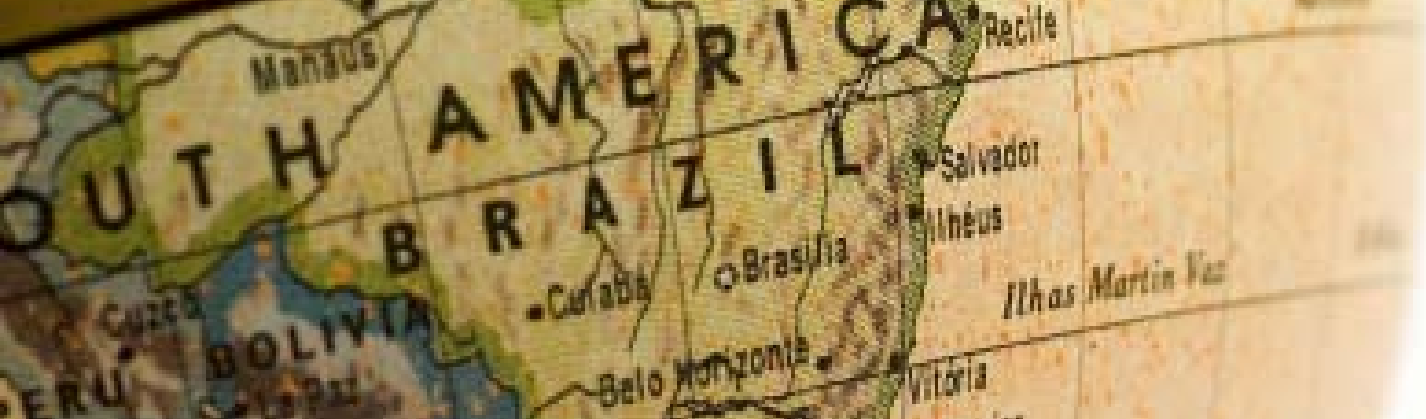
Rafael had accumulated great momentum by September 2008 and was already cash-flow positive within his first year in Brazil. But then things began to change dramatically. Until then, no spillover effect had been observed between the Brazilian economy and the U.S. Indeed, President Lula had declared that Brazil was immune to the U.S.'s economic woes since the U.S. no longer held Brazilian foreign debt and most of Brazil's trade was with China.

But due to the global financial crisis, Brazilian exports have stagnated, and Brazil's banks have watched their liquidity disappear. International investors, suffering from lack of liquidity in other markets, abruptly divested from this market. To make matters worse, prices for petroleum and other commodities plummeted as China reduced its imports in order to resolve its own liquidity and developmental problems. The real also saw a rapid depreciation from R\$1.52 to R\$2.4 (per US\$), and interest rates climbed up to 20% annually. In only a few months, the expected GDP growth had been reduced from 5.5% to 2.5%.

The impact on the housing market was dramatic. Fear of stagnation and lack of access to credit reduced consumer spending. For example, a large homebuilder saw its sales plummet by 25% over only a few weeks. In addition, banks halted long-term loans for real estate construction, freezing many projects throughout the country. Over a brief period of time, foreign investors linked to real estate fled Brazil, increasing volatility.

Rafael, who had been thinking of buying a motorcycle, now is not even able to secure its financing. He sees his investments in Brazil devalue at a time when his client banks have halted their lending. Although he correctly identified a billion-dollar opportunity in a developing country, his business is currently at stake because of external shocks caused in foreign markets. The need for housing and market potential has not disappeared; it has simply been put on hold for several years. One question remains: Is Rafael able to survive?

*This article was written by Marta Auleda, Gerardo Benítez, José Gómez, Juan Martínez, and Aleix Pares, members of the Lauder Class of 2010.*



## The Mexican Oil Dilemma: Refining Pemex

Mexico is running out of gas. The world's sixth largest producer of oil and America's third largest source of crude imports faces declining production at its primary oil fields, and the well may be dry in less than a decade. Meanwhile, the structure and management of Pemex (Petróleos Mexicanos), Mexico's state-owned oil monopoly, coupled with the government's historic dependence on its revenues, have limited the country's ability to bolster its reserves. And while the government celebrates the recent passage of a Pemex reform bill, the changes enacted are overly cautious. Experts predict that Mexico's reserves will run dry.

But all is not lost. The resulting turmoil may, in fact, save Mexico. The reality is that Pemex cannot simply be refined; it must evolve in the face of external pressures to remain viable and ensure Mexico's long-term energy independence. That change is coming, although it is taking an energy crisis to make it a reality.

What is causing the supply issues? According to the Ministry of Energy, Mexican oil fields are experiencing an accelerated decline. With its hands tied by the government, Pemex has been unable to allocate the necessary resources to explore new sources of oil. As a result, crude oil availability is forecast to decline from its 2003 peak of 3.5 million barrels per day to about 2 million barrels by 2016.

Conversely, demand for oil-derived products is rising — a demand that local production is currently unable to meet. Efforts are under way to increase production capacity, but because the country lacks advanced refineries, Mexico has negative trade balances in derivatives such as gasoline and fuel oil. Ironically, although the country is rich in oil resources, Mexico exports crude oil and then re-imports refined products, losing potential value and profit

to outsiders. Worse, the loss of self-sufficiency for both crude oil and refined products raises serious concerns about the nation's long-term security.

Pemex is owned and operated by the government. Company leadership changes every six years (tracking presidential term limits) and thus forces a short-term focus on profit making over long-term viability. Until the October 2008 reform, the organization was led by a board of directors consisting of members of the President's cabinet and industry union leaders. The uneasy power sharing between groups holding widely different interests has historically complicated decision making and inhibited the execution of a consistent company vision.

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It is estimated that the company pays four times more taxes than the average Mexican private company and three times more than other oil companies.

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### Tax Reform Needed

Compounding these challenges, Pemex must surrender significant amounts of taxes to the government. This means that reinvestment for growth is nearly impossible. It is estimated that the company pays four times more taxes than the average Mexican private company and three times more than other oil companies. The government relies on Pemex to supply the bulk (approximately 40%) of the fiscal budget. Company earnings are routed directly to the state, which then redistrib-

utes revenues to social projects and back to Pemex. Since social initiatives remain critical for maintaining popular approval, the Mexican government is often unwilling to pull funding away from health, education and other social initiatives in order to invest in the future of Pemex. Unfortunately, long overdue tax reforms aimed at decreasing government reliance on Pemex remain unpopular and have proven exceedingly difficult to implement.

Further muddling matters, competition — which stimulates innovation and efficiency — is lacking as Pemex is shielded by the nationalistic policies of the Mexican government, which awards it monopoly status within the country. Consequently, Pemex has not invested in research and development and now lacks the expertise needed to compete in a global market. For instance, deepwater drilling, which many believe is necessary to boost falling oil reserves, is beyond the Mexican company's technical capability.

Outsiders have the expertise to help, but even after the recent reform, Mexican law continues to ban foreign ownership or investment in oil exploration, production and transportation. Under the reform, Pemex expects to benefit from the expertise of outsiders by hiring them to explore and produce oil. But major oil companies may not find the proposition attractive without an ownership incentive. Thus, Pemex is structurally handicapped and, in many respects, hindered from accomplishing its goal of ensuring the energy independence of the Mexican state.

Pemex's predicament is a result of decades of mismanagement. In 1938, Mexico's oil industry was nationalized by President Lázaro Cárdenas in a populist move that redistributed wealth to citizens and affirmed the nation's sovereignty during a protracted recovery from the Mexican Revolution. The effects have been long-lasting: Energy is now defined in the Mexican constitution as a strategic sector and thus off-limits to foreigners.

The petroleum industry was expropriated by the government during modern Mexico's infancy and became a central part of its identity. Consequently, Mexicans have strong emotional ties to nationalized energy production, which is currently managed by Pemex. Ernesto Marcos, a former CFO of Pemex, describes the state-run company as "synonymous with the ultimate symbol of Mexican cultural identity: the Virgin of Guadalupe. The nationalization of petroleum is closely tied to our identity as a country and our sovereignty as an independent nation. It is almost a religious myth, an object of devotion."

Not surprisingly, a widespread belief exists that Pemex belongs to the people and should remain with the people. Many citizens believe that a public company puts food on the table and benefits the country, while a privatized company will benefit already wealthy, greedy foreigners and rob Mexicans of profits from oil. This historic backdrop framed the debate that led to the eventual passage of a weakened Pemex reform bill in late 2008, and will continue to color and restrain further initiatives to modernize the state-run organization.

In the debate over the Pemex reform bill, the country's historic relationship with oil was a critical issue. The three major parties — the PRI (Revolutionary Institutional Party), PAN (National Action Party) and PRD (Democratic Revolution Party) — accepted the need for reform yet struggled to agree on its execution. President Felipe Calderón's pro-business PAN party initiated the petroleum reform in hopes of making small changes that might grow into greater reforms permitting the transfer of international expertise critical for stabilizing reserves.

On the opposite end of the spectrum, the leftist-nationalist PRD has argued that any loss of sovereignty over the oil reserves would circumvent the constitution and directly violate the law. This resistance was crystallized by PRD founder Cuauhtémoc Cárdenas, whose father nationalized the industry, when he proclaimed resource availability concerns overly "alarmist" and proposed that nationalistic policies be passed to allow the necessary growth, development, and investment to come organically from within Mexico. The once-dominant PRI party stands somewhere between these two extreme positions. Many believe that this party — swing voters during the reform debate — hesitated to take sides in hopes of securing greater concessions from the rival parties.

Regrettably, the reform, handicapped by the country's politics and history, will not be enough to save Pemex. On the positive side, the bill approved by Congress contains several measures that will provide added flexibility and transparency to Pemex's operations. First, the reform will add independent members to the board of directors for more balanced, business-oriented, and less politicized leadership. Experts like Isidro Morales Moreno, director of government and public administration at the Technological Institute of Monterrey, believe the concept is admirable and that Pemex could certainly benefit from having experienced decision makers sit on a more balanced governing council. The reform also establishes an independent

auditing system, which should permit greater transparency in spending and decision-making.

## Addressing Critical Gaps

Finally, the reform grants more budgeting and management autonomy, freeing up the procurement process and adding agility to the organization. However, these changes, while improving matters, do not address critical gaps in Pemex's current structure. Weaknesses that remain unresolved include permission for limited private investment to help lower operating costs and improve performance, and a reduction in taxes paid by Pemex to allow budgeting for long-term activities such as exploration of new oil reserves. Moreover, provisions to attract the technology transfer required to stabilize reserves through deep-sea drilling were never completely addressed. Foreign companies may be hired to help and share their technologies, but may not invest in the Mexican petroleum industry. While the reform is lauded by all political parties, it remains too watered down to save Mexico from a future of energy dependency.

According to Marcos, the former CFO of Pemex, the reform leaves a lot to be desired. Each point reveals a weak compromise reflecting the controversial political climate and setbacks of previous reform attempts. For example, the "independent" members who will be added to the board of directors will be appointed by the executive branch. Not surprisingly, these experts will face the same political pressures as current Pemex leadership and suffer from the same shortsightedness, leaving one of Pemex's critical shortcomings unaddressed. In addition, the reform in its current incarnation does little to change the parasitic relationship that currently exists between the government and Pemex. The proposed reform does not relieve the inordinate tax burden on the company. Mexico's lack of tax base diversification represents a solvency risk for the government as oil fields dry up, gas prices fluctuate and exploration funds remain scarce or unpredictable.

For the Mexican people Pemex is many things: a cash cow, a revered national symbol, and a fundamental part of Mexico's sovereignty and independence. But at its core, Pemex is an oil company, and oil companies depend upon exploration to survive. As a state-run entity, the company is structurally incapable of funding the risks required to successfully explore for oil. There exist good alternatives to resolve this increasingly critical issue, but they involve the taboo of private investment. Due to Mexico's historic aversion to corporations and recent difficulties with the privatization of

other industries, any arrangement between Pemex and private interests will be difficult but remains promising. If newly discovered reserves prove sufficiently large, the nation would maintain its geopolitical importance as a secure source of oil.

Understandably, the critical points of independent governance, private investment and lower taxes are contentious and unlikely to result from any further reforms undertaken in the current political environment. Thus, Pemex and Mexico are on a collision course with crisis, a scenario that independent analyst group CERA believes will be necessary to stimulate action. Paradoxically, a crisis could catalyze the political parties to bury their differences and recreate a Pemex that can truly help Mexico address a changing energy world.

According to CERA, more than just a stronger Pemex is needed to resolve the situation. The technical, investment and risk-management challenges faced by the Mexican oil industry cannot be easily solved by a single company. To survive, exploration risk must be spread among private players, and Pemex must be permitted external partnerships in order to acquire needed technologies and skills.

Mexico is already forced to import refined oil products due to its insufficient refining infrastructure. As consumption continues to outpace exploration and development, Pemex will soon become unable to supply Mexican citizens and industries with a stable supply of oil. And as oil contributions to state revenue begin to evaporate, so may Mexico's resource-based credit rating and general investor confidence in its long-term stability. Falling oil prices may accelerate this looming crisis, creating the impetus for the cash-strapped government to implement real change and permit the organization to evolve more sustainably. A Pemex that is independently operated, funded and incentivized could become the new hallmark of the Mexican government. Just as nationalized oil solidified the base of a modern Mexican state in the early 1930s, a resilient, innovative Pemex could galvanize today's emerging Mexican democracy. Unfortunately, this prospect will likely require a crisis to unfold.

*This article was written by Megan Lan, Marcelo Silva and Renzo Weber, members of the Lauder Class of 2010.*



## La Michoacana: The Story of an Orphaned Brand

Anyone who has had a popsicle in Mexico is probably familiar with the La Michoacana brand. It is as ubiquitous as Burger King is to hamburgers or Dunkin' Donuts is to donuts. La Michoacana stores can be found anywhere — from the smallest villages to the largest metropolitan cities in Mexico and among Mexican immigrant communities in the United States. The signature product is called a *paleta*, a frozen fruit bar on a stick that comes in such flavors as spicy pineapple, cheese, and mango with chili. Although, at first glance, all La Michoacana stores appear to be alike, important differences indicate that they do not belong to a single franchise. The name suggests a common origin in the state of Michoacán, which stretches from the Pacific to central Mexico.

No one copyrighted or trademarked the name or the concept. Consequently, no single entrepreneur can claim ownership of the brand.

A common element in all of these stores — known as *paleterías* — is their name, which invariably features the words “La Michoacana.” Variants include La Fé Michoacana, La Michoacana Tradicional, La Michoacana Artesanal and La Michoacana Paletería y Nevería. Physically, all of these *paleterías* look similar: The format is typically an open-air storefront. Layout is kept simple and *paletas* are displayed in commercial freezers. The color scheme is pink and white. Fresh fruits, cheese nachos and fruit juices add a plethora of color. However, these *paleterías* do not pertain to any

single franchise, but rather constitute an “informal chain.” While many employ a common logo, there are variations in store layout, decoration and product selection. Given the differences and the lack of centralized management, what is the relationship across these *paleterías*?

The origins of the La Michoacana tradition provide clues to the mystery of its present configuration. A number of different stories suggest how it developed. One version is that in the 1960s, an ice cream maker from Tocumbo, Michoacán, worked in the United States and then returned home where he used his savings to launch an ice cream and *paleta*-making business. A competing version states that in 1932 (or 1942), Agustín Andrade and Ignacio Alcazar, also natives of Tocumbo, moved to Mexico City, where they worked at a *paletería* and subsequently launched their own store. They then brought the business model back to Michoacán, where it was emulated by other entrepreneurs.

### Family Connections

Regardless of which story is accurate, what is certain is that over the years, families from the region emigrated to other parts of Mexico, taking this business model with them. That gave rise to the ubiquity of *paleterías* in Mexico bearing the name La Michoacana or some variant thereof. Recipes, store set-up and the art of *paleta* production were mostly transferred via family connections. A 2003 *Austin Chronicle* article recognized that, at the time of La Michoacana’s inception, no one copyrighted or trademarked the name or the concept. Consequently, no single entrepreneur can claim ownership of the brand.

According to interviews with independent storeowners in Monterrey, Nuevo León, and Mérida,



Yucatán, many owners of La Michoacana stores now seek to establish legitimacy by claiming a direct family link to the original founders; authenticity is usually cited through a *tío* (uncle) or other relative from Michoacán. For example, the owner of La Fe Michoacana in Mérida proudly relayed that, “my husband’s uncle brought the knowledge of how to produce the *paletas* and ice cream from Michoacán to Merida about 40 to 50 years ago. He eventually taught my husband and transferred the business to him.”

This and other anecdotes illustrate the importance to storeowners of establishing authenticity by citing a family link to the founders. It also illustrates the problem of objectively attributing brand ownership. Given that Mexican trademark and copyright laws were not well developed at the time the La Michoacana concept first evolved, there is little evidence of early attempts to copyright the brand. In recent years, however, there has been a rush to capitalize on the brand due to several factors — the evolution of intellectual-property law in Mexico, business owners’ increased awareness of intellectual-property issues and the migration of La Michoacana to the United States.

No business ever takes branding lightly. According to the American Marketing Association, a brand is defined as the “name, term, sign, symbol, or design, or a combination of them intended to identify the goods and services of one seller or a group of sellers and to differentiate them from those of the competition.” According to this definition, the name, symbols and products associated with La Michoacana, indeed, constitute a brand.

La Tocumbita S. A., a company based in Tocombo, Michoacán, has attempted to leverage the brand power of La Michoacana through a unified brand image and standard product line. In the 1990s, Alejandro Andrade, the company’s director general, initially sought to develop a La Michoacana franchise. According to Andrade, attempts to convince the large number of independent storeowners to cede control were unsuccessful. In addition, by this time, many variants of the name had already been registered by other individuals with the Instituto Mexicano de la Propiedad Industrial (IMPI), the government body responsible for trademark, copyright and patent regulation in Mexico. This diminished Andrade’s ability to capitalize on the brand and further complicated trademark enforcement.

Andrade claims to have developed and trademarked the now ubiquitous and predominately accepted La Michoacana logo: an indigenous girl dressed in typical garb holding an ice cream cone with the words “La Michoacana—Es Natural” surrounding her. This logo proved to be highly effective and was eventually adopted by the majority of independently owned stores, mostly without Andrade’s authorization. For example, it became common business practice to stamp ice cream containers and freezers with the La Michoacana logo, with or without La Tocumbita’s permission.

Unauthorized permutations of the logo are also widespread. Some incorporate the La Michoacana girl holding a *paleta* in place of the original cone, while others contain variations on wording and font. La Tocumbita lacked the financial resources to enforce its trademark in Mexico and eventually lost control of the brand image it had developed. According to Andrade, “we really can’t do anything about it.... [W]hen I tried to fight [brand] piracy, I realized that I would have to spend large sums of money... and that I would never recover the cost [of doing so].... In the end, piracy far exceeded [our capacity to combat it].”

In response to these violations, La Tocumbita redefined its business model and began to offer pseudo-franchise packages to new, independent storeowners. The most comprehensive package consists of a step-by-step formula for launching a successful store, including everything from recipes to supply chain management. La Tocumbita provides advertising, equipment, and training and, perhaps most importantly, works closely with its clients. La Tocumbita’s business model, however, is different from that of a true franchise in two important respects. Storeowners are not obligated to follow the recommendations and standards put forward by La Tocumbita. Although the company receives payments for its services, it does not charge franchise fees. Once franchisees have successfully established their stores, they can choose to stop purchasing La Tocumbita’s services at any time. As Andrade points out, “we can’t force them [to conform] because we don’t sign a franchise contract ... due to legal loopholes in the registration of the trademark.”

Despite the challenges of piracy and the inability to enforce their trademark in Mexico, La Tocumbita’s business continues to grow. It claims between 400 and 500 total clients to date, with the number who have bought their full package at approximately 150. “My company continues to grow ... although not as

fast as I would like," he observes. Andrade's clients include several in the United States, though by the time he made his first moves into this growing new market, he found that he was blocked from using the logo and brand name he had developed.

## 18 Separate Trademark Applications

Given the success of La Michoacana in Mexico, it was only a matter of time before Mexican immigrants brought the brand to the U.S. Growth in the U.S. followed a pattern similar to that in Mexico: Independently owned stores characterized by the La Michoacana theme proliferated throughout the country. Numerous entrepreneurs in the U.S. have tried to lay claim to the La Michoacana brand by attempting to trademark it themselves. Public records at the U.S. Patent and Trademark Office (USPTO) contain at least 18 separate trademark applications for some variant of the name and logo.

According to a 2005 *Wall Street Journal* article, La Tocumbita did not immediately attempt to trademark its signature logo with the USPTO. Andrade claims that by the time La Tocumbita sought to market its services to customers in the U.S., American *paleta* manufacturers had already adopted the logo and brand image that he had developed. The *Wall Street Journal* cites one such company as Paleterías La Michoacana, based in Cerres, Calif., which mass produces *paletas* and ships them to supermarkets, convenience stores and snack-cart owners throughout the U.S.

Paleterías La Michoacana uses Andrade's original logo and brand image without paying royalties. Although Andrade attempted to set up a licensing agreement with this company in the U.S., he claims that owner Ignacio Gutierrez refused to comply. According to the *Wall Street Journal*, Gutierrez disputes La Tocumbita's claim to ownership of the logo and brand name.

After several other manufacturers in the U.S. also attempted to use the brand image, Paleterías La Michoacana moved to register the name with the USPTO in 2003 and filed to trademark the signature logo *La Michoacana—Es Natural* in April 2008. It is unclear what legal recourse, if any, La Tocumbita now has to contest the claims of Paleterías La Michoacana and enforce its Mexican trademark in the U.S. "Where I sell a dollar, he sells a million.... I don't have the resources to combat [brand piracy] here in Mexico, much less in the United States," says Andrade.

Unable to leverage its brand image in the U.S., La Tocumbita has decided to focus its U.S. business on selling services and equipment to storeowners. Packages now also include helping clients to develop and trademark their store brand, which is typically a variation of the La Michoacana theme. As Andrade states: "We tell [our customers] that we don't want the same thing to happen to them as happened to us in Mexico [with respect to the piracy of their brand names]."

The case of La Michoacana illustrates the importance of international brand protection and trademark enforcement. It is an example of a universally recognized "brand" that is not a concept or item attributable to a single company. Rather, La Michoacana developed through the efforts of multiple protagonists who created and fostered the growth of this cherished Mexican phenomenon. The La Michoacana story illustrates the complexities of entrepreneurial brand development in a rare demonstration of an orphaned brand owned by none, but loved by all.

*This article was written by Hussein Kalaoui, Stacey-Ann Johnson, Nicole Karlisch, and Leeatt Rothschild, members of the Lauder Class of 2010.*

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# FIRST-HAND PERSPECTIVES ON THE GLOBAL ECONOMY



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