

**The Lauder Global Business Insight Report 2011**

# ON THE MOVE: ADAPTING TO A NEW GLOBAL ECONOMY





## Introduction

### **On the Move: Adapting to a New Global Economy**

In this special report, students from the Joseph H. Lauder Institute of Management & International Studies analyze some of the more far-reaching changes affecting people, industries and regions around the world.

The articles offer new perspectives on trends that will shape the coming year, including the emergence of a high-tech sector in Russia, the growth of private equity in Brazil and China, and the rise of social investing in France. Industries undergoing significant change are analyzed in articles about new media-driven ventures in the Middle East, improvements in educational opportunities for lower- and middle-class Mexican students, the rise of solar power in France, China's push to speed up the manufacture of electric cars and Mexico's initiatives to promote sustainable housing.

Other articles look at the production of unique regional products in Japan, and an innovative French company that offers clients opportunities to become wine experts. The sports business is explored by examining new forces shaping China's approach to promoting basketball, and the ways in which Brazil may, or may not, benefit from the 2014 World Cup.

The rise of German patriotism, the economic impact of the drug wars in Mexico, and how new urban prosperity in parts of China is affecting the strategy of multinational retailers are also analyzed.

Taken together, the 16 articles identify existing opportunities and challenges for conducting business within specific cultural, political and institutional contexts, especially in light of dramatic events that have buffeted the world economy over the past two years. The articles are part of the Lauder Global Business Insight program.

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## Solar Power Incentives in France: Subsidization without Planification?

*Worldwide, energy policy has come to the fore as a driving force in domestic and international politics. Higher prices, coupled with potential environmental damage from the use of traditional fuel sources, have driven governments to search for alternative energy sources while simultaneously attempting to bolster their countries' access to the fossil fuels that will most likely drive economic performance in the short- to mid-term. In France, these recent pressures have given rise to a host of subsidies and policies designed to encourage a shift of energy production from conventional to renewable. Solar is one area in which the French have invested heavily.*

Worldwide, energy policy has come to the fore as a driving force in domestic and international politics. Higher prices, coupled with potential environmental damage from the use of traditional fuel sources, have driven governments to search for alternative energy sources while simultaneously attempting to bolster their countries' access to the fossil fuels that will most likely drive economic performance in the short- to mid-term.

In France, a nation that has traditionally been somewhat insulated from the need to purchase fossil fuels due to a strong nuclear power-generation capability (more than 77.9% of electricity production), these recent pressures have given rise to a host of subsidies and policies designed to encourage a shift of energy production from conventional to renewable. One area in which the French have invested heavily is solar. Two firms that stand out in this effort, Redavia and France Panneaux Solaires, have used subsidies to build profitable solar-panel installations on both commercial and residential scales. A third, Saint-Gobain, is focused on technology, innovation, and manufacturing.

French subsidies have facilitated the creation of a nascent market for solar energy and solar energy production capacity, although significantly more work remains

to catch up to more advanced countries, including European counterpart Germany, especially in technology R&D. Alternatives for more activity exist, including the possibility of additional French government involvement in the solar energy sector.

### Pressures in the Global Energy Market

Demand for energy has never been stronger. Over the past 40 years, consumption of fuel has doubled, rising from just over 4,000 Mtoe (megatons of oil equivalent) in 1971 to over 8,000 Mtoe in 2007. Electricity generation has increased even more dramatically over the same period, ballooning from 6,000 TWh (terawatt hours) to nearly 20,000 TWh, a growth rate of 3.4% per year sustained over 40 years. Recent growth has been driven largely by China and other developing economies: the OECD represents only 48% of total energy production today, compared with 61% in 1973. In contrast, China's share has increased over the same period from 7% to over 16%, an increase in absolute terms of over 400%. With the increasing importance of these new entrants and a full recovery from the recent economic crisis around the corner, growth in fuel and energy consumption will continue for the foreseeable future.

Within this context of overwhelming demand, it is not surprising that the price of energy is climbing as well, especially given a worldwide reliance on deposits of fossil fuels that are increasingly more expensive to extract. In France, for example, the price paid by industry for 100 kWh (kilowatt hours) of electricity increased from €2.5 (US\$ 3.25) in 1983 to nearly €6.0 (US\$7.8) today. Even more disturbing, the price of 100 kWh of energy produced from gas and heavy fuel has doubled from about €2 (US\$2.6) to €4 (US\$5.2) in the span of less than a decade — from 2000 to 2008.

In addition to causing a rapid increase in energy prices, the worldwide dependence on fossil fuels has contributed to overproduction of greenhouse gases, including CO<sub>2</sub>. While no binding international agreement including the U.S. and China has been signed as yet, European countries — including France — have generally agreed to meet targets to reduce the total output of greenhouse gases over the next few decades. Reductions will come from a combination of penalties for greenhouse-gas production in the form of tradable “carbon credits” as well as subsidies designed to shift economies to renewable sources of energy.

On the flip side, the past few years have witnessed a dramatic fall in the price of solar energy, a trend that will continue into the future. As an example, photovoltaic (PV) cells placed on a rooftop in Paris today produce energy at an average cost of €0.31 (US\$0.4) per kWh, down from €0.39 (US\$0.5) in 2007. This is still a long way from the €0.06 (US\$0.08) to €0.11 (US\$0.14) price range that would make solar energy cost-competitive with utility bulk power, but in some markets, such as Los Angeles, solar energy is already cost-competitive with peak rates. Cheaper production of more efficient PV cells will eventually make solar energy cost competitive even in markets in less sunny locations.

The confluence of rising energy prices, the threat of environmental damage, and the increasing competitiveness of an alternate energy source have pushed the French government to offer several layers of subsidies — primarily in the form of subsidies per kWh produced and income tax credits — to hasten the development of a competitive market. These subsidies include (1) a requirement that Electricité de France

(EDF) buy solar-produced energy at a rate that varies from € 0.31 (US\$0.4) to € 0.58 (US\$0.75) per kWh instead of the market rate of € 0.11 (US\$0.14), (2) income-tax credits for the installation of renewable energy sources, (3) direct subsidies for the installation of solar panels, and (4) 50% income-tax credits on labor wages during the installation of renewable energy materials. These incentives are designed to achieve grid parity, the point at which alternative energy production costs and market energy prices will be equal, artificially. To this end, rates are not uniform: Lower-cost renewable energy producers are compensated at lower rates than higher-cost producers, and companies operating in places with higher solar incidence receive lower subsidies than companies operating in less attractive regions.

The government will reduce these subsidies over time as the cost of solar energy production decreases. In the meantime, a nascent market for solar energy has begun to develop, thanks to the demand stimulus provided by the government and the activities of a number of firms.

### **Redavia: Solar Development on a Commercial Scale**

The primary result of France’s solar energy policy is that it has become profitable, after subsidies, to install and operate PV panels in most parts of the country. This, in turn, has led to a proliferation of project-development companies that find and secure land and financing to create new installations. In general, these companies fall into two broad categories: those that deal with large tracts of previously unusable, unused, or lightly used land to create solar installations on a commercial scale and those that deal with small-scale installations of solar panels in urban settings. In both cases, the key is that the companies are profitable thanks to government subsidies. As the government scales these subsidies back over time, companies will need to operate at a lower cost basis or expand their business models.

Redavia, a French company founded in 2010 by Erwin Spolders, finds land and financing to build PV panel installations on a commercial scale. Previously CEO of Q-Cells International France, a solar-panel manufacturer based in Germany, Spolders has a background in the solar industry as well as a strong network of contacts

in project finance. He saw a significant opening to take advantage of French subsidies for solar power to develop previously unused or underused land and created Redavia to pursue this opportunity. Under his leadership, Redavia has moved to the forefront of the charge to use government subsidies to create a solar energy market in France.

In many ways, Redavia is typical of other companies building commercial-scale PV installations. The company acts primarily as a broker between landowners, financiers, and panel operators. First, the company identifies a new site — typically old agricultural land, quarries, or even military bases. Redavia works to sign a lease with the landowner and to obtain all the necessary permissions and authorizations from the government and from EDF to create a PV panel installation. Next, the company identifies sources of financing — frequently external debt, sometimes Redavia equity — and negotiates all the necessary contracts with the panel-construction contractor as well as EDF to ensure connection to the electrical grid.

After all the paperwork and agreements are in place, Redavia supervises construction of the PV installation and its connection to the grid, and manages operations for a limited period of time. Finally, the company frequently looks to sell its interest in the project to a third party. Over all, Redavia contributes its expertise in project development in exchange for fees. The company is able to take very little balance-sheet risk, leaving that to banks and other players that have access to cheaper capital.

According to Spolders, the business has been highly successful to date but will require continued innovation to ensure further growth. Redavia is considering several new opportunities to anticipate that movement.

### **France Panneaux Solaires : A Small-scale Developer**

On the other side of the panel-installation landscape sit a number of companies that facilitate residential or smaller-scale installations. Among them is France Panneaux Solaires (FPS), founded in Vannes, Brittany, in 2006. FPS provides all the services necessary to manage solar installations for small customers, frequently on rooftops. These services include studies of need, studies of site appropriateness, physical installation of

the panels, management of all administrative and legal paperwork and processes, connection to the EDF grid and operation, provision of insurance, and maintenance. Since its inception, FPS has installed over 3,000 solar panels throughout France.

FPS's success is due largely to government subsidies, as is the success of all companies in its sector. To better understand the importance of subsidies in the residential solar industry, consider a case study of potential cash flows for the *Chambre de Commerce et Industrie de Paris* (CCIP), a large building in the center of Paris. An investment of €24,000 (US\$31,200) would allow the CCIP to cover its roof with solar panels, generating over 2,700 kWh of energy annually. Securing a 20-year contract with EDF at €0.58 (US\$0.75) per kWh would then allow the CCIP to generate over €1,600 (US\$2,080) annually and pay back the investment in 12.83 years. A positive cash flow would then be generated during the remaining seven years and two months of the contract, earning €12,000 (US\$15,600) in the process. This potentially profitable venture will come to fruition only because of the important subsidies: Over €26,000 (US\$33,800) of revenues — or 80% of cash flows during the 20-year production period — would be paid directly or via subsidy by the French government. In the residential sector, too, government subsidies have facilitated the proliferation of solar-panel installations.

### **Saint-Gobain: Technology R&D**

Although France lags behind other countries in alternative energy R&D, government subsidies have created an environment in which a few large multinational French-based companies, such as Saint-Gobain, have been able to expand solar panel research and production early in order to establish market share and develop industry-leading technologies in an otherwise potentially unprofitable segment.

Established in 1665 and with 2009 revenues in excess of €37 billion (US\$48.1 billion), Saint-Gobain is one of the world leaders in construction materials, particularly external glass and cladding. The company recently increased its public status in North America by manufacturing the glass for the eye-catching Skywalk suspended over the Grand Canyon. However, in attempting to enter the PV solar-panel manufacturing

industry, the company encountered stiff competition — most notably from First Solar in the U.S., Suntech in China, and Q-Cells in Germany.

As a latecomer, Saint-Gobain decided in 2006 to enter into a partnership with Shell Solar (a division of oil giant Royal Dutch Shell) to create Avancis, a leading PV research firm that developed the world's first commercial series production of CIS PV cells in California in 1998. To capitalize on the French subsidies, Saint-Gobain placed Avancis in its innovative materials division, which employs 60,000 employees worldwide and represents over 65% of Saint-Gobain's annual R&D budget.

In 2010, due in large part to the increasing demand for subsidized PV panels in Europe, Saint-Gobain decided to build a second plant in Torgau, Germany, to produce high-efficiency PV modules. This new Avancis plant will have a production output of 100 MWp per year.

### **French Solar Power: A Qualified Success**

Overall, it is clear that French subsidies have worked. While French electricity consumption increased from 478 TWh in 2006 to 486 TWh in 2009, new PV solar panels installed in the country increased from 8 MW in 2006 to 285 MW in 2009, of which 100 MW of capacity is still awaiting approval to be connected to the grid. In comparison to its neighbors, however, France is lagging. Germany and Spain, which surround France geographically and share similar regulatory environments with France, are commonly accepted as the industry leaders in PV; France is not. This leadership extends from actual PV installations to the perhaps more important field of R&D.

Spanish PV installations have been encouraged since 2007 by means of Royal Decree 661, which established the current subsidy environment. From 2006 to 2008, annual installations of PV panels in the country increased from 88 MW to 2,605 MW, or almost 30-fold in two years. In 2009, the market took a step back. Due to a combination of the credit crisis, cutbacks in guaranteed electricity payments, and a cap system limiting new installations, new panel installations in Spain dropped to only 69 MW. The European Photovoltaic Industry Association (EPIA) forecasts that installations in Spain will bounce back to 600 MW in new capacity in 2010 and will remain at that level until

2014. If political pressure plays a greater role, the total could reach 1,060 MW by 2014.

Germany's performance in the area of solar-panel installation has been even more impressive, a result that should be expected from a country with the most stable subsidy system in Europe. Germany's first law promoting the use of renewable energy dates back to 1991. However, the Renewable Energy Law of 2000 has driven most of the country's success in promoting alternative energy sources. New PV installations in Germany jumped from 843 MW in 2006 to an astounding 3,806 MW in 2009 — an increase of 315% in just three years. EPIA expects that Germany will install between 5,000 MW and 7,000 MW in new PV panels in 2010.

France has lagged behind Spain and Germany in solar-panel installation in the past, but this may be changing. EPIA estimates that France could reach 660 MW to 1,300 MW of new annually installed capacity by 2014, provided that administrative procedures are softened and support mechanisms accompanied by political drive are put in place. This scenario would make France one of the major solar energy producers in Europe. But the country appears to have a much more serious issue with R&D. According to Jason Matlof, a partner at Battery Ventures, an American venture-capital firm, "the French are way behind and far from leading the industry. Ten to 15 years ago, they had a few good companies, but no longer." He mentioned only Saint-Gobain as a French company offering much in the way of solar-technology development.

Why has France lagged while Germany and Spain have sped ahead? According to Matlof, the answer is most likely a combination of later and lesser subsidies for PV installations, combined with a lack of commercial incentives to get manufacturers to locate in France. As France considers its next few moves in energy policy, the examples of its closest neighbors will certainly drive the country's decisions.

### **The Future of Solar Power**

As the French example illustrates, subsidies can help build the foundations for a strong solar energy industry. Eventually, this industry will drive down the cost of solar energy until price parity exists with conventional energy, at which point solar can become self-sufficient.



This is the theory. In reality, it is unclear when price parity will be achieved and to whom the value of solar energy will accrue. It could be five years or it could be 20. The winners could be the French, the Germans, or the Chinese. Governments could allow a proliferation of private companies to reap the rewards of new energy sources, or they could place power and profit in the hands of state-run monopolies. Other questions arise: Will solar energy ever be profitable in northern Europe, with its low level of direct sunlight? Will the electricity grid ever be able to handle a less predictable form of energy and will people be able to store sunlight-created energy for the cold winter months? Will entrenched energy interests drive political will away from the transition to renewable energies?

Despite the concerns, there is promise in the interplay of (1) government subsidy and direction and (2) private initiative, as the French experience shows. This is exactly

the type of market — where real innovation in both technology and business process is needed — in which private companies are most helpful. In the presence of broad direction from the government, companies like Redavia, France Panneaux Solaires, and Saint-Gobain have been able to flourish. They are building the next generation of energy-production capacity, and they are finding ever-more-creative ways to do so. As long as the French government continues its support for the solar energy market, does more to encourage production as well as installation, and refrains from choking the market with undue regulation, the solar market will be a major contributor to electricity production in France.

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## Skolkovo: Russia's Emerging Silicon Valley

*Twenty years after its collapse, the lingering legacies of the Soviet Union continue to prevent Russia from re-emerging as the superpower it once was. Its latest initiative, Skolkovo, has the potential to be the solution the country has longed for since the days of perestroika. It is Russia's first real attempt to transition from the Industrial Age of the twentieth century to the Digital Age of the twenty-first. If Skolkovo can successfully achieve its objectives, it will position Russia once again among the technological and ideological leaders of the world.*

“We intended for something better, but it turned out just as it always does.”

This famous quip, coined by Russian politician Victor Chernomyrdin in 1993, has become a catchphrase in post-Soviet Russia. It perfectly summarizes the attitude of contemporary Russians toward innovation or any attempt to enact change in Russia. A sense of helplessness has dominated the collective consciousness in the face of pervasive corruption, bureaucracy and outdated Soviet mentalities rampant in the country.

Twenty years after its collapse, the lingering legacies of the Soviet Union continue to prevent Russia from re-emerging as the superpower it once was. Its latest initiative, Skolkovo, has the potential to be the solution the country has longed for since the days of *perestroika*. It is Russia's first real attempt to transition from the Industrial Age of the twentieth century to the Digital Age of the twenty-first. If Skolkovo can successfully achieve its objectives, it will position Russia once again among the technological and ideological leaders of the world.

### Creating a New Russia

In all of Russia's tumultuous history, the last 100 years have seen perhaps the most influential political and social upheavals, which have had a dramatic effect on the Russian psyche. Communist leaders Vladimir Lenin

and Joseph Stalin radically transformed a poor country with centuries of outdated agrarian traditions into one of the most modernized industrial nations in the world. The rapid industrialization catapulted the Soviet Union to the forefront of the global political economy, making it a superpower comparable to the United States. Yet the Soviet Union's demise was a result of its sustained path to industrialization and its underestimation of the vital importance of diversifying its base of technologies in a new information age — one focused on computers and nanotechnology.

According to Sergey Medvedev, a professor at the Higher School of Economics in Moscow and no relation to Russia's current president, “The Soviet Union collapsed partly because the state could not transition to the Information Age. The USSR became complacent — a victim of its own success. Bigger was no longer better. Russia stayed the modernization course at full speed ahead, while the rest of the world transitioned to new technology based on knowledge and to new organizational schemes based on networks.”

Russia's current leadership understands the past failures and is taking the steps necessary to position Russia back at the forefront of the global political economy. Such power moves intend to expedite the country's revitalization, revealing true foresight and a

commitment to the goal of advancing Russia into the Technological Age.

Recently, Russian leaders have made efforts to bolster the country's presence in the technology sector. In June 2010, Russian President Dmitry Medvedev made a special trip to California's Silicon Valley prior to attending the G8 and G20 summits. He met with representatives from Google, Apple, Cisco and Twitter, among other major tech companies. He hoped to entice them to invest resources and establish operations in Russia, specifically in Skolkovo, a small region just 12 miles west of Moscow where an innovative new business technology center is being developed. Because of Skolkovo's proximity to the heart of Russian power and enterprise, the new technology center is expected to get the governmental, financial, and entrepreneurial support necessary for its success.

Two major projects are already underway in Skolkovo as a result of collaborations between prominent business leaders and the government. Innograd — literally meaning “innovation city” — will be a cluster of numerous technological companies in one geographic location, referred to by the media as the “Silicon Valley of Russia.” In addition, a second project, establishing a newly founded and privately funded business school called “Skolkovo-Moscow School of Management,” is also underway; its campus just opened for the fall 2010 semester.

## **Innovation and Entrepreneurship in Post-Soviet Russia**

According to Courtney Bain of the University of Glasgow, it should not be at all surprising that in the years immediately following the collapse of the Soviet Union, there was little to no support for innovation in Russia. For almost an entire century leading up to 1990, the country had not allowed entrepreneurs to participate in the economy. All private enterprise had been banned or brought under direct state ownership and control. In the late 1980s and early 1990s, however, the situation for entrepreneurs in Russia slowly and gradually began to improve.

Beginning with Gorbachev's *perestroika* reforms in 1987 and 1988, the state began to loosen its iron grip on small and medium-sized enterprises. Then, in 1992, under

Russia's first popularly elected president, Boris Yeltsin, the new Russian government passed radical legislation in an effort to transition the former Soviet economy to a new free-market system in which innovation could reign. Another law, “On State Support for Small Business in the Russian Federation,” was passed in 1995 to further stimulate and regulate the newly created small-business sector of the economy. This law planted the seeds for Skolkovo, calling for government support of the information sphere, such as “assistance with modern equipment and technologies including the creation of a network of business technoparks and business incubators.” Despite all of these efforts by the new Russian government, however, the laws proved virtually powerless in light of the pervasive corruption and thuggery in the early Russian Federation.

Following the financial crisis of 1998, it seemed that all of Yeltsin's efforts would be for naught. The small business sector had once again all but disappeared. When Vladimir Putin came into power upon Yeltsin's resignation in 1999, he continued many of his predecessor's policies. In his introductory speech, Putin said, “it needs to be recognized that without the development of [the small business] sector in the country, there will neither be a steady improvement in economic growth, nor an improvement in people's lives. The more people are involved in small business, the more stable and healthy is the Russian economy.”

The difference between Putin and Yeltsin ultimately came down to the fact that Putin ruled Russia with an iron fist and brought more control back into the hands of the federal government. According to Bain, this fact, combined with the economic recovery that followed the financial crisis in 1998, has led to steady growth in the number of small- and medium-sized enterprises every year since 1999. Between 1999 and 2004, the Russian economy grew 48%, the value of the ruble completely recovered, wages increased and unemployment declined to 6.8%. Despite all the economic progress Russia has made in the last decade, however, entrepreneurs still face some of the worst bureaucracy, red tape and most expensive capital anywhere in the world. The Russian administration still has much to do to bring the level of innovation and ease of entrepreneurship on par with its counterparts in the West.

## The Silicon Valley of Russia: Innograd

The global financial crisis of the past two years has exposed Russia's one-dimensional economy — one focused mainly on oil, gas and metallurgy. But unlike previous Communist leaders Krushchev and Brezhnev who resisted change, current democratic decision-makers Medvedev and Putin have realized that Russia's main dependence on limited natural resources is headed toward a dead end. The prevalence of technological innovations and a heightened awareness of “green” initiatives around the world have recently weakened the demand for oil and gas. One of Innograd's major goals is to foster an environment of technological innovation and thought leadership in Russia. The Innograd technology center will focus on research in five priority spheres: energy, information technology, communication, biomedical research and nuclear technology.

Shiv Vikram Khemka, vice chairman of SUN Group and co-founder of the Skolkovo School of Management, believes Innograd will revolutionize the landscape of the Russian economy through diversification and development of essential business sectors in the twenty-first century. “Skolkovo has the potential to bridge the gap between Russia and the rest of the modernized world,” he stated, “and could even serve as the model for other developing countries like China and my home country, India.”

Why should international companies risk entering this new market? First of all, establishing operations in Russia now gives major technology companies a stronghold in one of the key emerging BRIC countries. These companies can access an educated work force that is also cheaper to employ than those in the U.S. and other fully modernized nations. For example, computer programmers and IT professionals in Russia are paid on average about 55% less than their U.S. counterparts. In combination, these are financially enticing incentives for U.S. companies to build business operations in Skolkovo.

In addition, nearly 43% of Russians have university degrees that have equipped them to pursue advanced research programs and highly skilled jobs. More importantly, of all university graduates, 27% graduate with a specialization in science or technology disciplines, compared to only 16% in the U.S. With such a strong

emphasis on science and technology, Innograd should be able to find an ample supply of qualified professionals eager to advance their careers. Furthermore, Innograd can incentivize qualified Russian professionals to remain in Russia to work on technological advances, as opposed to leaving the country for better opportunities and greater financial rewards. By reducing and ultimately eliminating the current “brain drain,” Russia can further position itself as an innovative leader in the technology sector.

Finally, international technology companies will be able to see that the Russian government is actively vying for their business and will support their new ventures. Companies will be given access to tax breaks, incentives and fewer regulations. Russia already boasts a corporate tax rate of 20% and an individual tax rate of 13% — much lower than the 35%-40% rates found in the U.S. Presumably, these political and financial incentives will motivate companies to establish operations in Russia.

## Potential Pitfalls of Innograd

If successful, the Skolkovo project will re-establish Russia as a thought and business leader in the global economy. But the question remains whether foreign support will be enough. To attract innovative companies and venture capitalists, basic systematic improvements must be made in the government. For example, unless Russia reduces the political red tape and addresses the day-to-day corporate corruption that is commonplace, U.S. and other foreign businesses will more than likely be deterred from entering.

There are other reasons that the idea of Innograd may be limited to just that — an idea that will never become a reality. Opponents of the Skolkovo project fear not only that it will fail, but also that the funding will be misused, stolen, or “suspiciously” spent. As Professor Medvedev noted, “Everything in Russia is a scheme; everything eventually turns into massive, legalized theft.” Although he believes the overall concept of innovation and nanotechnology is necessary for Russia's development, he doubts it can be implemented successfully under Russia's current political and economic system.

The unknowns of Russia's infrastructure may prove to be too great a risk for U.S. investors to supply the kind of capital necessary for an international tech center like



Innograd to succeed, observers say. Proponents will be hard-pressed to turn Innograd into a “Silicon Valley” without smart governance and legal reforms. Skolkovo’s main hurdle will be convincing businesses to invest in building their intellectual capital and operations in Russia while not merely outsourcing cheap labor to Russia’s blue-collar class.

## Innograd vs. Silicon Valley

President Medvedev has said that Innograd will try to replicate Silicon Valley’s success while paving its own way to completion. Therefore, it is important to analyze some of the factors that led to Silicon Valley’s success and to determine whether Russia will be able to cultivate the right environment for Innograd to be successful.

Silicon Valley became the main technology center of the U.S. due primarily to funding from the U.S. Department of Defense in combination with an influx of highly trained graduates from the engineering departments of reputable universities in the area, such as Stanford and U.C. Berkeley. Interaction between Silicon Valley and these graduates fostered a culture conducive to technological progress. President Medvedev’s goal is to create a similar environment in Skolkovo, promoting the development of technology in Innograd and fostering diversification of Russian business with the proposed MBA program. Innograd has underpinnings very similar to those of early Silicon Valley, with a high level of government support and several Moscow universities in close proximity to the technology center.

For Innograd to succeed, Russia will need motivated entrepreneurs trained in emerging markets, with specific knowledge and skills pertaining to the Russian landscape. The Skolkovo-Moscow School of Management is intended to provide precisely such training. For graduates lacking interest in the volatile oil and gas sectors, Innograd is looking to attract the leaders who wish to remain in Russia to pioneer new entrepreneurial technology-based businesses. Therefore, the relationship between Innograd and the Skolkovo-Moscow School of Management will mirror, in theory, the existing relationship between Silicon Valley and its local universities.

However, there is a key difference between traditional business schools like Stanford and the Skolkovo-Moscow

School of Management. The intent of the Skolkovo MBA program was never to “reinvent the wheel” or imitate the West by cloning the model of well-established graduate business programs such as Wharton, Harvard and Stanford. Rather, the program is intended to design a Russian-branded institution from the ground up. The result is a program in which students spend a total of only four months on campus in Skolkovo. The remainder of the 16-month program is spent working off campus on consulting projects in both the private and public sectors in India, China and the U.S.

Interestingly enough, the concept for the Skolkovo-Moscow School of Management predates the concept for Skolkovo’s Innograd by about eight years. The idea for the MBA program originated when Shiv Khemka’s family in India and Rajat Gupta, former managing director at McKinsey, recognized the need for talented local managers to run its Russian companies. Nand Khemka, Shiv’s father and chairman of SUN Group, approached Herman Gref, Russia’s minister for economic development and trade, in 2001 to discuss the possibility of starting a Russian business school. Eventually, eight like-minded leaders of prominent Russian companies and nine well-known oligarchs — including Alexander Abramov, Roman Abramovich and Ruben Vardanian — partnered with the Khemka family and agreed to fund the venture privately. The founders remain actively involved in the leadership of the Skolkovo MBA program.

As optimistic and exciting as the project sounds, the founders realize that developing a previously non-existent business school in Russia is a risky endeavor. They have already spent over half a billion U.S. dollars on the project. The campus alone cost over US\$250 million to build. Designed to resemble a painting by the famous modernist Russian painter Kazimir Malevich, it is purportedly visible from outer space. However, if the MBA program is unable to establish a decent reputation and garner sufficient external support, it is likely to end up as another expensive scrap heap like the countless other fully funded but abandoned Soviet projects. Another unanswered question is whether Skolkovo’s graduates will be able to compete with the graduates of the already-established and well-respected MBA programs around the world. If not, the school will have trouble attracting potential students



in the future. Nonetheless, if successful, the Skolkovo model could become the new standard for graduate business education, making more traditional models such as Harvard and Stanford seem irrelevant and perhaps even obsolete.

### **Looking Ahead**

The distinction between Skolkovo's Innograd and its business school is profoundly important because, although they are different organizations under different management bodies with different sources of funding, both initiatives share the same name and a common purpose. A symbiotic relationship will likely evolve

between the town and the school, further developing the entrepreneurial and technological sectors that the Russian economy currently lacks. President Medvedev's warm reception abroad this summer seems to be a strong indicator that other countries are beginning to recognize the importance of investing money, time and resources in Russia. Such efforts by Skolkovo's leadership are clearly intended to create something better for the country. And this time it seems quite plausible that it will not "turn out just as it always does."

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*This article was written by Robert Thornock and Wesley Whitaker, members of the Lauder Class of 2012.*



## The Middle East's Media Cities and the Global Film Industry

*In recent years, filmmakers and business executives from the United States, South Asia, and Europe have shown a growing interest in the Middle East and North Africa (MENA) region, not only as a potential market but also as a wellspring of talent and inspiration. Major motion pictures — such as *Syriana*, *The Kingdom*, *The Hurt Locker*, *Transformers: Revenge of the Fallen*, and *In the Valley of Elah* — were all filmed in the MENA region and have since achieved blockbuster success, suggesting that film directors are acknowledging the unique cinematic opportunities this region can offer.*

In recent years, filmmakers and business executives from the United States, South Asia, and Europe have shown a growing interest in the Middle East and North Africa (MENA) region, not only as a potential market but also as a wellspring of talent and inspiration. Major motion pictures — such as *Syriana*, *The Kingdom*, *The Hurt Locker*, *Transformers: Revenge of the Fallen*, and *In the Valley of Elah* — were all filmed in the MENA region and have since achieved blockbuster success. Since the early 1940s, Western film directors have realized that this region — defined by idiomatic histories, ancient cultures, and remarkable landscapes — represents a unique and vibrant cinematic opportunity.

### Egyptian Media Production City

Egypt has long been the center of modern media production in the Arabic-speaking world. Its vibrant music, television, and film industries have traditionally dominated the transnational Arab media market. The late 1990s saw a major expansion of media production in Egypt and the rest of the Arab world — the result of the launch of the first communications satellites in the region, with the aim of reaching a transnational audience of consumers through the proliferation of home satellite dishes. In 1996, Nilesat was established to operate future

communications satellites that would be launched for the purpose of broadcasting media in the region. The following year, the Egyptian Radio & Television Union and the Ministry of Information proposed to create a special zone for media production that would host studios for the television channels broadcast by Nilesat.

In 2000, the Ministry approved the creation of the Egyptian Media Production City (EMPC), 48% of which is owned by the Ministry and 52% by banks and primarily local private investors. Presently, EMPC contains a variety of facilities, including presses for print media, studios and sets for television programs, an academy of media sciences, advertising services, and cinema production capabilities. This city represents the first deliberate attempt to create a media industry cluster in the Middle East. To attract international investors, it has operated as a free zone, exempting all project imports from taxes, custom duties, and tariffs. Thus far, EMPC has been able to attract television, print, and film productions from across Egypt and around the world, using a number of arrangements ranging from facility rental agreements to profit-sharing and co-production schemes.

EMPC's Cinema City plays a major role in producing Egyptian cinema. Its administrators also seek to

attract regional and global production studios. To that end, many of EMPC's advantages have been crafted specifically to draw non-domestic business — in particular, Western film production, which is usually based in Morocco and Tunisia.

Despite vast pools of talent in all fields of the film and television industry and the third largest production facilities in the world after the United States and India, EMPC has struggled to attract major international film production houses. Over the past 60 years, roughly 36% of Western films set in Egypt were actually filmed there. Many of the others were filmed in Morocco or Tunisia. If one takes into account the total number of movies set in locales similar to those found in Egypt, the percentage is even lower. Youssef Rizkallah, renowned Egyptian film critic and head of international cooperation at EMPC, notes, "We have learned from institutions such as the British Columbia Film Commission which has been very successful in attracting film studios by offering tax incentives. Not only does EMPC offer incentives to studios seeking to control production costs, but the city offers pre- and post-production capabilities, historical shooting areas, and capacity to create customized sets."

Yet EMPC continues to experience problems in attracting foreign film production. The four major challenges are the hesitance of producers to try new and untested filming centers, the bureaucratic hurdles foreign studios face when trying to film on site in Egypt, the lack of a prominent film commission in the country, and the effects of regional security issues on insuring film productions. Given the logistical requirements and seasoned expertise required to support large movie productions, many producers and directors prefer shooting in locations that already have proven track records. This risk aversion creates an inertia that does not favor new media industry clusters such as EMPC. Furthermore, although film producers are often attracted to Egypt's many historical locations, the procurement of permits to use these sites can be problematic.

For example, with EMPC's assistance, director Michael Bay sought to film *Transformers: Revenge of the Fallen* (2009) on site at the Pyramids and Luxor. Although Bay describes the experience as "remarkably smooth," permission to film at these locations was delayed by

the Ministry of Culture. Rizkallah attributes such bureaucratic problems to the lack of a dedicated film commission headed by a prominent government official or public figure: "A film commission would signal to outsiders a constructive climate for international filming [in Egypt], and if it is headed by a prominent public official, it would also foster confidence in the government's willingness to maintain this climate."

Furthermore, regional security issues have made it difficult for production companies to obtain the necessary insurance coverage to film in Egypt. Most recently, Gavin Hood, director of the blockbuster movie *Rendition*, was forced to change the location of his CIA-themed drama from Egypt to Morocco after being denied insurance coverage. To avoid these complications, many major production houses in Hollywood have deliberately avoided Egypt, opting for more accessible and affordable conditions for their projects.

As Egypt continues to struggle with internal problems, competition in the MENA region for the international film business is becoming increasingly intense. Countries are now competing aggressively to attract major motion picture productions from Hollywood, Bollywood, and Europe.

The film industry in Jordan recently received accolades for its role in the filming of *The Hurt Locker*, which won the Oscar for Best Picture at the 2010 Academy Awards. Kathryn Bigelow, the director, has stated on several occasions that shooting in Jordan was a great experience and that the Jordanian actors and crew (around 150 total, according to the Royal Film Commission in Jordan) involved in the movie were consummate professionals.

## Dubai Media City

The United Arab Emirates (UAE), the Middle East's rising giant in the film industry, has grabbed the attention of media companies around the world. Of the five media cities established there over the past 10 years, Dubai Media City (DMC) is the first and foremost industry cluster. Founded in 2001, it is the main media entity of TECOM Investments, a company focusing on the information technology and telecommunications sector. It is a subsidiary of Dubai Holding, which is

owned by the emir of Dubai, Sheikh Mohammed bin Rashid Al Maktoum. Operating under the mission statement of being involved with “anything and everything to do with media,” DMC was created with the clear aim of making Dubai the media industry hub of the region.

Its status as a government property has not hindered its ability to grow rapidly. To date, more than 1,300 companies from over 70 countries are registered there. This success is rooted in DMC’s convenient location in a cosmopolitan city and international trade hub, its tax-free status and its multibillion dollar media infrastructure. In addition, DMC covers the entire media value chain — from consumer research to post-production services—for all companies located in this free zone.

Recognizing the success of DMC and the opportunity to provide more targeted offerings, Dubai Holding launched Dubai Studio City in 2005. This city is a 22 million-square-foot production cluster with state-of-the-art filming and broadcasting facilities. Umran Shah, development manager at DMC, notes that “Dubai Studio City was created to attract film production away from traditional Middle Eastern film production countries, such as Morocco,” in addition to attracting lucrative Bollywood film productions, which currently make up the majority of films shot in Dubai. Dubai Studio City offers offices, post-production studios, sound stages, workshops, warehouses, and back lots. Registered companies are also able to build their own studios and facilities on custom-sized plots. As Dubai Studio City executive director Jamil Al Sharif notes, “[Dubai Studio City] will offer anything that is needed to facilitate excellent production.” Furthermore, it was also designed with the aim of promoting domestic film production among the local Emirati population. These efforts have culminated in the production of the first UAE-based films, such as *City of Life*, a 2009 drama by Emirati director Ali F. Mustafa.

Despite the rapid growth of the film industry in Dubai, movie-making has had its share of controversy. The National Media Council of the UAE governs all media productions in the country. This entity, based out of the federation’s more conservative capital, Abu Dhabi,

ensures that any film production follows the country’s code of conduct. With taboos surrounding religion, sex, and politics, many Western studios have been hesitant to bring their productions to the UAE. The most recent example is exemplified by the decision of the *Sex in the City 2* producers to film their Abu Dhabi-based plot in Morocco, without ever approaching the UAE’s National Media Council.

There is also a general wariness by the Council to green-light the filming of Western movies following the political controversy caused by *Syriana* and *The Kingdom*, filmed in Dubai and Abu Dhabi, respectively, which dealt with topics such as immigration, labor rights, and extremism in the Middle East. For example, although *Syriana* was filmed in Dubai, the film was censored before being released into the local market, resulting in the excision of scenes that portrayed the mistreatment of South Asian workers by local authorities in an unnamed Gulf State, an image of the late Saudi King Fahd bin Abdul Aziz Al Saud, and a reference to the multinational construction conglomerate, the Saudi Binladin Group. Aleem Jumaa, head of Dubai’s censorship office, notes, “We would never allow anything that is disrespectful to the country or the president, causes security problems, insults religions, exhibits immorality like nudity or promotes vices like alcohol and drugs.”

## Unseating the Industry Leader

Morocco and Tunisia have long-established track records with the film industry in the West. Both countries are recognized as failsafe locations that have hospitable conditions devoid of unnecessary administrative and governmental complications. Morocco has become the favorite location for notable directors like Ridley Scott, who has shot a number of films there, including *Black Hawk Down*, *Gladiator*, and *Kingdom of Heaven*. The governments in Morocco and Tunisia have implemented regulations, established councils, and allocated significant funds to ensure that their countries remain attractive markets for filmmakers around the world.

For decades, Morocco has received the lion’s share of interest from foreign production firms, earning an estimated US\$50-US\$70 million annually. A combination of factors has led to Morocco’s



attractiveness as the preferred film production center for Western studios.

Morocco has a more developed industry for supporting the production of movies, from the elaborate to the more mundane, at a lower cost than other locales in the region. There are a number of ready-made sets that the country has accumulated over the decades, capable of depicting just about any scene in the Middle East — from the Pyramids in Giza to the Ka’aba in Mecca. This offers directors and producers great flexibility by allowing them to avoid the expense of traveling to shoot multiples scenes on location for the same movie.

In addition, a stable and experienced labor pool exists in Morocco. On average, more than 600 foreign films receive authorization each year, using local talent as extras as well as technicians, grippers, and post-production specialists. These individuals are multilingual and experienced workers who have worked with foreign production teams on a consistent basis. In fact, the country claims their local movie production labor force is the most competent and cost-effective in the region. To further add efficiency to this labor market, the Moroccan Cinema Center even publishes labor rates and standard contract conditions to facilitate speedy contracting.

Morocco boasts a far more accommodating atmosphere for foreign film production companies than anywhere else in the MENA region, with far less censorship and regulation of content. In contrast, we have seen how newer regional entrants into the international film

business, like the UAE, have shied away from certain films if the content transgresses “cultural norms,” which are sometimes ill-defined.

Morocco’s seriousness in supporting its media industry is evidenced by the ministerial-level Moroccan Cinema Center, which oversees the sector. By direct coordination through this body, directors and film producers can, for example, gain access to use as props almost any asset the Moroccan government possesses. The MCC even provides foreign production companies with the request forms. The actual logistics needed to accomplish these tasks are administered by private companies licensed by the MCC.

No other place in the Middle East region demonstrates such a long-lived legacy of support for foreign film production. Countries like the UAE and Egypt have tried to attract foreign productions through their media cities. But, thus far, these industry clusters have been unable to replicate the deep and widespread support for the industry witnessed in Morocco. Given the range of challenges facing the Middle East’s recently established media cities in entering the filming industry, one may conclude that Morocco and Tunisia will continue to be the primary centers of Western film production in the region for the foreseeable future.

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## In Vino Veritas: Innovating in the French Wine Industry

*How does an entrepreneur successfully introduce innovation to a gastronomic tradition that is a cornerstone of French culture and identity? Stéphane Girard, who graduated from the prestigious Bordeaux Wine School in 2004, has launched a modern concept in wine degustation to make understanding viticulture more accessible.*

How does an entrepreneur successfully introduce innovation to a gastronomic tradition that is a cornerstone of French culture and identity? Stéphane Girard, who graduated from the prestigious Bordeaux Wine School in 2004, has launched a modern concept in wine degustation to make understanding viticulture more accessible by placing the individual's discovery of wine at the center of the experience.

In August 2010, Girard's Facebook profile noted, "Stéphane Girard proudly presents the WINEpad: a tablet computer developed by WINE by ONE providing educational information about wines (a perfect complement to the WINEcard that gives you access to 100 wines by the glass)." WINE by ONE opened in May 2010 near Place Vendôme, a sophisticated neighborhood in Paris near the Louvre. Visitors admired the sleek Enomatic machines that poured glasses of wine at the push of a button and formed the backbone of the new concept. Despite a relatively slow summer due to long vacations and the World Cup, business was still ahead of both profitability and revenue forecasts. In fact, revenues had reached Girard's January 2011 target by August 2010. However, additional growth and new customers were needed if the bar was to become a franchisable concept. Girard hoped that the launch of a full marketing effort, including a paid advertising campaign, would enable him to continue to exceed projections.

Buoyed by the strong results of the first few months, Girard was confident that the risks he had taken to become an entrepreneur would pay off. However, he also worried about being able to scale the strategy according to plan.

### History of an Idea

A Bordeaux native, Stéphane Girard grew up surrounded by viticulture. His personal interest in wine developed further after he explored local production while working as an investment banker in Sydney. At Wharton, where he earned his MBA, his passion for helping others learn to discover and appreciate wine resulted in his being elected president of Wharton's largest extracurricular club — the Wharton Wine Club (WWC). In a Wharton entrepreneurship class, he and several classmates created a business plan to address the fact that wine drinkers often do not actually know which wines they like and why. He and a few others designed a novel concept comprising a wine bar, a wine store, and a wine club, all in the same location.

After graduation, wine tasting remained a key part of Girard's daily activities, even while he worked as a consultant at Bain in Paris, where he created a wine club to give colleagues the opportunity to socialize while learning. As word spread about the club, friends and professional contacts asked him to establish similar

groups at their companies. Even self-proclaimed wine connoisseurs found they knew less than they thought about their own personal tastes, relying too often on guides such as *Wine Spectator* or a restaurant sommelier instead of their own palates.

Girard was also aware that many French consumers had no knowledge of global vintages due to the limited, France-centric selection available at most wine bars as well as the exclusive nature and high fees at wine clubs and wine expos. He identified the opportunity to change how people discover and purchase wine, and decided that the wine bar/store/club concept he had developed at Wharton could work well in Paris.

### **WINE by ONE: A Three-in-one Concept**

Imagine that you purchased a bottle or glass of wine, not because the label was attractive or you had read about it in a magazine, but because you had tasted it and found it pleasing. WINE by ONE facilitates that experience through its three-in-one concept of a wine bar, store, and club in a single location.

A typical Parisian wine bar has a selection of 10 to 30 bottles, seven to 10 of which are available by the glass. In contrast, WINE by ONE offers 100 bottles available by the glass, including approximately 20 bottles from origins as diverse as South Africa, Austria, the United States, and Australia — a novelty in Paris, where international varieties are scarce. In addition to geographic diversity, the selection includes a range of styles from grand crus and full-bodied reds to French rosés and sweet dessert wines. In France, wines are normally categorized by appellation (region of origin). WINE by ONE, on the other hand, organizes its selection by grape type (chardonnay, shiraz, etc.). Customers have commented on the depth of the offerings and the way they are presented.

WINE by ONE's day-to-day function relies on distribution machines from the Italian company Enomatic. Each machine holds between six and eight bottles, and dispenses wine tastings in three different sizes — “the impression” (3 cl), “the temptation” (half glass), and “the sensation” (full glass). Customers add money to a personalized WINEcard from which the

price of each glass is deducted automatically. Servings cost between €1.20 and €25.00, depending on the size and the wine. The machines prevent oxidation, ensuring a constant, ready-to-serve temperature and maintaining drinkability for up to three weeks.

By outsourcing the pours, the machines allow two employees to serve an entire bar. To guide the wine discovery process further, each machine has a WINEpad that provides information about each bottle, including notes from sommeliers, so customers can synthesize what they taste with a wine's technicalities. Unbiased by the recommendations of hovering waiters or barmen eager to fill their glasses, customers can examine the vast array of wines, reading the details of each on the WINEpad before choosing what to drink. By limiting staff involvement, Girard encourages customers to experiment and judge wines for themselves, instead of through the biases of wine “experts.”

Unthinkable at a typical Parisian wine bar, all 100 bottles can be purchased to take home from WINE by ONE. Moreover, unlike other wine stores that close in the early evening, WINE by ONE is open from noon until 10 p.m. These extended hours present a competitive advantage, as professionals who leave their offices late have the opportunity to purchase wine after other outlets have closed. Furthermore, when an individual discovers a bottle of wine, he or she can then purchase additional bottles to drink at home, making the connection between the consumer and the wine more lasting. These individuals are more likely to return to WINE by ONE to further their oenological education.

The final component in the WINE by ONE equation is its wine club, a community of members with a shared interest in discovering wine. Loyal customers have access to themed tastings with producers and sommeliers as well as wine classes for connoisseurs at all levels. Typically, wine clubs are private communities arranged through institutions and corporations. WINE by ONE, on the other hand, offers the educational advantages of a wine club without the exclusivity or prohibitive fees.

In its first few months, 70% of WINE by ONE's sales came from wines by the glass, 20% from the sale of bottles, and 10% from the sale of food and other accompaniments.

## Wine Consumption in France

Understanding the evolution of wine in French daily life is essential to fully comprehend the shop's success. Despite a central place in French culture, the consumption of wine in France has been falling over the past few decades.

In 1980, the French consumed wine in quantities greater than both tap and bottled water. Three decades later, however, wine is now served at only one meal out of four, and bottled water is the most commonly consumed beverage. While wine remains the primary alcoholic beverage in France — representing approximately 60% of all alcohol — per capita consumption has decreased from 61 liters per year per person in 1995 to 48 liters in 2009, the result of changing societal patterns such as longer commutes, a crackdown on drunk driving, and increasing concern about the health effects of excessive alcohol consumption.

Regular consumers are being replaced by occasional ones. This is significant because, although regular consumers represent only 21% of the population, they consume nearly 75% of volume (or five to six times the amount of an occasional consumer). In contrast, occasional consumers frequently split their alcohol consumption between beer, wine, and aperitifs; and infrequent consumers (those who drink wine less than once a week) tend to prefer sparkling wines, cider, and liqueurs. The other significant trend that developed over the last decade is the increasing preference of young people, ages 18-35, for hard alcohol and spirits.

These changes in wine consumption patterns have created a new culture of less frequent consumption but greater appreciation. Sophisticated wines are being consumed at festive occasions more often than table wine at every meal. Now that French wine drinkers consume less frequently, they are willing to pay more per bottle, and they are also beginning to explore foreign wines.

As the culture of consumption has evolved, wine bars in Paris have undergone a modernizing transformation over the last decade. While it is impossible to quantify the exact number of wine bars in Paris, given the variety of formats and constant turnover, they fall into two broad categories: (1) traditional, those that

replicate the Auvergne model dating to the early Industrial Revolution, and (2) modern, those focused on innovative food, décor, and biodynamic wines.

A traditional wine bar is centered on the owner/sommelier's preference for wines and his relationship with long-time customers. Traditional wine bars serve French wine exclusively, typically from key regions such as Beaujolais, the Loire Valley, Burgundy, Côtes du Rhône, and Bordeaux. The average French person associates wine with food, so traditional wine bars focus on simple and robust cuisine (including cheese, charcuterie, and a few regional dishes) to frame the wine.

At the same time, entrepreneurs are modernizing the wine bar scene in Paris by introducing unique bottles and creative food. Several key trends include a focus on natural, "eco-friendly" wines and "locavore" foods, specially chosen from local farms to complement the selected wines. Despite their differences, both traditional and modern wine bars share a similar structure and strategy — sommelier- and French-wine-focused.

In keeping with traditions of conviviality and family, the largest volume of wine consumption still occurs at home, and the 5,000 local wine shops in France are critical to serving this need. Sales at small, unique outlets have steadily declined over the last decade, due primarily to the expansion of supermarkets and hypermarkets (over 85% of the volume of wine sales) and large franchised distributors (e.g., Nicolas, with 464 outlets across France). Nevertheless, independent wine shops have benefitted from the increased consumption of more expensive bottles.

The traditional independent wine stores work with other independents to purchase wine at wholesale from the vineyards. They generally stock 300 to 500 bottles of almost exclusively French wines. Recently, new players like Lavinia, a Spanish firm, have introduced novel concepts such as large spaces, modern designs, significant variety (including obscure grapes and organic wines), and occasionally Enomatic machines.

While WINE by ONE offers a smaller selection of wines than traditional wine stores, the focus on the complete discovery and introduction of foreign wines differentiates it from both traditional wine stores and innovators.



## The Challenges of Entrepreneurship in France

With months of work completed and his market and concept ready to be rolled out, Girard quickly discovered that commercializing an entrepreneurial concept in risk-adverse France would be an uphill battle. Selecting the right location, securing the necessary financing, and actually pulling everything together for the construction phase all required local support and knowledge.

In the affluent business and chic tourist neighborhoods that WINE by ONE was targeting, vacancies are infrequent, competition is fierce, and rents are exorbitant (particularly for an entrepreneur). Furthermore, Parisian property holders are extremely reluctant to rent to an innovator, preferring luxury retailers with established brands and assured revenue streams. After months of searching, in June 2009 Girard finally identified a suitable location near the Place Vendôme in the Second Arrondissement.

An initial round of equity fundraising (primarily from friends and family) provided 40% of the necessary capital of €1 million. However, obtaining the remaining funds through debt financing was particularly challenging, not only due to the ongoing financial crisis of 2009, but also because Girard lacked direct experience in the hospitality industry, and his three-in-one concept was untested. All the major French banks refused to fund his endeavor.

Girard turned to OSEO, a French non-governmental organization dedicated to helping entrepreneurs and small business owners through the provision of low-cost loan guarantees, which significantly reduces the risk to traditional bank lenders. With a guarantee from OSEO in hand, Girard secured financing from HSBC and finalized the lease of his ideal location in July 2009. Construction got underway in January 2010 and was completed for a soft opening in mid-March and the official opening in May 2010.

## The Road Ahead

Following on these initial successes, Girard aims to expand WINE by ONE's operations by opening new locations — not only in different Parisian neighborhoods but also in other international cities. These efforts will

allow him to recoup the initial investment and achieve the desired scale and reach of WINE by ONE's concept and brand. These new bars will rely substantially on shrewd decisions regarding location and cultural acceptance of the Enomatic machines. Girard's second foray will prove whether the concept is scalable — a critical component to his overall business plan — and whether WINE by ONE will succeed without his presence behind the counter.

While the first location took nearly two years to open, Girard is confident that strong financial results from the inaugural WINE by ONE endeavor will accelerate the process in the future. The skill set necessary to thrive will change as he attempts to scale his idea, and he hopes his newly acquired real estate selection acumen and his ability to bring a second bar online will accelerate with experience. Although it is still too early for studied consideration, a franchising model might help to mitigate these risks.

Girard's growth prospects are buoyed by substantial interest and positive reviews from leading cultural tastemakers, including *ELLE Paris* and *Luxos International* travel guides. Other publications have described the new concept as “innovative,” “playful,” and “chic.” As for Girard, through the use of new media marketing strategy — including Facebook, Twitter, and blog reviews — he has targeted an upscale audience that is interested in a novel approach to traditional French wine culture.

WINE by ONE's long-term viability remains unclear. Other reviewers have been slow to embrace the sleek, modern feel of the bar, one of them citing “an icy ambiance” that could drive away potential customers. With a cutting-edge concept, Girard has created buzz but has also found that the edge cuts in two directions, intriguing modern and hip customers at the risk of alienating the more traditional ones.

With the launch of its three-in-one concept, WINE by ONE has successfully created a “blue ocean” in the wine industry, with little competition in the market. Parisians can now access global wines, tourists can sample French appellations, and all clients have the opportunity to discover their personal preferences anonymously without revealing a lack of wine

knowledge (a major faux pas in France and other sophisticated milieus). Many opportunities exist for WINE by ONE, including geographic expansion, the creation of official corporate wine clubs, and monetizing card member/loyalty programs.

To assure WINE by ONE's expansion, Girard can adjust the ambiance to capture both innovative and traditional patrons (simultaneously modern and convivial) and expand the food offerings to assuage those traditionalists searching for a framework in which to discover wine flavors, while simultaneously encouraging all patrons to linger longer. More broadly, the marketing program

can be expanded further by closely targeting specific segments such as high-end hotels, business professionals, and wine aficionados. Finally, the hours can be extended, consistent with a bar (10 p.m. is late for a store to remain open, but early for a bar to close).

Proving the concept is scalable without Girard's presence behind the counter is the crucial next step to long-term success.

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## German Patriotism: A Fresh Start

*During the summer of 2010, while visiting troops in Afghanistan, German President Horst Koehler set off a political and media firestorm both inside and outside Germany when he referred to the need “when in doubt or in emergency situations ... to deploy our military forces to protect our interests.” His comments, which resulted in his resignation days later, triggered a heated debate over whether Germany, nearly 70 years after the National Socialist period, could invoke any mention of military might to protect German interests. The dilemma also depicts a much broader debate over German patriotism and its role, if any, in Germany today.*

“A country of our size, with its export-based economy and associated dependence upon foreign trade, has to realize that, when in doubt or in emergency situations, it is also necessary to deploy our military forces to protect our interests.”

With that one sentence, uttered while visiting troops in Afghanistan during the summer of 2010, German President Horst Koehler set off a political and media firestorm both inside and outside Germany, resulting in his swift resignation just a few days later. His comments triggered a heated debate over whether Germany, nearly 70 years after the National Socialist period, could invoke any mention of military might to protect German interests. This dilemma also depicts a much broader debate over German patriotism and its role, if any, in Germany today.

While former President Koehler felt comfortable enough as a German leader in 2010 to use those words, this is a relatively new sense of German confidence, one that Germans are testing at this moment — not without stirring controversy. Nor is it the first time that Germans have been embroiled in such debates. As Mary Fulbrook argues in the book, *German National Identity after the Holocaust*, “the definition of German national identity has been central to much of German politics and public debate over the best part of the last half-century.”

The use of national symbols was muted in Germany during much of the postwar period. Even as late as the 1990s, it was hard to find a store where one could buy a German flag. Ordinary Germans often reflect on the meaning of being German and on the symbols of national identity. As a German interviewed for this article noted, “This is also new for me. As a 30-something who grew up in West Germany, I never remember seeing a flag. It was considered in very poor taste.” Few government buildings even displayed one. Today, it has become far more common to see the flag displayed and to hear the national anthem being sung, although this happens most often at sporting events.

Patriotism in Germany has been a taboo topic since the time of Adolf Hitler, with the vast majority of Germans accepting that they cannot express any form of national pride. The re-education of Germans after World War II, in both the West and the East, included heavy indoctrination bent on instilling fears that patriotism would result in the nationalism that had led to National Socialism and foreign aggression in the 1930s and 40s. In addition, the West German government and its people felt significant shame and guilt for the atrocities that had occurred. That shame, and fear of what could happen if patriotism were taken too far, helped mold the modern German understanding of patriotism.

## Ready to Move Forward

For decades following the creation in 1949 of the German Democratic Republic and the Federal Republic, Germany as we know it today was occupied and thus controlled by foreign powers. The East created an environment in which its people recognized that the socialist brotherhood was far more uniting than a simple country. In the West, Germans had an immense sense of gratitude to the occupying powers for freeing them from National Socialism and protecting them from the Soviets. Thus, residents on both sides of the Berlin Wall were made to feel like children under the great powers, thus greatly limiting their own abilities to “grow up” and come into their own selves. This, combined with its paradigm of understanding national identity and pride, led Germany to further suppress any such feelings.

The fall of the Berlin Wall in 1989 brought not only the end of communism and the restoration of a united Germany, but also a new opportunity for the country to define itself. In 1990, the occupying powers finally signed away their rights, and Germany became a completely independent country, free from foreign powers’ involvement in its political and societal systems. At the same time, the world began to see signs that Germany was becoming more comfortable with being German, and a new generation of German and foreign historians duly reflected the newly found identity. When holding long conversations with Germans about issues of patriotism, nationalism, and national identity, one immediately notices that they believe there is no more reason to continue feeling guilt and shame about the German past. After World War II, German companies — many of which were important players in the global economy — that had participated in some way in the National Socialist movement showed their compassion by researching the facts and their own roles in the horrors of the Holocaust and, in most cases, paying reparations.

Then-Chancellor Gerhard Schroeder (1998-2005), the leader of the Social Democratic Party, publicly stood up to President Bush in 2003 against the invasion of Iraq. Germany was finally defining herself, no longer worrying about the old super powers. A university student interviewed for this article noted: “This was the first time I really saw my government standing up for our interests. It’s both exhilarating as well as frightening.

We [Germans] need to always be careful not to step on the toes of foreign countries.” This new sense of German identity was not just seen in politics, but quickly spread to everyday German life — most notably in recent soccer tournaments.

For Germany, hosting the 2006 World Cup offered the opportunity to stand on the world stage and show that Germany was no longer ashamed to be German. “The black, red and gold flag that had almost become an embarrassment to generations suddenly became the fashion item to have – whether flying from apartment balconies, painted on faces or dangling from earrings,” reported the *Financial Times*. As Norbert Lammert, President of the national parliament put it, “it is the reconstruction of normality.”

The 2006 World Cup enabled Germany to reap economic benefits through tourism and also to gain greater visibility on the world sports stage. The Germans, working under their new sense of identity and pride, delivered what was generally considered by the international press to be a well-organized event. “When South African journalists saw Germany’s rail systems, sparkling stadiums and organization, many wondered if their homeland could manage such an event,” reported the *Wall Street Journal*. “The mood was helped by a perfectly plotted World Cup,” argued the *Financial Times*. An English fan even argued that “the Germans have been so nice I hope they win it.”

But the World Cup presented even more than these rather tangible objectives. The competition was an opportunity to showcase the “new” Germany. The subsequent success of these games contributed further to the rebirth of German patriotism. German Chancellor Angela Merkel noted that “the world became a guest through friendship.” The great summer weather — a phenomenon that happens only once every five years — also played an important role. Not by accident, the summer of the 2006 World Cup in Germany was characterized by the German press as the *Sommermärchen* (summer fairy tale). In addition, as reported by the daily *Die Welt* newspaper, the match between Germany and Spain attained the highest TV-ratings in the history of soccer, with 83.2% of the TV market tuned in.



This new sense of pride carried into the 2010 World Cup in South Africa. Unlike in 2006, the sentiment wasn't based only on victory. Right after Germany's defeat in the semi-finals, newspapers printed the words "Respect" and "Thank you, team." And *Süddeutsche Zeitung*, one of the largest newspapers in Bavaria, stated, "An Eleven [i.e., a team] for the future."

This rebirth of German patriotism over the past few years has not been without controversy. In the political arena, particularly from the left, there have been major discussions about whether all the flag-waving and national-anthem-playing has been getting out of hand. In addition, some of the opposition politicians to the current Christian Democratic government have been attempting to evoke fears in the population of a reemergence of Nazism. Some media outlets are beginning to criticize this new sense of pride while opponents of German patriotism point to recent incidents that, they say, show what too much patriotism can lead to. In particular, a German reporter was fired after, on live television, she compared her feeling of pride to that felt during the famous Nuremberg Nazi rallies.

Germans continue to debate the forms and the implications of the new manifestation of patriotism.

Some state they are comfortable with German flags waving but do not feel the national anthem should be sung so freely and so publicly. The source of the rebirth of patriotism is connected not to politics but to culture, which is consistent with German history of nation building. Germans are displaying their pride in their talent and their capabilities rather than the country's political positioning in the world or its history as a nation — quite different from the sense of nation that arose in the 1930s. In the words of historian Mary Fulbrook, German national consciousness is driven by a "respect for German high culture," something that sets the country apart from most others.

Yet as former President Koehler discovered himself in the summer of 2010, there are limits to what Germans can say and do in public. At the same time, Germans, wanting to step out of the shadows of Auschwitz, are finally on their way to making this transition.

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*This article was written by José Carlos Thomaz, Jr., and Brian Weigandt, members of the Lauder Class of 2012.*



## Private Social Investment in France: Meeting Two Goals

*Social investing is en vogue. As the investment landscape evolves, investors are looking increasingly toward non-conventional assets that satisfy a more complicated objective: earning returns while promoting positive social impact. Motivated by a desire to help those in need, contributors who want to see their funds used in a sustainable and accountable way have found that private social investing meets both these goals. France is one example of a country where social investing has recently begun to take off.*

Social investing is *en vogue*. As the investment landscape evolves, investors are looking increasingly toward non-conventional assets that satisfy a more complicated objective: earning returns while promoting positive social impact. Motivated by a desire to help those in need, contributors who want to see their funds used in a sustainable and accountable way have found that private social investing meets both these goals.

At the end of 2009, social investing in France reached €4 trillion (US\$5.7 trillion) after nearly doubling between 2005 and 2008. The dominant investment vehicles in this field are socially responsible index funds. The leading investors, initially religious organizations, are now high-net-worth individuals, foundations and even institutional investors, a reflection of the domain's greater visibility and the increased access to social-impact investment institutions.

According to Novethic, an affiliate of government pension fund manager Caisse des Dépôts, social investing in France is still in its fledgling stage, but it has been encouraged by French legislation that promotes social investing, such as a regulation requiring pension funds to invest at least 10% of their assets in socially conscious projects. The potential of this domain in France is further demonstrated by the recent entrance of financial institutions that formerly valued only the economic “bottom line,” such as the “Club of Six,”

comprising prestigious French banks with assets over €1.5 trillion (US\$2.1 trillion).

Against the background of this growth in socially responsible investing, which is dominated by specialty index funds, the field of private social investment in France started in the late 1990s. While public social investing is recent but increasingly accepted, private social investing is brand new and just starting to gain traction. Matt Christensen, Executive Director of Eurosif, a European think tank for sustainable investment, notes that “the challenge in the past has been that many French investors traditionally viewed social venture as a role for the State rather than a role for private investment.... [I]nvestors are [now] better understanding that this form of investment can be done through private capital more efficiently than with public capital. The French social venture capital market is poised to grow significantly in the coming years as the ‘impact investor’ movement has taken off in the U.S. and U.K.”

### Two Styles of Investing

Two main approaches to private social investing emerged: location-agnostic investing in social enterprises, such as PhiTrust Partenaires, and providing capital to profit-seeking small and medium enterprises (SMEs) in underprivileged areas. The latter category is divided into community redevelopment funds that

focus on economically depressed French suburbs and emerging market private equity funds. This category of funds considers private-sector investments that facilitate job creation and human capital development, to be social in their own right. Bac Partenaires and Citizen Capital represent the former sort of fund, whereas Investisseur et Partenaire pour le Développement (I&P) focuses on emerging markets.

The two styles of investing are illustrated by I&P and PhiTrust. These two firms' approaches show signs of evolving in different, though equally promising, directions, thus offering alternative models of understanding and implementing social investing activities. I&P focuses on profit-generating investments in SMEs in developing economies, while PhiTrust generally funds social-impact projects primarily in developed markets.

PhiTrust, based in Paris, is an asset-management firm offering a multi-faceted approach to social investment. The company seeks "double bottom line" returns on its investments, combining financial and extra-financial objectives — such as governance, environmental concerns, and social impact — in each project. The firm has three arms: socially responsible mutual funds, a social venture capital fund called PhiTrust Partenaires and a grant-making foundation called La Fondation PhiTrust.

PhiTrust Partenaires supports social entrepreneurs by applying market-based methodologies to investments structured similarly to venture capital, but with the additional requirement of both financial and social returns. "We demand a double return on our investments," says Florence Goudchaux, director of project analysis at PhiTrust Partenaires. "We are looking for projects that are ... financially sustainable and make a strong social impact."

Not only are the objectives different from traditional venture capital, but the scale is also considerably smaller. As of June 2010, PhiTrust Partenaires's fund was €7 million (US\$9.8 million), the average investment was €300,000-500,000 (US\$420,000 – 700,000) and the target return on investment (ROI) was 5% (the firm has yet to exit an investment). PhiTrust Partenaires partners with a variety of actors in the field, such as co-investments

with the corporate social responsibility (CSR) arm of Groupe Danone, investing in I&P to contribute to developing country projects, and financing schemes that have also historically received foundation funding. "The Partenaires fund's aim is to show investors that there is a for-profit sector that can achieve financial sustainability," notes Devin Blondes, a financial analyst at PhiTrust Partenaires. "The fund also wants to show investors that it can accomplish this through economic activity, whether that is through its employees, its services, the goods it produces or its social and/or environmental impact."

PhiTrust Partenaires manages risk by choosing businesses with proven track records of accomplishment to maintain a higher probability of success. When the opportunity arises, the company also helps non-profits develop for-profit arms. In these cases, says Blondes, "we give [financing] to encourage the creation of a sustainable for-profit company that will help the Association further its mission. The business plan we design aims at financial sustainability, which will lead to sufficient profit fed back to the Association for it to achieve financial independence."

PhiTrust Partenaires employs a "bottom-up" approach of targeting high-quality projects led by social entrepreneurs, mostly in Europe and in Francophone developing countries. Project selection also includes an audit and review by the investment committee. According to Goudchaux, "the committee tries to choose projects in areas where someone around the table has an expertise, so that person can take the lead advisory role." After the investment is approved, that expert guides the portfolio company in developing tactical and strategic plans in addition to measuring the financial and social impacts resulting from operations. For the duration of the investment, the target company provides regular reports on operational activity, as well as financial, social, and environmental impacts. Social metrics are distinct and non-standard among individual investments. Goudchaux notes: "In our opinion, there is no way to compare the impact of an organization that employs the mentally handicapped with one that helps poverty-stricken farmers in Senegal through sustainable milk production."

Two projects from PhiTrust Partenaires' portfolio show the vibrancy of social investing in France. The first

project, Ethical Property Europe, rents environmentally responsible office space to associations and non-profit organizations. Following a successful first year in Belgium, the company sought to expand its model across continental Europe. In 2009, the firm realized a profit of €524,000 (US\$734,000) and met a social objective of providing office space for 44 non-profit organizations. Since non-profits are likely to place a higher value on environmentally responsible office space than other organizations do, Ethical Property Europe is able to concurrently fill a market niche and realize profits. This approach enters precisely into PhiTrust Partenaires' investment philosophy, which emphasizes filling social needs through profitable models.

Ecodair, the second project, seeks to integrate mentally handicapped individuals into the workforce by employing them to refurbish used information technology materials. The company initially received funding from La Fondation PhiTrust as a non-profit but later incorporated two for-profit social enterprises, into which PhiTrust Partenaires then invested capital. "At the moment, Ecodair is the only Partenaires investment that also received Foundation funding," Blondes says. "The grant was made to their Association to assist it in setting up two for-profit companies. We then invested capital and debt in each of the two companies."

Although Ecodair realized a loss of €9,000 (US\$126,000) in 2009, the number of handicapped employees increased from 38 in 2008 to 46 in 2009. Ecodair may continue to struggle with profitability, because its principal objective is to employ a maximum number of handicapped workers. However, the company fills a social need that would otherwise not be met by the market, because mentally handicapped workers are less likely to find employment. PhiTrust Partenaires maintains a high risk tolerance for investments with long time horizons for profitability, provided these investments respond to a social need that would otherwise remain unfilled by the private sector.

"In the case of Ecodair, we know that our investment will be longer-term as we need to develop the company enough for it to become sustainable," says Blondes. "The cases that will necessitate funding from the Foundation can be expected to take longer to mature before we

consider an exit. Ecodair is a company on which we expect low return, but this would not necessarily be the case if we were to make other [investments with funding from both the VC Fund and the Foundation]." To date, Ecodair is PhiTrust Partenaires' only project that has previously received foundation funding.

PhiTrust Partenaires' main strengths are its strong network of sophisticated investors with social interests, who serve as both investors and advisors to portfolio companies, and its extensive social enterprise network, which facilitates investment selection. Projects are geographically close enough for investment committee members to act as expert consultants, thereby allowing PhiTrust Partenaires to avoid the costs associated with hiring technical specialists. The company's main weakness is its low historical returns, which limit the pool of potential investors, and hence its potential social impact.

Given PhiTrust Partenaires' target ROI of 5%, investors motivated by economic returns will generally prefer to invest elsewhere. Furthermore, the long time horizon of the investments, in conjunction with the anticipated returns and relative illiquidity, is less attractive than other investments. PhiTrust Partenaires is threatened by competitors that present social-investment alternatives to their social venture capital model, such as a growing number of socially responsible index funds in France. In addition, the heavy involvement of investors may become untenable as the investor pool grows. Lastly, non-standard social metrics do not allow for a comparison among investments' social returns. However, the development of this sector offers the opportunity to attract new investors to PhiTrust Partenaires. A recent French regulation requiring pension funds to invest at least 10% of their assets in socially responsible investments and the potential for future similar legislation represent a growing opportunity for asset-gathering from French institutional investors.

The venture capital-based model provides a powerful new way to raise capital and provide management expertise to organizations responding to social needs, as well as a dynamic way of cooperating with the CSR missions of large firms. As foundation management and grant-making become increasingly impact- and metrics-focused, this model could emerge as a new way



of managing diverse, private-sector-oriented charitable giving and outcome management, as long as firms like PhiTrust Partenaires adopt a long-term perspective, have high risk tolerance, and emphasize the social aims of its portfolio companies.

## Investing in Africa

Another organization in the social investing sphere is the private investment company Investisseur et Partenaire pour le Développement (I&P), founded in 2002. I&P invests in SMEs and microfinance institutions (MFIs) in African countries and supplements its capital investment with technical assistance. I&P's investments are managed by I&P Etudes et Conseils, its management company.

I&P invests in high-potential private enterprises in developing countries, particularly in West and Central Africa. In September 2009, the company's portfolio had grown by 45% to €14.1 million (US\$19.7 million), comprising 19 SMEs and 4 MFIs in 13 countries. The firm's average funding level is between €200,000 and €800,000 (US\$280,000 and US\$1,120,000), with an investment horizon of five to seven years.

In I&P's case, investment in small and medium-sized profit-seeking enterprises is considered a social investment insofar as these are companies located in African countries that contribute to local development, job creation and the growth of a "mezzanine" private sector.

"We invest in French-speaking African countries such as Niger, Mali or Senegal," says Sebastian Boye, investment director at I&P. "These countries are among the poorest and have a particularly weak SME landscape. This lack of development of SMEs is not due to a lack of talented entrepreneurs. They do exist but they have very few tools to help them. Local banks do not finance SMEs, or very exceptionally only with strong collateral. They focus on big companies and projects. I&P is focusing its investments in the so called 'missing middle.' We consider encouraging SMEs to have social benefit, but these projects are not 'social businesses' per se."

I&P also applies a negative screen to its investment, only investing in those projects that are considered to add value to the local economy. While this screening process is ad hoc, in the past I&P has rejected investments that

are focused on importing foreign goods (as opposed to those focused on the development of local industry), and also micro-finance institutions that charge high commercial interest rates.

I&P takes a bottom-up approach in selecting SMEs for investment. It acquires minority equity stakes, thereby taking an active role in the governance of its partner enterprises, and commits to empowering the entrepreneur and the local team. "We never replace the CEO," says Boye. "We are investing in the person." I&P provides a broad range of services to portfolio companies to maximize performance. This typically includes strengthening governance structures, establishing or improving accounting and management practices, providing strategic direction and engaging consultants for specific projects. The latter is partly subsidized by grants from foundations or development organizations. By the end of fiscal year 2009, I&P had invested in a total of 23 businesses and institutions and had successfully exited 2 investments, each of which yielded returns in excess of 20%. I&P expects an average return of 10% to 15% on its portfolio.

With respect to MFIs, I&P employs a similar approach in terms of technical assistance by acquiring equity stakes and promoting growth in the scale and services of MFIs in developing countries. In these countries, and especially in Africa, the formal banking sector only serves a small minority of the population," says Boye. "MFIs bring financial services to microentrepreneurs, mostly in urban areas. The amounts lent by MFIs can vary but typically [range from] US\$50 to US\$2,000. I&P considers MFIs to be a specific kind of SME." The current portfolio includes stakes in MFIs in Uganda, Côte d'Ivoire and Cameroon. I&P ceded its stake in the Mexican MFI Semisol in 2009 following a five-year engagement.

Two of I&P's projects illustrate its social impact. The Mexican MFI Semisol was founded in 2004, when I&P entered as a majority shareholder. Between 2005 and 2009, Semisol increased its client base sevenfold, created a regional network of five agencies, and employed 75 people. In addition, between 2007 and 2008, the company's net profit increased by 53%. As a result, in 2009 I&P sold its position under favorable terms to Apoyo Integral Inversiones, a consortium of two

specialized microfinance investors, and to a Salvadorian company. Subsequently, I&P decided to focus on microfinance investments located exclusively in Africa, where it thought it could maximize social impact.

The second project involves Cameroun Breuvages, a West African company that packages and distributes water in plastic pouches, responding to a local difficulty in accessing potable water. I&P had a multi-faceted role in developing Cameroun Breuvages, providing both funding through equity and debt investments, and managerial and technical assistance. In addition, I&P raised capital for the company from another investor. By the end of 2009, the company's revenues, distribution network and product offerings grew significantly, with sales of over 15 million units.

I&P helps its portfolio company improve performance by providing advice on product offerings and helping develop managerial skills. "Guidance and accompaniment are extremely important factors in the success of our portfolio companies," says Boye.

Given the relatively higher risk and lower return profile of its investments, I&P's main weakness is an unattractive risk-return ratio for profit-seeking investors. Nevertheless, the company is poised to become a market leader. As I&P grows and the social investing space develops further, the company may face the challenge of identifying the appropriate performance measurement metrics and benchmarks for a non-traditional investment product.

The social investment landscape in France today is becoming increasingly sophisticated and complex. PhiTrust Partenaires' social venture capital model and

I&P's emerging-markets private equity model represent two evolving and distinct ways of approaching social investment. While the former model may turn into a prominent way to bring funding and expert management practices to organizations addressing social issues, the latter has the potential to encourage sustainable economic growth in developing countries. Just as microfinance emerged as a new and powerful approach adopted by charities, investors and development organizations alike, I&P's private equity model has the potential for attracting a wide variety of investors.

The remaining challenge for the social investing sector is the development of demonstrable and comparable social impact metrics or a benchmark that will facilitate evaluation of the social impact of different investment schemes. If such metrics were currently available, investors could rank and compare investments on the basis of potential social impact, thereby reducing the information asymmetry surrounding social benefits. There may indeed be a convergence of the social venture capital model and the emerging-markets private equity model as the establishment of standardized social impact metrics facilitates the comparability of investments pursued by both business models. Thus, investors would be able to remain agnostic to the specific model employed when analyzing potential social investments, enlarging the universe of social impact opportunities that are available.

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## Head: Private Equity in Brazil: Entering a New Era

*The relatively youthful Brazilian private equity (PE) industry has undergone an unprecedented expansion since 2004 as investors have donned their samba shoes and tested the rhythm of fund managers focused on this emerging world power. Over the past six years, the amount of capital committed to PE in the region has grown nearly sixfold — reaching approximately US\$28 billion today. The retail, IT, and industrial sectors have received the greatest share of interest. So what has drawn all this investor attention to Brazil?*

The relatively youthful Brazilian private equity (PE) industry has undergone an unprecedented expansion since 2004 as investors have donned their samba shoes and tested the rhythm of fund managers focused on this emerging world power. Over the past six years, the amount of capital committed to PE in the region has grown nearly sixfold — reaching approximately US\$28 billion today. The retail, IT, and industrial sectors have received the greatest share of interest. So what has drawn all this investor attention to Brazil?

Encouraging macroeconomic policy, favorable market conditions, and effective regulatory changes have combined to entice investors to PE opportunities in Brazil. Recent developments — such as an upgrade of the government debt to investment grade, massive oil discoveries, and plans to host both the World Cup in 2014 and the Olympics in 2016 — have added to the hype for a region that was already on the rise. These encouraging events have allowed Brazil to stand out on its own merits. But they are especially compelling when juxtaposed with a relatively discouraging set of realities in other parts of the world. As José Augusto Carvalho, director of Axxon Group, notes, “investors are recalibrating what they define as ‘risky’ and realizing that Brazil is no longer as far apart as people once thought it was.”

Important challenges remain, of course, such as the fact that Brazil’s real interest rates continue to be among

the highest in the world, the Brazilian judiciary system is relatively inefficient, and PE investors in the region generally lack experience. The PE industry may still have several stages of growing pains to overcome before it can reach a new era of stability in which investors and managers can truly master the rhythm of the samba. Overall, however, a tremendous opportunity exists for PE firms to both benefit from and contribute to the seemingly imminent expansion of the Brazilian economy in the years to come.

### Macroeconomic Progress

The last 30 years of Brazilian history can be broken down into two distinct periods to help highlight the radical changes the country has undergone and to explain the country’s emergence as a highly attractive investment opportunity in the minds of investors. During the first period, 1980-1994, Brazil had 15 finance ministers, five presidents, and six currencies. This period was marked by low GDP growth (2.1% per annum), high interest rates (45% in 1994), and currency depreciation that led to extraordinary inflation (as high as 5,000% in 1993).

In stark contrast, from 1995 to the present, Brazil has had three finance ministers, two presidents, and one currency, the real. This period of impressive stability began with a sound economic policy that targeted inflation through the implementation of the plano real, developed by then-Finance Minister Fernando Henrique

Cardoso. The success of this currency stabilization, combined with lower net debt levels and a rise in foreign currency reserves (up from US\$49 billion in 2003 to US\$239 billion at the end of 2009), led to a significant decrease in real interest rates (from 45% in 1994 to a low of 8.75% in 2009) and a general period of macroeconomic stability that have been the basis for Brazil's sustained growth over the past decade.

## Consumer-led Growth: A New Middle Class

Brazil has long been one of the most inequitable countries in the world in terms of income and wealth distribution. The last decade, however, has seen considerable advancement of lower-class Brazilians into the middle class. Specifically, Brazil's Class C — defined as Brazilians earning monthly wages between US\$581 and US\$2,508 — has grown from 42% of the population in 2004 to 52% in 2008, now representing more than 100 million people. While social programs, such as Bolsa Familia, have received much publicity, the major contributors to Class C's growth have been the increase in real wages for workers and the extension of credit to consumers.

One of Brazil's leading economists notes that for each 1% increase in Brazil's GDP, the per capita income of Class C constituents on average increased by about 7% in recent years. Meanwhile, bank credit, which was virtually non-existent in times of macroeconomic instability, has expanded dramatically. In 2003, credit represented about 24% of Brazil's GDP; by June 2010, it had reached 46%. This credit, moreover, was extended to a record 48% of Class C in 2009.

The combination of increased real wages and the expansion of credit has fueled a new class of consumers looking to buy homes, cars, and other desirable consumer goods. The success of Positivo Informatica, Brazil's largest personal computer (PC) manufacturer, illustrates this phenomenon. From 2005 to 2009, the company's top-line compounded annual growth rate exceeded 108% as PC penetration among Class C consumers doubled from 16% to 32%.

The recent success and future potential of Positivo Informatica highlight the fantastic types of opportunities available to PE funds resulting from Brazil's consumer-demand-led growth. It is noteworthy that only 500 of the country's 12 million companies are publicly traded. The

remaining private institutions represent a considerably large pool of potential star investments for PE funds and, ultimately, the public markets.

## Key Regulatory Modifications

Several major changes in legislation have increased the country's attractiveness for both local and foreign PE investors. One of the most important improvements for PE investment in Brazil occurred in 2003, when the government passed several laws to legally adopt the registration of PE funds, to regulate such establishments, and to address their formal obligations in a method similar to that of the Limited Partner (LP) structure of funds in the U.S. and Europe. In the past, the funds had no clear legal framework on which to base their activity beyond acting as an offshore investor. This changed in 2003 with the introduction of FIPs (Fundos de Investimentos em Participações), investment vehicles that benefit from tax exemptions on capital gains, as found in other developed PE markets.

The Brazilian government has also approved several reforms in the last five years related to the regulation of majority and minority shareholder rights. These reforms have enhanced the rights (e.g., pre-emptive rights, tag-along rights) of minority shareholders and provided additional clarity and security for investors. As a result, there has been an increase in the number of minority investments in Brazil. Gávea, one of the most successful local PE funds in Brazil (it was recently acquired by JP Morgan), has benefitted from these reforms to execute a winning strategy based on minority positions. A recent example of such activity is the fund's investment in Odebrecht, a leading engineering and construction conglomerate, which opened the capital structure of its subsidiaries to attract investments into its businesses in the high-capital-demand industries of oil and gas and infrastructure.

New capital market regulations have also played a significant role in increasing liquidity opportunities for PE investments. In particular, these rigorous regulations were implemented through the creation of the Novo Mercado and the Mercado Mais, two stock markets (similar to the NASDAQ or the AIM) in which listed companies must adhere to stringent transparency and corporate governance rules as well as strict accounting



standards. Investors have generally attributed greater valuations to companies listed on these exchanges due to their higher level of confidence in the quality and transparency of the information shared. The presence of better-regulated capital markets led to a widening of the IPO window as a viable exit option for investors.

Between 2004 and 2008, an unprecedented 113 companies went public on the Bovespa, representing nearly one-third of the 363 companies listed as of September 30, 2010. One of the most successful IPOs of this era was Equatorial Energia, which returned 32 times the capital invested to its investors, GP Investimentos and Banco Pactual. Since 2009, however, the market for IPOs has cooled, with only 27 companies going public. Despite the recent slowdown, PE investors remain optimistic about this exit strategy.

Another notable regulatory adjustment was the government's easing of restrictions on Brazilian pension funds. The government increased pension funds' limits on non-fixed income investments from 50% to 70%. With more than US\$265 billion in aggregate pension-fund assets, this adjustment theoretically freed up US\$53 billion in capital that can now be invested in PE. Similar to what occurred during the 1980s in the U.S., allowing pension funds to be invested more freely in alternative assets is boosting the capital allocated by these institutions toward PE investments. However, the fact remains that PE allocation by pension funds in Brazil is still well below the average of other developed markets (2% vs. 10%), suggesting there is still ample capital available to continue fueling the sector's growth.

Despite these favorable adjustments to its legal framework, Brazil faces two significant legal challenges. The first is to simplify the nation's extremely bureaucratic legal and tax systems, which inevitably lead to high transaction costs for PE investors. According to data from Veirano Advogados, a law firm, an average-size corporation in Brazil spends 6,000 labor hours per year to comply with all its legal obligations and tax payments (vs. approximately 200 hours per year in the U.S.). Second, Brazil must act to accelerate processes in its judiciary system. Legal experts indicate that, on average, competition lawsuits and patent conflicts typically remain unresolved for four to seven years.

## The Evolution of Investor Appetite

The period of the late 1990s was the first real "trial run" for PE in Brazil. Unfortunately, this period of growth ground to halt around the turn of the century due to both substantial depreciation of the real and several instances of fraud or mismanagement (the most notable being Daniel Dantas' Opportunity Fund) that resulted in sub-par returns and caused investors to hesitate to commit to PE strategies in the region. The instances of fraud led many investors to view the PE industry in Brazil "skeptically at first — almost as a dirty business," according to one fund manager. In recent years, greater transparency and standardization have allowed the sector to regain credibility with investors while currency exchange levels have remained relatively stable.

Investor sentiment has grown increasingly positive toward Brazilian PE since 2003, and this tendency continued, if not accelerated, through the financial crisis of 2008 and 2009. Kevin Johnson, of Liberty Global, an emerging-markets-focused placement agency, comments on this dramatic shift in investor appetite: "In 2003, limited partners ... were almost universally negative about investing in PE in Brazil; now, more and more people are enthusiastic about the macro situation." Indeed, the most recent LP survey, conducted by the Emerging Markets Private Equity Association, found that 17% of LPs with existing investments in Brazil planned to increase their allocations, while 11% planned to enter the country for the first time in 2010.

While the macro picture may be rosy, Todd Basnight, who specialized in emerging markets PE for Cambridge Associates, an investment consulting firm, notes that "investors need to first focus on the managers; bad managers in a great environment will still underperform."

Investors agreed at a recent roundtable in San Francisco on PE in Latin America that the main concern with investing in managers in Brazil is their limited experience. Few firms have realized returns to speak of, and historically returns have been sporadic. For these reasons, LPs investing in Brazil not only face the risk of sub-par returns, they also face, as one investment advisor describes it, the even more disparaging possibility of personal "reputation damage" when they back GPs

that are relatively unknown and unproven. Only time and proven performance will give investors additional comfort to allocate more capital to the most talented managers in the region. For now, as Johnson notes, investors are analyzing GPs and are forced to wonder, “How deep of a bench do they have?”

Large international PE firms — such as Carlyle, Warburg Pincus, Apax, Blackstone, and TPG — having recognized the growing investor interest in the region, recently began ramping up their efforts in Brazil. These groups can offer investors a more proven alternative to local shops and the comfort of the franchise value their brands bring to bear. It is too soon to tell how international PE firms will fare in Brazil in comparison with Brazilian-born shops, but LPs agree that having a local team on the ground in Brazil is key to a successful outcome. International GPs are taking different approaches to getting on the ground. Some firms, such as Apax and Carlyle, are setting up greenfield offices while others, such as Blackstone and JP Morgan, have bought stakes in existing Brazilian players to establish a presence.

Not only is investor demand driving international GP interest, but some international funds believe they bring unique expertise that will allow them to succeed in the region. As Jason Wright, an executive from Apax Partners who led the firm’s first investment in Brazil, notes, “large buy-out deals in Brazil are meant to be done by international funds because they have more resources available and a broader network of experts to analyze transactions.” Apax Partners recently entered the region with a splash by purchasing TIVIT, a business-process outsourcing company, at a US\$1 billion dollar valuation, making the deal the largest PE transaction in Brazil to date. So far, however, international funds have only a handful of executed deals to their names. Octavio Lopes, a Partner of GP Investimentos, with more than 15 years of experience in the sector, agrees that these international heavyweights may be the frontrunners to execute future “mega deals” (US\$1 billion plus). But he adds a caveat: “They will probably win the deals at higher prices.”

## Potential Growing Pains

The rapid expansion of the PE sector itself has also sparked some concerns for investors. Several established

PE groups in the region are now on their third or fourth consecutively larger fundraising, while international buyout funds are becoming increasingly active. Industry observers wonder if the large funds being assembled today can source and execute on deals of significantly larger size and also whether these larger funds will be required to shift their focus beyond what most specialists agree is the most attractive segment in which to invest: the middle market.

Another concern for investors is a general lack of specialization. This allows funds to throw money at the latest trends, perhaps in sectors that are overheated. According to one PE professional, “in 2006, everyone wanted to invest in ethanol; the result was that several deals were done that ended poorly.” With growth, PE firms will need to implement size and sector discipline to satisfy investors.

## A Question of Leverage

Although lower interest rates have increased investor confidence in Brazil’s macroeconomic stability, they have not fundamentally changed the way deals are structured. That is, most deals continue to be financed entirely with equity, and those that are not tend to have relatively low debt-to-equity ratios.

In the U.S. and Europe, PE deals tend to be highly leveraged in the pursuit of attaining target returns of 20% for investors. In Brazil, many investors believe they can obtain rates of return of 25% (or higher) without any debt financing. Prior to 2005, prohibitively expensive interest rates took debt out of the equation. Presently, PE funds report borrowing rates of around 13%-15%, which continue to be very high, but well below the typical 25% rate of return. A key issue for PE firms, however, is accessing long-term credit.

Bank lending to companies in Brazil has increased, as have tenors. Certainly, more PE deals have been financed with some debt in recent years than in the previous PE wave of the 1990s, and some investors claim to be able to access tenors of up to seven years. However, most Brazilian banks tend to lend for two years at most (less than the typical three-to-five-year PE investment cycle).

In Brazil, BNDES, Brazil’s national development bank, funds 65% of the nation’s capital expenditures at

subsidized rates. As Bernardo Gradin, CEO of Braskem, Latin America's leading petrochemical company, notes, BNDES is a "necessary evil," as it offers companies the long-term capital that private institutions will not because it is much more profitable for them to lend at high rates over the short term. To understand BNDES' significance in Brazil, consider that its budget currently accounts for 9% of the country's GDP.

According to Lopes, PE deals in Brazil are financed, on average, with 0% debt; when they do have leverage, it is limited to 2-2.5 times EBITDA. This compares starkly with multiples of 4-7 times EBITDA, seen in the heydays of the U.S. and European LBO markets.

In the boom years of 2006 and 2007, Brazil did see some significant leveraged buyouts. Two remarkable deals were performed by GP Investimentos, the largest PE fund in Brazil and Latin America. The first was the acquisition of Magnesita, today the world's largest player in the refractory industry, which was financed, according to industry sources, with 40% debt and 60% equity. Industry observers note that Banco Real lent US\$500 million as a 1.5-year bridge loan and then Unibanco took on the loan for about five years.

The second notable deal was the purchase of San Antonio, a drilling company, that was perhaps the most leveraged transaction Brazil has ever seen. According to a company insider, the deal was financed with approximately 60% debt and 40% equity. Many industry experts doubt that such leverage ratios will be seen again anytime soon. Since the credit crisis, several highly leveraged deals have required restructuring, and both investors and banks have become more cautious when considering leverage levels.

It is interesting to note that, although equity markets have deepened significantly in Brazil over the past few years, local debt-capital markets (in the form of debentures) remain a capital-raising alternative only for large, well-known companies such as Vale and Petrobras. A former Carlyle executive believes that when Brazilian debt-capital markets take off, there will be a new boom for PE in Brazil, as more access to long-term financing will likely bolster returns on investment.

## The Opportunity Ahead

The combination of sound macroeconomic policies for the past 15 years, the emergence of a new middle class, key regulatory and legal improvements, and a deepening of capital markets has enabled Brazil to stand out on an absolute and relative basis on the world stage and to gain investors' confidence. The outlook for PE investments in Brazil at this moment is positive, despite concerns about high real interest rates, legal inefficiencies, and a natural experiential learning curve that the industry must climb. According to Lopes, there are still many opportunities for PE funds to invest in companies and improve management, operations, and processes.

It is important to recognize that much of Brazil's historic and present progress has been made possible by the stability achieved within national politics and by subsequent policy decisions. With Dilma Rousseff as president, the general consensus of fund managers in Brazil is that a stable political environment and steady macroeconomic policy will continue.

There is a clear opportunity both for Brazil and for investors to take advantage of the momentum at hand. Brazil requires investment in almost every sector — in particular, oil and gas, education and infrastructure — to modernize the economy and to continue fueling sustainable growth. After relying for years on highly leveraged acquisitions concentrated in ultra-competitive, low-growth markets, investors are eager for opportunities with attractive growth perspectives, such as those that Brazil stands to offer.

Large players have understood this and have already established or are about to establish permanent offices. A new wave of actors and deals is expected in the coming years that will mature and consolidate the PE industry in Brazil and remain, even after Carnival is over. Moreover, many expect that once debt-capital markets deepen and real interest rates fall further, there will be a greater opportunity for increased returns through leverage that will lead to a new wave of industry growth. For now, however, PE managers will need to make good on the mountain of capital at hand. An estimated US\$9 billion in uninvested PE capital awaits deployment — certainly too much to spend just on caipirinhas. Many deals and

subsequent successes in the near future will most likely set the pace and rhythm of an established and influential sector of the Brazilian economy for years to come.

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## Sustainable Housing: A Solution for Mexico

*Political instability. Drug-related violence. Poverty. Global warming. Although Mexico faces seemingly insurmountable challenges, the current government is taking innovative action to address these issues. One particularly significant step forward can be seen in initiatives to promote sustainable housing development for those most in need.*

Political instability. Drug-related violence. Poverty. Global warming. Although Mexico faces seemingly insurmountable challenges, the current government is taking innovative action to address these issues. One particularly significant step forward can be seen in initiatives to promote sustainable housing development for those most in need.

The Mexican Housing Authority estimates a deficit today of approximately 8.9 million homes — a number that increases annually by 200,000. With a total of 24.3 million homes in Mexico as of the 2005 census, the country needs more than 35% additional homes for the current population. This deficit results from a lack of real estate development and financing options, among other factors. According to the *Global Property Guide*, housing financing is available to only 10% of the total labor force. As a result, in 2000, as many as 70% of new homes in Mexico were constructed by individuals rather than developers. *This number has since dropped to 30% due to government initiatives.*

The deficit is expected to increase over the next two decades, while the population is projected to grow from 37.8 million people between the ages of 25 and 45 (the prime home-buying age group) in 2005 to 45.8 million by 2030, resulting in a dramatic upsurge in the number of potential buyers. The *Global Property Guide* indicates that the mortgage market represents only about 10% of GDP, which is “significantly smaller than

other Organisation for Economic Co-operation and Development [OECD]-member countries,” suggesting that the market is underserved based on its potential.

In addition to housing deficit concerns, Mexico is already suffering from the effects of year-round climate change in terms of higher temperatures and lower rainfall. The *Fourth Assessment Report* of the Intergovernmental Panel on Climate Change predicts that temperatures could increase in Latin America by 0.4 to 1.8°C by 2020 and by 1 to 4°C by 2050, which would significantly increase the number of consecutive dry days and the length of heat waves in Mexico. Combined with reduced rainfall, this would intensify water shortages, which have become a serious national problem, particularly in Mexico’s urban centers.

In response, Mexico must move from a carbon-intensive to a carbon-neutral economy. At present, the country emits 715 million tons of carbon dioxide into the atmosphere each year. Total greenhouse gas emissions exceed the per capita emissions in Brazil and India and on par with those of China. Left unchecked, the consequences of climate change and water scarcity are expected to have adverse effects on social and financial conditions in Mexico.

Sustainable housing can help reduce these problems. In the context of Mexico, sustainable housing refers to the homes and communities developed with the objective of (a) reducing environmental impact through the use

of ecological materials, equipment and practices; (b) improving the quality of life for society by creating a social fabric that fosters prosperous societies, as opposed to simply building commuter cities with little to no interaction among inhabitants, and (c) increasing access to financing for those in need while promoting savings through the efficient use of water and energy.

Through public-private-sector partnerships and attractive incentives, the sustainable housing initiative innovatively addresses several of Mexico's problems, namely, the massive housing deficit, the marginalization of low-income families, a lack of social integration, and growing environmental concerns. To this end, the Mexican government, along with private-sector firms, have instituted sustainable housing-development initiatives as a means to ensure the country's economic, social and environmental viability.

## An Innovative Public Sector

When President Felipe Calderón took office in late 2006, his administration proactively began to address deficiencies in the housing market. In response to this new mandate, in early 2007, the federal housing commission, CONAVI, initiated the National Housing Program — an aggressive plan to construct six million homes by 2012, roughly one million of which are to be sustainable. The government soon elevated the program to legal stature and developed a multi-pronged execution strategy targeting several issues, such as access to financing, options for low-income residents and the availability of “green” (i.e., environmentally friendly) housing.

To promote economic and social sustainability, the National Housing Program has put forth objectives to expand financing coverage for low-income families and marginalized groups, such as indigenous populations, single mothers and senior citizens. For example, in 2007, CONAVI launched *Ésta es tu Casa* (“This Is Your Home”), a program to provide subsidies worth 20%-25% of the acquisition costs of homes for families earning up to four times the minimum wage (74,000 pesos or roughly US\$6,000 per annum). To help fast-track such initiatives, the government granted contracts, credits and favorable financing terms to private developers constructing green or low-income homes.

In addition, CONAVI also partnered with INFONAVIT (the National Workers Housing Institute) to ensure the provision of approximately 500,000 mortgages per year, including funding for low-income families. To reach the lowest-income populations, organizations such as FONHAPO (the National Peoples Housing Trust) and SEDESOL (the Secretariat for Social Development) provide mortgages to those without credit histories, to seasonal or temporary workers and to those participating in Mexico's large informal economy.

The Mexican government and CONAVI have made environmental sustainability another clear priority. CONAVI's National Housing Program includes the regulation and standardization of green-housing modifications and norms to maintain high-quality, environmentally sustainable housing options. It also promotes green mortgages and subsidies, and has led to the launch of pilot training programs to educate the population on the benefits and operation of sustainable homes.

To standardize and promote green housing development, CONAVI developed the *Paquete Básico* (“Basic Package”), a set of environmentally sustainable criteria that address site and terrain viability, water and waste management, and energy usage and insulation. CONAVI offered families purchasing homes that complied with the *Paquete Básico* an additional subsidy of 20%, in addition to the potential 20%-25% from the *Ésta es tu Casa* program. In 2008, CONAVI further expanded its commitment to environmental sustainability by modifying the subsidy program to make the *Paquete Básico* a requirement of all homes eligible for a single subsidy of 20%.

In addition to subsidy programs for homeowners, INFONAVIT has committed to offering green mortgages to some low-income families. These mortgages contain (a) higher up-front costs to acquire green modifications and (b) a payment plan that takes into account the long-term utility savings, allowing low-income families to purchase green homes that have larger capital requirements.

With this government initiative in place, Mexico needed the participation of the private sector to boost the supply of sustainable housing options. CONAVI, in conjunction with several other organizations, instituted

the DUIS (Integrated Sustainable Urban Development) certification program, whereby certified developments are eligible for government financing for infrastructure and housing construction, equipment and land acquisition, bond structuring, promotion of private investment, and technical assistance.

According to CONAVI's Director of Construction and Technology, Cristina Gonzalez Zertuche, "The DUIS doesn't only address the concept of the home, but as the name suggests, it addresses the entire community while integrating the home with its environment." DUIS certification allows private developers to undertake sustainable housing projects under more favorable financing terms. This is particularly significant given the restricted capital markets and otherwise sparse government loans — financial conditions that often leave housing projects at a standstill. The overriding goal of this model is to promote the coordinated participation of federal, state and local governments to develop holistically sustainable projects that address infrastructure, transportation, public-space utility and the green nature of the homes.

The benefits of a multi-tiered approach involving several public-sector organizations and private-sector developers quickly became apparent through a test run of the National Housing Program in 2007-2008. The pilot program built 5,000 homes in the northeastern state of Nuevo Leon and bordering Tamaulipas. These modular, replicable homes were constructed in conjunction with state-level organizations, private developers and top universities as an opportunity to test new technologies, measure economic and environmental benefits, study the broad-scale feasibility of the DUIS program and promote inter-organizational cooperation. Private-sector developers took an active role in determining how the private sector would set the pace for sustainable housing development in the future. According to Gonzalez Zertuche, the pilot program's success and the extent of cooperative involvement of such a diverse range of entities has created a strong sense of optimism toward achieving the National Housing Program's goals for 2012.

## Scaling the Initiative Through Private-Sector Collaboration

Following the success of the pilot program, the private sector seized the opportunity to undertake large-scale sustainable housing developments. The five biggest independent developers in Mexico are Urbi, Geo, ARA, Homex and Sare. Urbi, with a 7% share of the market, pioneered the first government-backed sustainable housing project and has since been setting standards for other developers.

Urbi's DUIS-certified project serves as an instructive example of the private sector's role in implementing the government's vision and subsequently promoting social, economic and environmental sustainability. In 2007, the government approved Urbi's proposed macro sustainable housing project in Valle de Las Palmas (Tijuana, Baja California), calling the "sustainable city" a new development paradigm. The goal over the next five years is to build 100,000 homes there and, over the next 20 years, enough homes to support a population equal to the size of Tijuana today (i.e., more than a million inhabitants). The housing development targets the "social-interest" segment of the population, comprised of workers who earn less than four times the minimum wage.

With the unified support of national government agencies, Urbi was able to bring on board the local government of Baja, California, the municipal government of Tijuana, and other outside organizations, such as the World Bank. The resulting public-private partnership allowed the project to move forward efficiently in all aspects of its development, from legal hurdles — such as building permits — to more technical considerations, such as the system design of the water supply.

Beyond logistical advantages, this public-private partnership was instrumental in making the project financially viable. According to the head of Urbi's Corporate Communications, Alma Beltran Rosales, and the project leader for Urbi's Innovation and Sustainable Growth Program, Fernando Mayagoitia, four key factors support profitability. The first, and most significant, is scale. In the first phase of construction, from 2007 to



2010, Urbi built 10,000 houses. The company plans to add continually to this number over the next 20 years, allowing it to take advantage of significant economies of scale. The second factor relates to access to capital and favorable interest rates. The government provides capital at favorable interest rates that, in turn, encourage private-sector banks to offer lower rates because government support often translates into lower risk.

Accordingly, during the first phase of development, Urbi received 100 million pesos (US\$7.7 million) from public funds and 350 million pesos (US\$27.0 million) from private funds. The third factor relates to the perceived appreciation of Urbi's land, given the 20-year commitment to the macro project. The final factor is revenue generated from carbon-emissions trading. Urbi earns credits through its developments by reducing carbon emissions, which it can then sell on the open market.

These favorable political and financial conditions have given rise to Valle San Pedro of Valle Las Palmas — the seed community of a modern, sustainable city recognized in August 2010 as one of the 15 most innovative macro projects in Latin America. After phase one is completed this year, 10,000 homebuyers will have the opportunity to buy subsidized, high-quality homes designed to be environmentally, socially and economically sustainable.

Valle Las Palmas' environmental impact is significant, as the city has extensive infrastructure for water treatment and reuse, renewable energy and waste recycling. The water supply comprises a mix of reservoir water, treated salt water and recycled water, all processed at a hydraulic facility. The city's energy sources are just as diverse, incorporating solar energy, wind energy and methane gas. These varied resources, in turn, help to fuel the on-site waste-recycling facilities.

In the area of social sustainability, Urbi encourages all community members to share the right and obligation to maintain a clean and organized environment, with the objective of raising the collective standard of living. On a more practical level, the Valle Las Palmas developers have also incorporated employment and educational opportunities into the community design. The site was chosen, in part, for its proximity to the Tacoma

automobile factory, where Toyota recently invested 461 million pesos (US\$37 million) in plant expansion. In addition, Urbi designated 500 of 1,900 acres to an industrial complex that has the potential to generate 8,000 new jobs. Moreover, the federal government has promoted investment in new industrial plants in sectors already active in the area. With regard to education, in 2007 Urbi donated land to the Universidad Autónoma de Baja California. The new Valle Las Palmas campus opened this year with an initial enrollment of 4,000 students.

With regard to economic sustainability from the consumer standpoint, CONAVI and INFONAVIT offer targeted buyers favorable financing terms. For an average Valle Las Palmas home priced at 212,000 pesos (US\$16,500), the typical buyer will make a small down payment of approximately 7,400 pesos (US\$600) in savings, which is then complemented with a subsidy of 34,500 pesos (US\$2,800) and a credit of 162,000 pesos (US\$13,100) through the green-mortgage program. Reduced utility bills over the long term are expected to compensate for sustainable housing price premiums not already covered by the subsidy.

The initial success of Urbi's federal, regional, and local government partnerships is paving the way for private-sector developers to undertake more sustainable housing projects while, at the same time, achieving sustainable profitability. As noted by Cuauhtémoc Pérez Román, general director of Urbi, "Without a doubt, in Mexico we have the historic opportunity to develop a model for sustainable communities ... through the joint effort of society and government, which can be transformed into a motor for growth and job creation."

## The Challenges Ahead

While the Mexican government has made a bold decision to address the ongoing housing deficit and environmental deterioration, many challenges persist. Perhaps the greatest threat to the sustainable housing program is the instability of Mexico's political system. In the recent state and local elections of July 2010, the opposing political party, the Institutional Revolutionary Party (PRI), won the majority of the neutral states and could potentially regain the presidency in 2012. Many wonder how a political turnover will affect the sustainable housing projects and whether a new



government will choose to continue to pursue the goals set by CONAVI and the Calderón administration.

Considering the global financial standstill and the constrained access to liquidity and credit, it is questionable whether the Mexican government has sufficient funds to continue financing these housing initiatives. Approximately 40% of the national revenue is generated by PEMEX, the state-owned petroleum company. Revenues are plummeting as a result of the company's inefficient management and the rapid depletion of the country's petroleum reserves. It is unclear how this will affect the budget in the medium term.

Furthermore, one should also consider the social implications of building sustainable housing developments away from city centers. As Gonzalez Zertuche noted, "The demand definitely exists, especially due to new young families and a growing population — this has been studied. In addition, there is an abundance of homes that need to be improved, generating additional demand for renovation. If such homes are sustainable and compliant with the requirements, they, too, will receive credits and subsidies." Given worldwide urban migration trends, it is quite possible that said demand will be concentrated in Mexico's most populated cities, leading to decreased occupancy rates in housing developments outside city limits. This could be troublesome for public safety and the maintenance of theoretically "sustainable" communities. Alberto Chaia, a McKinsey Partner based in Mexico City, challenged CONAVI's decisions, arguing that Mexico should focus on building vertically — rather than horizontally — since commuting is both a financial burden on the worker and an environmental burden on the atmosphere.

An additional concern relates to homebuyers' receptiveness to maintaining the sustainable communities. Professor Pablo Rene Ramírez, director of communication and development at el Instituto Tecnológico de Estudios Superiores de Monterrey (ITESM), noted that lower-income families are not always cognizant of the concept of sustainability. Due to daily economic constraints, many think only in the short term. According to Ramírez, "Those targeted for these large-scale, low-income developments are unable

to comprehend the advantages—the beneficiaries do not see the benefit." To illustrate he adds, "The main challenge is to understand the incremental cost of a home with green components, such as solar water heaters, as compared with normal homes, as well as the associated long-term utility savings. When INFONAVIT finances the cost through green mortgages, people are more willing to acquire the sustainable homes. However, what occurs is that people then sell the heaters for quick cash, and then do not benefit from the long-term utility savings and thus are unable to pay the mortgages or make ends meet."

This then begs the question of how well CONAVI, INFONAVIT, the private-sector developers and other intermediaries are able to cooperate and provide the necessary education and training to mitigate this. Ramírez continues, "Overall, the integration of solutions for sustainable housing represents serious hurdles for INFONAVIT. Those taking on the mortgages are not sufficiently educated to understand or value the positive impact they are having. There isn't a legal body tasked with supervising the maintenance and proper use of green modifications." Ramírez, in association with ITESM, has proposed the implementation of community training centers to conduct programs to educate such communities about the culture of sustainability. In addition, he has also questioned (a) the ability of the government and the homebuilders to perform adequate quality control on the sustainable technologies incorporated in the projects and (b) whether these green technologies are transferrable across Mexico's distinctive climates, from the northern deserts to the southern tropics. In general, it is unclear whether these large-scale housing projects are, indeed, replicable across Mexico and the rest of Latin America.

Despite these questions and concerns, the initial achievements and anticipated long-term impacts of the program arguably outweigh the challenges. After all, risk is an essential component of any large-scale, innovative initiative. With regard to social sustainability, the sustainable housing projects have already succeeded in offering homes to individuals who were previously unable to obtain mortgages. The concept of integrally sustainable communities has significant potential to generate a

positive cycle whereby higher-quality houses, cleaner water, cheaper utilities and improved access to education and employment opportunities will start replacing the cycle of poverty that fuels deep social problems.

From an economic perspective, all the parties involved have access to appropriate financial incentives. For instance, INFONAVIT guarantees homebuyers' mortgages and covers their down payments on sustainable houses, which in turn generate savings from the efficient use of water and electricity. Likewise, DUIS certification assures developers access to more attractive financing solutions and indirectly introduces these companies to a large pool of potential clients.

As of 2010, five DUIS-certified sustainable housing projects are underway across Mexico. These developments are already having an environmental impact, with reductions in carbon emissions, water contamination, and other pollutants. The wave of sustainable housing projects is expected to gain strength in the near term, Greener communities are expected to serve as models for housing development, subsequently encouraging other communities to adopt best practices for water, energy, and waste efficiency.

## A Sustainable Future

Large-scale sustainable housing developments in Mexico are proving to be a creative and inspiring approach to addressing the housing deficit, environmental degradation, and the lack of access to home financing for Mexico's lower-income families. Projects such as Urbi's Valle Las Palmas incorporate the social, economic, and environmental elements necessary to achieve long-term sustainability. The Mexican government has successfully managed to align the interests of private-sector developers with those of numerous public-sector entities. Although it is difficult to truly quantify this impact, it is hoped that the material successes to date will inspire public confidence and set an example for collaboration that will propel Mexico's sustainable housing initiatives into the future.

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## From the Periphery to Prosperity: The Brazil 2014 FIFA World Cup and the City of Salvador

*Expected economic impact: R\$183.2 billion (US\$107 billion). Estimated new jobs: 710,000. Projected impact on tourism: R\$9.4 billion (US\$5.5 billion). As Brazil prepares to host the 2014 World Cup, the front pages of newspapers across the country offer stunning predictions that this World Cup will provide an incredible boost to the Brazilian economy. But will it? As seen with previous mega events, the huge investments required to host the event successfully do not always bring the expected economic returns or immediate increases in tourism.*

Expected economic impact: R\$183.2 billion (US\$107 billion). Estimated new jobs: 710,000. Projected impact on tourism: R\$9.4 billion (US\$5.5 billion). As Brazil prepares to host the 2014 World Cup, the front pages of newspapers across the country offer stunning predictions that this World Cup will provide an incredible boost to the Brazilian economy.

Unfortunately, the literature suggests that mega sporting events, such as the World Cup, have been credited with having a greater economic impact than they actually do. Some of the recurring estimation mistakes include (1) overlooking the fact that many internal consumers have relatively fixed leisure budgets, (2) not knowing enough about economic activity patterns of those full-time residents not attending the event, and (3) ignoring the fact that regular tourists avoid already-popular tourist spots. In addition, as seen with previous mega events, the huge investments required to host the event successfully do not always bring the expected economic returns or immediate increases in tourism.

The FIFA (Fédération Internationale Football Association) World Cups held in South Korea-Japan in 2002 and in Germany in 2006 help to reinforce the fallacy of mega events as major economic boosters.

South Korea spent approximately US\$2 billion to construct 10 new stadia. However, tourism to the region was barely impacted by the incredible investment in infrastructure. The number of visitors was exactly the same during the summers of 2001 and 2002, approximately 460,000. Germany showed a similarly inconsistent immediate economic impact when it hosted the World Cup in 2006.

Despite these somewhat unimpressive economic returns, the World Cup matches in both South Korea and Germany were still considered to be huge successes. In light of this observation, are there other types of benefits — potentially less tangible — that come from hosting such events? If so, do they help explain why cities and countries, particularly in the developing world, are so intent on hosting them? An analysis of Brazil's decision to host the next World Cup provides interesting answers to this question. An analysis of the projected impact of the World Cup on one of the selected host cities is even better as it provides an opportunity to look more narrowly at the other potential benefits, such as large-scale improvements in infrastructure that might otherwise be politically untenable and a unique opportunity for the country and the city to brand themselves internationally.

## Kicking off the World Cup in Brazil

In 2007, FIFA selected Brazil to host the World Cup in 2014. This decision is in line with FIFA's strategy of rotating the World Cup between the continents and giving new emerging economies the opportunity to host. The selection was, therefore, not a surprise: A South American country had not hosted the event since 1978, and Brazil's recent economic and political performance continues to amaze the world. As Ronaldo Helal, professor of sociology at the State University of Rio de Janeiro and author of "Passes e Impasses: Futebol e Cultura de Massa no Brasil" (Passes and Impasses: Football and Mass Culture in Brazil), noted in a recent interview, "The country has experienced 16 years of economic stability, 20 years of democratic rule, and has done well during the economic crisis that affected most developed countries in the past few years."

Currently the eighth largest economy in the world and the largest in Latin America, Brazil was expected to have a GDP growth of 7.8% during 2010. Unlike most countries, the 2008 crisis had a quasi-imperceptible impact on its economy, with a -0.2% GDP growth in 2009.

Salvador, founded in 1549 and capital of Brazil until 1763, is one of the 12 cities selected to host the competition (along with Belo Horizonte, Brasília, Cuiabá, Curitiba, Fortaleza, Manaus, Natal, Porto Alegre, Recife, Rio de Janeiro, and São Paulo). The city is one of the cultural hearts of the country, and its colonial historical center, Pelourinho, was declared a World Heritage Site by UNESCO in 1985. Salvador has a population of 2.9 million inhabitants and is the third largest city in Brazil, although considerably smaller than São Paulo (10.9 million) and Rio de Janeiro (6.1 million). Salvador contributes about 1% of national GDP and occupies the 11th place nationally. However, due to its high level of inequality, the city occupies the 23rd position in GDP per capita at R\$9,240 (US\$5,400). In comparison, the city of São Paulo has the highest GDP per capita at R\$29,394 (US\$17,200).

Salvador's largest economic sector is tourism, and it is currently the second most popular destination in Brazil after Rio de Janeiro. According to the city's local government, commercial and services activities account for 75% of the city's economy and industrial activities

account for 25%. The Port of Salvador, located in Bahia Todos Los Santos, is the largest port in the northeastern region of Brazil.

Hosting a World Cup is not an easy venture, especially in a developing country like Brazil. Looking toward the World Cup, each host city has to be prepared in three main areas: the stadium, airport and transportation, and accommodations for tourists. Salvador will receive financing and investments of approximately R\$1.24 billion (US\$730 million), of which about R\$1 billion (US\$588 million) will come from the federal government — approximately 6% of the government's total planned investment in World Cup preparations. The remainder will be provided primarily by the state of Bahia. Observers see this as an enormous net gain for Salvador and a significant opportunity for the city to improve its infrastructure.

## Fonte Nova Stadium

FIFA requests that host nations have stadia with seating capacities ranging from 40,000 to 60,000 and be adapted to specific standards, regardless of their locations and plans for long-term usage. Unfortunately, Salvador's Fonte Nova Stadium does not currently adhere to these norms and is thus in the midst of a major renovation. According to Adriana B. Dantas, from the department in charge of World Cup projects at BNDES (Banco Nacional de Desenvolvimento Economico e Social), "the demolition and reconstruction of the Fonte Nova Stadium will cost R\$714 million (US\$417 million), from which R\$400 million (US\$234 million) will come from BNDES funding." The new stadium will have a capacity for approximately 50,000 people and will include 50 suites for 1,000 people, a press area for 1,600 journalists and a VIP area for 2,500 guests.

One of the key issues when building new stadia is to have a plan in place to maximize their use once the event is over, according to Derrick Heggans, Managing Director of the Wharton Sports Business Initiative. This is precisely one of the concerns often associated with organizing mega events such as the World Cup. Cities end up with stadia that are not used regularly and become known as "white elephants." Although there are two important football teams in the Bahian capital (SC Bahia and Vitoria FC), analysts fear that



Fonte Nova Stadium will become one of these “white elephants” because so few people can afford tickets to sporting events on a regular basis. According to research carried out by SINAENCO (National Association of Architectural and Consulting Engineering Companies), “the most important challenge for Salvador in the 2014 World Cup is to balance the sustainability of the new stadium with the increasing social inequality in the city. The metropolitan region of Salvador presents the highest level of inequality in the country.”

Despite this fact and the inability of most residents today to pay for tickets to regular soccer games — which would have to be priced at R\$30 (US\$18) to make the construction project economically feasible — the emergence of a new Brazilian middle class, known as Class C, might change this equation in the medium to long term.

### **Salvador’s Strengths: Airport and Accommodations**

The greatest challenges for cities often take place outside the playing fields. Host cities need to be prepared to receive a significant number of visitors and have all the necessary facilities in place for a worldwide event like this. During June and July 2014, when the World Cup will take place, Brazil expects approximately 600,000 foreign tourists and 3.1 million domestic tourists, according to the Brazilian Sports Ministry.

As a major tourist destination, Salvador already has an airport handling six million people annually (about 80% domestic travelers and 20% foreign), indicating that the city can manage the approximately 300,000 people who will be arriving during the matches in 2014. Dantas pointed out that, “according to Murilo Barboza, president of the airport infrastructure company of Brazil [INFRAERO], Salvador International Airport is already prepared for receiving the additional demand during the 2014 World Cup.”

Similarly, the number of hotel accommodations is already nearly adequate. The 24,000 beds currently available in Salvador will need to be increased to approximately 30,000 over the next four years.

With these amenities in place, Salvador seems well-prepared to cater to the large number of tourists who

will be visiting during the World Cup. However, what will happen to Salvador’s existing tourists at that time? Will they feel crowded out?

Salvador’s high season for tourism runs from December to March and is highlighted by the Carnival Festival, which usually takes place in February. Since the World Cup begins in June — one of the worst months for tourism in the city — a crowding-out effect is not expected. On the contrary, Salvador views this as a unique opportunity to increase the number of visitors during the low season while boosting the city’s long-term appeal to traditional tourists through the renovations being implemented with the influx of government funding and investments.

Yet while the Bahian capital may be in a good position with respect to its airport and accommodations, it is seriously lacking in the area of urban transportation. This is Salvador’s greatest need in the run-up to the World Cup; its successful management could become the best benefit for the city in the long term. The city’s authorities need to improve the public transportation system by adding more capacity to avoid the current peak-hour traffic jams. Several projects are underway, at an estimated cost of R\$1.3 billion (US\$760 million), including the extension of subway line 1, which will have a daily capacity of 250,000 passengers; improvements to subway line 2, which will connect the airport to the hotel area and city center; and the integration of the different public transportation systems (the Transalvador project). In addition, the BRT project, a fast commuter bus, will connect the northern area of Salvador with the airport at a cost of R\$567 million (US\$332 million).

### **Beyond the Economic Myth: Image and Infrastructure**

Brazil, as a rapidly developing country with the resources to host the World Cup, is perhaps also uniquely qualified to benefit from such a mega event. The analysis presented here makes the case for conceptualizing the World Cup, not as a direct stimulator of the economy, but perhaps more as one of the single best opportunities for a country to improve its internal infrastructure. The 2014 World Cup presents the country — and its cities, in particular Salvador — with a unique opportunity to upgrade its transportation system above all else. As one

looks at Brazil's current state of development and the degree to which it has grown over the last two decades, improvements in this arena will definitely help the country show the world that it belongs in the major leagues.

As Joao Alberto Viol, president of SINAENCO, noted in a recent interview: "Our involvement with the 2014 Cup is directly linked to our desire to show the importance of this event for the development of Brazilian infrastructure, with the objective of giving — starting in 2015 — greater visibility to international tourism and moving Brazil one step closer to fully integrating itself in the world of developed countries."

Wolfgang Maenning, in his assessment of the 2006 World Cup in Germany, writes that, despite the limited economic success of the event, "Of more significance ... are other measurable effects such as the novelty effect of the stadiums, the improved image for Germany and the feel-good effect for the population." As a result of the World Cup, he adds, "the perception of Germany has risen in other countries. The erstwhile image abroad of Germany as 'hard and cold ... not a nation much associated with warmth, hospitality, beauty, culture or fun' was improved through the World Cup...."

Similarly, Willi Lemke, special advisor to the UN Secretary-General on Sport for Development and Peace, said in a recent interview about the 2010 World Cup in South Africa: "[Image] has long been a problem in Africa, and when the media focus on scandals and other problems, that only serves to make the vicious circle even bigger.... It is incredibly important that Africa manages to get people talking about the positive side for once. South Africa has the perfect opportunity to show the world its beauty, its animal world, its culture, its diversity and its happy people." In 2014, Brazil will have a similar opportunity.

As Helal put it: "The World Cup is going to be a very symbolic moment for Brazil. Like in 1950 [when Brazil last hosted the World Cup], Brazil wants to show the world its great capacity for growth and its role as a 'great nation.' The difference from 1950 is that the country is, in fact, experiencing a very special moment in its history. Brazilian people will be very mobilized for the event."

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## Drug Trafficking, Violence and Mexico's Economic Future

*Mexico produces and distributes marijuana, cocaine, heroin, and methamphetamine to most of the world. Drug trafficking is a lucrative activity for the Mexican cartels, generating annual revenues of US\$35 billion to US\$45 billion, with a profit margin of approximately 80%. Given these numbers, many cartels use violence and intimidation to protect the profits they make producing and distributing drugs. What are the sources of increasing drug-related violence in Mexico and what is its economic impact, including direct and indirect costs? Finally, what has been the response of the global business community?*

In June 2010, in the days leading up to Mexico's state elections, Rodolfo Torre, a leading gubernatorial candidate from the northern state of Tamaulipas, was assassinated. He had campaigned against Mexico's drug-related violence. Shortly thereafter, in July, drug criminals used a car bomb for the first time in the history of Mexico's drug war and killed four people in Ciudad Juárez. In August, the bodies of 72 migrants were found in northern Mexico. They had been shot after refusing to work for a drug gang. Days later, a prosecutor and police officer investigating the crime disappeared.

Headlines such as these have become commonplace in today's news stories. Yet the reasons behind this escalating violence and its broader impacts on Mexican society are not fully understood because public attention is consumed by the shocking nature of the crimes. Since the scale of the human tragedy has already been well-examined, this article focuses instead on the source of increasing drug-related violence in Mexico; its economic impact, including direct and indirect costs; and the response of the global business community.

Mexico produces and distributes marijuana, cocaine, heroin, and methamphetamine to most of the world. Its largest market, the U.S., sources 90% of its cocaine from Mexico. Drug trafficking is a lucrative activity for the

Mexican cartels, generating estimated annual revenues of US\$35 billion to US\$45 billion for Mexico, with a profit margin of approximately 80%. For this reason, many cartels are fighting for the profits involved in producing and distributing drugs. Currently, seven powerful drug-trafficking organizations occupy different regions of Mexico — La Familia Michoacán, the Gulf Cartel, Los Zetas, the Beltrán-Leyva Organization, the Sinaloa Cartel, the Tijuana Cartel, and the Juárez Cartel.

Mexico's drug trade and these cartels have existed for many decades. However, the violence related to the country's drug trade has increased dramatically since President Felipe Calderón took office in December 2006. While previous administrations did not confront the drug trade aggressively, Calderón launched a total war, believing the increasing power of Mexico's drug cartels poses a serious threat to the country's security.

Almost immediately after taking office in 2006, Calderón deployed 36,000 national troops to nine states to destroy crops, collect intelligence, interrogate suspects, and confiscate contraband. He has also initiated a variety of public security and judicial reforms. For example, the Mexican government is working to improve the effectiveness of its federal police force, planning to hire 8,000 additional police investigators during 2010, while

at the same time trying to purge the force of corruption. In August 2010, nearly 10% of the federal police were fired for failing lie detector, drug, or other tests that form the “trust control exams” designed to identify officers with ties to organized crime.

In addition, *Plataforma México*, a recent reform related to information management, aims to create real-time interconnectivity within Mexico’s police force by developing a national crime database to facilitate tracking drug criminals. Some of the judicial reforms include the introduction of oral trials, plea bargaining, and alternative case-resolution methods, as well as the possibility of engaging anonymous judges for drug-related prosecutions in order to increase the efficiency and safety of the judicial process. More importantly, the government is taking the punishment of convicted drug criminals seriously and has increased extraditions to the U.S.

Recognizing that the drug trade is not only Mexico’s problem, the U.S. has also pledged to help the country through the Mérida Initiative, an agreement under which the U.S. will provide support to Mexico and other Central American countries in their fight against drugs. Specifically, the U.S. has allocated US\$1.5 billion over a three-year period to eliminate corruption within these countries’ government institutions by funding training for police forces, security-development programs, and purchases for equipment used in the war against drugs.

### **New Alliances, More Violence**

Despite the efforts of Calderón’s administration and the increased cooperation between Mexico and the U.S., drug-related violence in Mexico continues to rise. An estimated 7,000 people died in Mexico in 2009 as a result of the drug war — significantly more than the 1,300 people who are believed to have died in 2005 before the war began. There were also an estimated 1,200 kidnappings in 2009. Paradoxically, Mexico’s strong stance against the cartels seems to be contributing to increased drug-related violence. While the efforts of Calderón’s administration have, indeed, weakened the cartels, the capture of key leaders has upset their dynamics as members fight for powerful and profitable leadership positions.

The Mexican government’s war against drugs has also affected the distribution of power *among* the cartels as they fight to gain the rights to their now-weaker competitors’ drug routes. This fighting is so extreme that it has resulted in alliances between certain cartels in order to defeat others. For instance, *La nueva federación* is an alliance that was formed recently between La Familia Michoacán, the Gulf Cartel, and the Sinaloa Cartel.

Another likely explanation for the increase in drug-related violence is that the drug cartels are attempting to force the government to back down by terrorizing the public. As a result, violence has now spilled beyond the cartels, embroiling Mexico’s public and creating an insecure environment within Mexico, especially for businesses. The cartels now use various forms of violence against corporations — from kidnappings to theft to extortion — as a means of gaining power and profit. Pemex, the state-owned petroleum company, has been a repeated target of the cartels. In 2010, the company experienced multiple kidnappings and theft by the cartels and corrupt employees. Reuters estimates that Pemex loses “US\$750 million of fuel and oil from its pipelines each year” along with “valuable spare parts and equipment.”

The drug cartels challenge the viability of safe and secure business environments not only for large companies such as Pemex but also for small business owners and average citizens. In July 2010, gunmen ambushed a birthday party in the Mexican state of Coahuila, killing 17 people and injuring many more. Some sources believe these mass killings were the result of the innkeeper’s not paying the extortion fees that had been demanded of him. Clearly, the carnage of Mexico’s drug war is now affecting all strata of society — from impoverished migrants to the wealthiest elite and from neighborhood businesses to Mexico’s largest firms.

In August 2010, the far-reaching impact of Mexico’s drug-related violence prompted Calderón to open debate on legalizing drugs. While there are differing opinions among Mexican politicians, many influential figures — including current Partido de la Revolución Democrática leader Jesús Ortega and former presidents Ernesto Zedillo and Vicente Fox — believe the government’s strong stance against drugs is not working and that



legalization must be explored. Their main argument is that by eliminating the black market for drugs in Mexico, the price of drugs will decrease, along with the profits and power of the cartels. Calderón has been quick to respond that the price of drugs is not determined by the market in Mexico, but by the market in the U.S., where the Mexican cartels sell the majority of their drugs. Thus, unless the U.S. also legalizes drugs, Calderón has said “it would be absurd” for Mexico to do so. He is strongly opposed to creating an environment that facilitates drug use and addiction.

In addition, he and some members of his administration oppose legalization due to the cartels’ pervasive influence in Mexican society. Even if drug production, distribution, and use were legalized, the cartels would likely increase other criminal activities, such as extortion and kidnapping, as a means of maintaining or boosting their earnings. Therefore, it is unlikely that legalization would affect the current levels of violence and corruption in the near future.

The attitudes of business leaders with operations in Mexico reflect the deteriorating conditions and suggest that insecurity has significant economic consequences. For the past two years, American Chamber Mexico (AmCham) has conducted a survey of its members — foreign and national managers — to gauge their sentiment regarding corporate and personal security: 75% say their businesses have been affected by the country’s insecurity. While their principal concerns have consistently been employee security and executive protection, other results show divergent perceptions of key issues. Nearly 60% of the respondents felt less secure on a personal level in 2009 than in 2008; but the same respondents were equally divided as to whether their respective companies were more, less, or equally secure across the same period.

Of the third of the respondents who viewed their companies as being less secure than the year before, the most commonly noted contributing factors were the strengthening of organized crime activity, impunity in the judicial process, and activities associated with drug trafficking. Among those who felt their companies were more secure, 25% credited the work of the Mexican authorities, while 75% attributed the improvement to the

results of efforts within their own companies. Whether respondents felt their companies were better or worse off in 2009 than in 2008, there appears to be a consensus that the government is not succeeding in its efforts to provide a more secure environment.

## The Role of the Private Sector

As these survey results suggest, because the government is not capable of providing adequate security, the private sector has been playing a more prominent role in this arena. The market for private security in Mexico equals 1% of GDP, or \$8 billion. In response to this significant market opportunity, there are now over 10,000 private security firms compared to 6,000 15 years ago. Only 10% of these firms are professionalized, meaning they invest in training, infrastructure, technology, and analysis. Private security employs a workforce of 500,000, equal to nearly 85% of the public security sector excluding the military.

The most common goods and services provided by Mexican private security firms are bodyguards, electronic devices, and armored cars. The April 2010 Mexico Security Expo, a conference that showcases a wide range of the industry’s products and services, was 20% larger than the previous year’s. A conference spokeswoman illustrated the growing need for security services: “Sadly, the violence generated by organized crime has made Mexico one of the best markets for multinationals specializing in security.” In a move that reflects this sentiment, the Spanish security firm Prosegur augmented its presence in Mexico with its acquisition of a local security firm in 2009. Prosegur has seen its revenues there grow from US\$1 million in 2007 to an expected US\$17 million in 2010.

As previously noted, vehicle armoring is a principal offering of the security industry, and it is not surprising that the growth of the market is most visible in this subsector. In Latin America, the armoring market has increased by 850% in the last eight years, and Mexico is now the second largest market after Brazil. Since 2008, the number of armored cars has increased by 25% in Mexico City and by 60% in the rest of the country. This market is expected to grow by 20% in 2011. Businesses have responded to this need: There are now 70 registered providers of armoring, compared to only three 15 years ago.

Car manufacturers are also producing armored cars targeted toward this market. The extent to which the profile of the typical armored car owner has changed demonstrates the broad societal impact of insecurity. In 2008, CEOs of large companies were the principal users. Two years later, executives two or three levels lower in the hierarchy, as well as their family members, are using armored vehicles. The CEO of International Armoring Corp., an American firm that has seen a great increase in its shipments to Mexico and U.S. border cities, confirms that his client base is shifting: “[These cars] are made to blend in.... They are no longer only for heads of state. Our customers at the borders are normal executives who are concerned for their safety.” Even more tellingly, the 40% growth of the market for used armored vehicles and the introduction of armored versions of mainstream, affordable brands such as Chrysler and Volkswagen suggest that the need for this protection has spread beyond the elite.

Confronting this troubled security situation is undoubtedly costly to the Mexican government and society. Kroll estimates the direct cost of insecurity to the government, businesses, and citizens to be US\$65 billion, or 8% of GDP. While the magnitude of this figure is notable on its own, when put in the context of other key economic data, it is even more striking. Also, according to Kroll’s figures, this amount represents 75% of the total income and sales taxes collected by the Mexican government, 2.5 times the inflow of remittances to the country, and 3.5 times the amount of foreign direct investments. It is twice the size of Mexico’s oil exports.

Violence and insecurity clearly come with negative economic consequences, even beyond the staggering direct costs. As former president Vicente Fox (2000-2006) commented recently on his website, “the magnitude of the damage [of the violence associated with the fight against organized crime] has also extended to the perception and image of the country, economic activity, particularly in tourism and foreign direct investment, as well as the formidable opportunity cost that we are paying in resources, people, and time that have to be sacrificed at the expense of other strategic areas.” President Calderón has voiced a similar sentiment, stating, “the insecurity, in general, and the information that derives from it send, not only to

Mexico but to the world, a sign of violence that worsens the image of our country.”

Beyond the perception, though, it is difficult to quantify the economic impact. International tourism revenue, the third largest source of dollar inflows, fell 15% in 2009, the first decline in a decade. This cannot be attributed solely to a fear of violence, however, as that year saw the global economic crisis as well as the swine flu outbreak in Mexico, both of which discouraged tourism. While authorities maintain that tourist areas remain safe for visitors, there have been incidents of violence in formerly popular destinations such as Acapulco, Puerto Vallarta, and Taxco.

It is also commonly believed that the insecurity is negatively impacting foreign direct investment, particularly as violence is increasing in Monterrey, one of the country’s principal industrial cities. Local business leaders there say that some foreign investments have been put on hold due to security concerns, but they are reluctant to give specific examples. Of course, it is impossible to identify all of the investments that would have been made had the security atmosphere been more favorable, but 27% of AmCham survey respondents indicated they had reconsidered investments in Mexico due to security issues. This figure represents the views of managers who already have ties to Mexico.

It is likely that negative publicity would have an even greater influence on those making the decision whether to *begin* investing in Mexico. However, capital continues to flow into the country. In fact, foreign direct investment is experiencing an impressive recovery from the economic crisis and is expected to reach 2006 levels of US\$20 billion in 2010. As the director of the Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe) recently noted: “What is important for an investor in regards to security has to do with legal security and country risk. In both aspects, Mexico has advanced a lot, and this is the type of security that affects the investor.”

This positive trend, however, should not be over-emphasized. While some progress has been made in Calderón’s fight against organized crime with the arrests and killings of key traffickers, four years into the

struggle the violence is worsening, with no end in sight. An increasing proportion of AmCham respondents do not expect to see improvements in the security context within the next five years. While the private security industry is benefiting from its increased relevance, this crisis is imposing significant financial, social, cultural, and psychological costs on Mexico. Adding to the difficulty of gauging these costs, specifically in economic terms, is the reluctance of key stakeholders to speak openly and frankly about the topic.

Executives are understandably unwilling to discuss in detail the full extent of their security concerns and, even more so, their precautions, as such candor could make them less effective. Security consultants are similarly mum on specifics because discretion is key to the services they provide. Stakeholders with sufficient interests in the country — whether they are investors, government

officials, or well-connected citizens — may be hesitant to contribute to negative perceptions of Mexico.

This results in starkly mixed messages: Near-daily headlines tell of torture, shoot-outs, kidnappings, and murders that should scare off tourists and investors. At the same time, some maintain that insecurity is highly regional, limited primarily to those involved in the drug trade, and is not a significant business concern. Like most such dichotomies, the truth lies somewhere in the middle — for now. The fight for security in Mexico has the potential to move the country toward one of those extremes; overcoming the drug violence, therefore, is of utmost importance to the country's future.

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*This article was written by Devon Duff and Jen Rygler, members of the Lauder Class of 2012.*



## Will For-profit Universities Solve the Access Problem in Mexican Higher Education?

*Despite boasting one of the world's 15 largest economies and preferred access to the U.S. market, Mexico still struggles to meet some of its citizens' basic needs. Yet there is good news as well: Although 50% of Mexicans continue to endure some type of poverty, the historic wide gap between rich and poor has recently been narrowing, and an increasing number of young Mexicans are now demanding access to superior education.*

Despite boasting one of the world's 15 largest economies and preferred access to the U.S. market, Mexico still struggles to meet some of its citizens' basic needs. Yet there is good news as well: Although 50% of Mexicans continue to endure some type of poverty, the historic wide gap between rich and poor has recently been narrowing, and an increasing number of young Mexicans are now demanding access to superior education. Indeed, many of these new students are “pioneers,” a term used by Manuel Gil Anton, a sociologist at the Autonomous University of Mexico, to refer to Mexicans who are the first members of their families — or even their small towns — to ever set foot in a university classroom.

The government remains by far the major provider of tertiary education in the country, handling 2.3 million students — or 67% of total enrollment. But since the early 1980s, it has limited the creation of additional places in certain traditional careers, claiming that Mexico already has too many lawyers, business majors and accountants. Instead, the government set up new technical schools and universities, some of which sit half-empty today.

Yet for the majority of those Mexicans now aspiring to enter college — and for their families and social circles — the traditional careers are the only ones worth pursuing, which means these prospective students must

compete with wealthier and better-prepared men and women for the few places available in public universities. According to Gil Anton, most pioneers have two options: either drop out or seek admission to a demand-absorbing university. In response to this situation, private, for-profit institutions — specifically targeting lower-income segments of the population — have opened all over the country, filling a social gap left by the government while also earning high profits.

Institutions such as Universidad ICEL, Insurgentes, Univer, and Londres were set up by entrepreneurs or university professors who saw an opportunity in the lack of educational offerings provided by the government, and by private universities targeting more affluent segments of society. The new budget universities offer no-frills undergraduate and sometimes master's degrees at low price points, starting as low as 1,500 pesos per month (about US\$114).

This opportunity has also attracted international capital to the sector. For example, Laureate, one of the largest private education providers in the world, has made Mexico its biggest market, with one of its offerings focused exclusively on the lower-middle-class population.

While growth has been respectable (6.8% per year between 1997 and 2007), questions remain regarding



the quality of the new educational offerings. Serious schools such as Laureate are able to offer degrees that are valued by the market, but it is unclear whether the same is true for the smaller institutions that have sprung up. Only a fraction of them are properly accredited, and doubts have been raised about the sustainability of their business models. Although there is little data on the career performances of these schools' alumni, one could safely predict that the formal market will have a hard time absorbing them. The challenge for the private sector then is to offer education that is both affordable to students and regarded as relevant by the job market. Institutions that can accomplish both have much to gain. But it takes time to build a good reputation.

The private sector first made inroads into Mexico's higher education system in the mid-1930s when an intense debate was taking place about the role of public universities. According to Adrián Acosta Silva, a public policy professor at the University of Guadalajara, Mexico's legendary President Lázaro Cardenas (1934-1940) defended the idea that public education should be a tool to advance the socialist ideals of the Mexican Revolution of 1910-1917. Amid such debates, a number of scholars who proposed a more liberal role for academia — or who just wished for more independence — founded the country's first private institutions, starting with the Autonomous University of Guadalajara in 1935. In the 40 years that followed, 13 private universities were created — including world-class institutions such as TEC of Monterrey — whose main goals were to boost Mexico's industrialization process and support a still-fledgling business community. However beneficial these schools may have been to Mexico's economy, they catered to fewer than 100,000 students by the early 1980s.

According to Imarú Arias Ramírez, director for new products for Laureate, the economic crises that swept through Latin America in the 1980s practically froze education spending in Mexico for many years. The country saw its output grow significantly in the late 1980s and throughout the 1990s, the tequila-crisis recession of 1994-95 notwithstanding. But public universities could not keep up with the increasing demand for a college education, which paved the way for the establishment of myriad private institutions. Only recently has the federal government ramped up

investment in higher education. However, total spending still comes to a paltry 0.65% of GDP, far below the target of 1.5% set by President Felipe Calderón at the beginning of his term in December 2006.

According to Gil Anton, net coverage by public and private universities combined is still a modest 21%, meaning that only 2.1 million of the 10 million Mexicans of college age (19-23 years old) have access to universities, a number dwarfed by Argentina's 70% and Chile's 50%. This suggests great growth potential if Mexico's economy continues to expand. According to Carlos Iván Moreno, advisor to the Ministry of Education, if the government increased spending from the current 0.65% to the targeted 1.5% of GDP, placements would reach almost 50% by 2020. Nevertheless, to achieve such a level, Mexico would still have to rely on the private sector for at least one third of the expected growth.

## The Accreditation Issue

With the government's reliance on the private sector to educate such a large segment of the population, its standards for accreditation are neither prohibitively rigorous nor demanding. Accreditation is not mandatory for institutions of higher education in Mexico. This stems from a constitutionally guaranteed right to impart education without government interference. Consequently, the government may accredit institutions of higher education, but it may not obligate such institutions to adhere to its standards.

The Ministry of Public Education grants accreditation through the Reconocimiento de Validez Oficial de Estudios (RVOE). The RVOE is granted to particular carreras (courses of study) and not to institutions as a whole. It is thus possible — and common — for a university to offer a wide variety of majors, master's programs, and doctorates, of which only one or two have the RVOE. One of the most significant requirements is having a certain percentage of full-time professors, which are a big expense for universities and companies. The benefits, office space, and incidental expenses associated with their employment represent roughly 70% of their salaries. When low-cost institutions seek to maximize profitability while simultaneously remaining competitively priced, full-time professors are sacrificed.

Cognizant of the costs of full-time professors, the government has balanced the staffing requirements for RVOE accreditation to encourage private investment while, at the same time, maintaining reasonable standards. However, these standards have led to an investment bias toward the social sciences. Natural sciences and other courses of study that rely on a large amount of one-on-one instruction require a relatively high percentage of full-time professorial staff (30%). The social sciences, on the other hand, do not require a single full-time professor, which makes these courses much more attractive financially to private universities.

Of the 21,938 RVOE accreditations issued as of June 2009, social sciences and administrative studies unsurprisingly represent 59.6% of the total. Fields that require more full-time professors to gain the RVOE are less represented: engineering, 18.3%; education and humanities, 13.8%; and natural sciences, health sciences, and agrarian sciences, the remaining 8.3%.

As noted above, accreditation is not mandatory, and some institutions have no RVOE-accredited courses. The largest risk for a student pursuing a non-accredited degree lies in the simple fact that he or she may not be able to obtain a professional title or license, which is necessary to practice in fields such as law, surgery, and engineering. This situation may also interfere with a student's ability to pursue an even higher degree, such as a master's or doctorate.

Although only 10% of courses receive accreditation, it is important to note that the ROVE requirements are actually very low. Therefore, alternative accreditations have been developed. Just as private companies have filled the void in public education, private schools have also begun to offer their own form of accreditation. For example, the Federación de Instituciones Mexicanas Particulares de Educación Superior (FIMPES) is a private regulatory body for private education. It generates standards that are more demanding than those of the Ministry of Public Education. Only a few of the lower-cost universities are members of FIMPES and enroll just 16% of students who attend private universities in Mexico. Furthermore, the 109 FIMPES institutions (67 already accredited, 42 about to be) have approximately 400,000 students.

Private institutions that cater to the lower levels of the income pyramid need to keep costs low and do so by one of two methods. First, they employ a very strict fixed-cost management. They tend not to engage in research, which would demand substantive, long-term investments with unclear contributions to profitability. Similarly, they generally do not offer programs that require significant investments in facilities, such as medicine or many engineering programs. Law, social sciences, and psychology represent the popular majors at these universities. Unlike their up-market counterparts, low-cost universities place almost no emphasis on extracurricular and sports activities, and have facilities designed primarily to fit as many students as possible.

Second, as mentioned earlier, these institutions carefully manage their main variable cost — professors. They rely mostly on part-time professors, paid hourly, thereby avoiding the costly non-salary benefits associated with full-time employment contracts. Along this line, while professors at more expensive colleges are required to have a degree higher than the one they teach — for instance, professors in a bachelor's degree program must have at least a master's degree — there is no such requirement for the low-cost institutions, further reducing costs.

In addition to their distinct cost management, low-cost universities also differ from top-ranked institutions in their marketing strategies and practices. While the latter rely on their brand and prestige to attract students, low-cost schools generally strive to meet the minimum requirements to gain RVOE accreditation and they count on low-income students — who cannot obtain admission to a public university and do not have the resources to attend a more expensive and prestigious private university — to have no other choice for higher education. As Laureate's Arias Ramírez noted, “Low-cost universities rely on the fact that low income people see a higher degree as an opportunity to progress economically, which is ultimately one of the things they want most.”

## Representative School Profiles

Three institutions illustrate the different educational experiences students may go through, and provide a better understanding of how private universities differ.

The first is Universidad Valle de Mexico (UVM), which targets middle-class and upper-middle-class students. The second is UNITEC (Universidad Tecnológica de México), which targets middle- to lower-middle-class students. The third is Universidad ICEL, similar to UNITEC in focus but with greater emphasis on lower-class students.

UVM charges its students around 5,570 pesos (US\$450) per month. Generally, these students' parents have also attended college. This implies not only a familial environment that supports studying, but also sufficient purchasing power to support a child in his or her studies. While students enrolled in less expensive schools usually work part-time, UVM offers its students a wide range of sports and cultural programs on campus. In order to provide this "college experience," the institution must spend additional money on sports fields, theaters, and so on.

UNITEC's tuition fees are around 3710 pesos (US\$300) per month. The profile of a typical student is a pioneer who is the first in his or her family to have access to higher education. He or she may thus lack a familial role model. In addition, the immediate family may be unable to provide economic support, and the student will resort to financial help from a wider family network. Given their circumstances, these students are normally very excited by the opportunity to advance academically. They spend more on tuition than do students at one of the most affordable institutions — not for soccer fields or theaters, but rather for prestige, which they hope will afford them greater job opportunities upon graduation. If the right financial-aid products are available to students to fund this kind of education, schools such as UNITEC will most likely sustain interesting growth for many years to come.

Universidad ICEL's tuition fees range from 1,432 pesos to 1,868 pesos (US\$115 to US\$150) per month. It is not uncommon for a student at ICEL to be one of many siblings and to have parents with limited resources. The students here are also *pioneers*. Their fathers may be taxi drivers while their mothers may be nannies. The families are decidedly socioeconomically disadvantaged, and these students would probably never have attended college if this inexpensive option did not

exist. According to Sylvie Milverton, CFO of UNITEC, students from the lower socioeconomic segments, to whom these low-cost educational offerings are targeted, typically have low expectations of any tertiary education and are pleasantly surprised by punctual professors and the presence of computer labs. In fact, they consider the labs a premium. The students in this segment aim to use their education to move into office jobs or perhaps secretarial or IT positions. The potential of this segment is enormous, but serious purveyors of education targeting low-income students will have to continue to work very hard to offer a relevant education that is valued by the broader job market at a low price point.

The growth of the private university system in Mexico has been handsomely profitable to its shareholders. Managers at these universities mention EBITDA margins of between 25% and 50% and internal rates of return of up to 30%. However, education is a good that provides social value. Thus, in evaluating this sector, both the private profits and the benefits private tertiary education has provided to the lower income segments of Mexican society should be considered.

From a purely quantitative perspective, the private sector has contributed significantly to the expansion of the higher education system. Starting from a much smaller base of 458,000 seats in 1999, private investment added 287,000 seats to the overall capacity of 2.2 million by 2008, compared to 217,000 seats added by the public institutions over the same period. Simply counting seats can be misleading, however, because this does not capture the quality of the education imparted. This matters because students who are charged relatively expensive tuition at private universities expect a pay-off from their investment in the form of better job opportunities and higher salaries. If the quality of education is low, then the value of their degrees and thus the marketability of their skills will also be low.

No systematic studies exist yet that examine the issue of quality at the budget institutions. Anecdotal evidence, however, hints at a mixed record. As one might expect, there seems to be a fairly direct link between the quality and cost of the educational program: The less one pays, the less one gets. The balance shifts at some point on the price spectrum of private universities, and that point

seems to be at monthly tuition levels of around 1,240 to 1,860 pesos (US\$100 to US\$150).

Above the 1,860 pesos (US\$150) threshold are private universities that target the lower-middle-class population, such as UNITEC. They still “make the [national] ranking,” an important factor for many students in terms of marketability, although they do not always feature all the accreditations. Students are confident, however, that recruiters know the brand and care more about their past experiences with the university’s graduates than the accreditation alone. Administrators at UNITEC noted that first-year salaries for their graduates are around 86,600 pesos (US\$7,000) per year, and students can expect to search six months for a full-time job. This places recent graduates at the lowest end of the middle-class salary range and, one could argue, fulfills the students’ aim to improve their standard of living.

Institutions that charge tuition lower than 1,860 pesos (US\$150) per month usually do not figure in the rankings and have poor name recognition with recruiters and the general public. In addition, they carry scant accreditation. According to Roberto Rodriguez Gomez, a researcher at UNAM, these institutions are described disparagingly as being “patito” (little duck), a derogatory nickname referring to the supposedly low standards and quality of instruction. An administrator we spoke with at one of the largest and more established institutions in this segment informed us that average starting salaries are significantly lower than for graduates of UNITEC.

Thus, while the private education sector has created an alternative to public universities that can deliver a quality, low-cost education to as wide an audience as possible, it seems clear that a private-university education alone is not the magic bullet for increasing university enrollments in Mexico. Even at a minimum standard, quality has its price and is out of reach for many. This does not discount the value private institutions add. However, this section can be only one leg in a multi-pronged public policy strategy on education, augmented by a number of complementary steps:

- Most obvious — but perhaps most problematic given past history — is for the government to accelerate its expansion of programs to ensure that low-income students who are well prepared to enter a university can do so. Particular emphasis should be put on expanding the offerings in professions that are in demand by the labor market, avoiding the inefficiencies observed in the technical schools.
- Another approach would be for the finer private institutions to enter the fray and offer more affordable, simplified versions of their value propositions. This is exactly what the TEC of Monterrey did in 2002 with the creation of the Universidad TecMilenio, which now has 33 campuses all over Mexico.
- The Mexican government should step up its policing of private institutions. Although its hands are tied to some extent by the country’s constitution, it should be able to design incentives and transparency programs that expose underperformers and nudge them toward improvements in quality.
- Finally, the private sector should work with the government on financing solutions to increase access to private institutions. This last concept is not yet very popular in Mexico, as the market is still uncomfortable with the idea of unsecured borrowing against future income. But this might be changing. UNITEC convinced one commercial lender, FINAI, to provide unsecured loans to UNITEC students at a rate of 11%. This rate is not cheap, but it does serve as a further step in giving low-income students access to higher education.

Education is the most effective long-term tool for changing society for the better. If developing and emerging countries aspire to one day enter the select group of wealthy nations, education must become a priority for both their public and private sectors. From a business perspective, the opportunity is huge. But so is the responsibility that comes with it.

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## Can BYD Build China's Dreams in the Electric Car Industry?

*As car ownership skyrockets at an astonishing rate in the world's fastest-developing nation, Chinese automakers are taking a big gamble in their bid to dominate the emerging global market for electric cars. They have low-cost manufacturing, new technology and, in the case of automaker BYD, US\$232 million from Warren Buffett, who has helped speed the company's expansion into the U.S. market. What challenges do these companies face in terms of stiff global competition and the need to improve consumers' perceptions of quality?*

As car ownership skyrockets at an astonishing rate in the world's fastest-developing nation, Chinese automakers are taking a big gamble in their bid to dominate the emerging global market for electric cars. They have low-cost manufacturing, new technology and, in the case of automaker BYD, US\$232 million from Warren Buffett, who has helped speed the company's expansion into the U.S. market. Similar to the Japanese automakers in the 1950s and Korean automakers in the 1980s, BYD faces resistance from American consumers who perceive Chinese-made goods as being cheap and of low quality. But the Chinese government has set its sights on the economic and environmental future of electric cars, which means the Chinese automobile manufacturers will have to overcome stiff competition in the years to come as they develop a global brand and test consumer confidence across the globe.

### The Birth of BYD

In 1995, 29-year-old engineer Wang Chuan Fu launched a start-up with US\$300,000 and 20 employees, determined to stake a claim in the world's fast-growing electronics market. Named BYD for "Build Your Dreams," Wang's company embodied the new entrepreneurialism of China's transforming economy, churning out low-cost batteries for electric shavers,

toothbrushes, cameras and countless other gadgets. Within five years, BYD went from being just one of hundreds of electronics manufacturers in Shenzhen to becoming one of the world's largest manufacturers of batteries, riding the wave of a surging global mobile phone market.

Defined by the hard-charging work ethic of the company's young and pioneering founder, BYD quickly gained an advantage over its competitors by tapping China's enormous labor surplus and developing a reputation for superior technology. By 2003, the company had grown to nearly 100,000 employees, and Wang was on the lookout for new opportunities. In an unexpected move, he purchased a 77% stake — about US\$32 million — in faltering automobile manufacturer Zhen Chuan Automotive in Xi'an. Wang, known for his fierce entrepreneurial spirit, had discovered a new application for his cutting-edge battery technology — the electric car.

### Emerging Demand for Electric Cars

Worldwide, research and development in energy-efficient vehicles over the past several decades have been spurred largely by government support, with lagging consumer demand discouraging full-scale production. In recent years, however, a perfect storm of soaring

fuel prices, increasing investment in clean technology and the poor performance of American automakers has ignited renewed public interest in, and government support for, the development of the next generation of cleaner, more efficient automobiles.

To date, Japanese and European automakers have been at the forefront of fuel efficiency and automobile technology. In 1997, Toyota introduced the Prius — the first hybrid electric vehicle (EV) to sell more than a few hundred — which now makes up nearly half of all hybrid EVs sold in the U.S. Despite the global recession, Toyota sold more than 401,300 Priuses in 2010. In Japan, it was the best-selling car among all models.

Sales of hybrid vehicles continue to climb. From 2008 to 2009, while vehicle production fell by 21.2% worldwide, hybrid vehicle sales grew by 33%, according to SBI Energy, a consultancy. In Japan, hybrid sales shot up by as much as 185% during that period, showing strong market demand and a marked shift in consumer preferences toward energy-efficient cars. In the years to come, analysts predict an upward surge in demand for EVs worldwide as government policies continue to limit CO<sub>2</sub> emissions while offering incentives to consumers and businesses to adopt environmentally friendly modes of transportation. According to SBI Energy, annual total worldwide sales of pure electric cars will grow to 68,000 by 2014 as the market becomes increasingly segmented.

Japan and the U.S. will continue to be the largest markets, although electric car sales in emerging markets will quadruple between 2010 and 2014, according to SBI Energy. As EVs and plug-in hybrid electric vehicles (PHEV) become the optimal option for long-term policy goals across the globe, new entrants in the U.S., China, and India are emerging as fierce competitors.

Electric cars have zero-to-low emissions and are 90% more efficient than conventional fuel-powered cars, with less than one-tenth the parts of conventional cars, according to the Royal Academy of Engineering. If powered by renewable energy sources, they also have the potential to be carbon neutral. While biofuel feedstock sources continue to pose a long-term challenge for alternative fuels, the infrastructure installment for EV charging sockets is seen as widely attainable in the next 10-20 years.

Despite high consumer demand for EVs, an affordable model has yet to come to market. Battery technology continues to pose the greatest hurdle for automobile manufacturers, which are searching for ways to increase storage capacity, shorten charge times and improve safety. Batteries are the most expensive components in electric cars, making up as much as 50% of the total cost. In response to these needs, a host of battery manufacturers and auto makers are now working in tandem to lower costs, increase battery range and improve safety in a range of climates. The competitive landscape has grown increasingly cut-throat, with newcomers such as BYD and Tesla Motors competing fiercely, each equipped with unique battery technologies.

In addition, once relatively unknown companies from emerging economies such as China's Chery, and India's Reva now aim to compete in the U.S. with long-standing auto makers such as Nissan, Ford and Chevrolet. In a sprint to market the first affordable electric car in the U.S., each of these companies hopes to release electric models by 2011. Tesla's Roadster, priced between US\$109,000 and US\$129,000, is the only highway-capable EV in current production in North America and Europe. The company sold 1,200 Roadsters worldwide in July and August 2010. By 2011, Nissan hopes to release the Leaf, retailing for US\$32,780. By the end of 2012, Chevrolet will have its own version, the Volt, selling for US\$41,000.

### **BYD and Warren Buffett's Gamble**

Against this backdrop, BYD's 2003 foray into the Chinese auto market was well-timed, garnering intense interest and speculation from analysts and Wall Street investors alike. BYD's metamorphosis from battery manufacturer to car manufacturer has also attracted the attention and scrutiny of industry experts. The company is the only vertically integrated car manufacturer that makes its own batteries. As Henry Li, a Chinese venture capitalist who invests in electric car technologies, points out, "BYD has the full package: charger, battery, car."

With seven models now on the market — two electric and five conventional — BYD is currently ranked sixth in sales in China, the world's largest market for automobiles. In 2009, BYD sold 450,000 vehicles there. During the first half of 2010, the F3, a conventional four-

door sedan, was China's top-selling car. BYD was also the first company to release a plug-in electric model in China. The F3DM, a technological breakthrough for the company, has a range of 330 kilometers and a battery that can be fully charged in an hour. It retails in China for US\$22,000.

But with seven plants across China, BYD continues to be primarily a battery manufacturer. The company, the world's fifth largest manufacturer of batteries for cell phones and other electronics, claims its expertise in batteries is its competitive advantage in electric cars, an industry it plans to dominate through aggressive expansion in the coming years. The company's bold corporate culture takes cues from its dynamic leader, Wang, who claims that "Build Your Dreams" stands for the company's grand ambitions. In a 2009 interview with CNN, Wang described his designs to make BYD China's first international brand with a reputation for quality: "For new energy vehicles, China is on the same level or even leading other countries. In the field of new energy cars, China hopes that Chinese companies can catch up with the rest of the world."

In October 2009, Warren Buffett invested US\$232 million — a 10% equity stake — in BYD, catapulting the company into the international spotlight. This investment from Mid-American Holdings, 87%-owned by Berkshire Hathaway, gave the company not only the capital to consider global expansion but also the credibility to test the waters in a foreign market. Prompted to take a bold step outside China, in April 2010 the company opened an R&D center and a sales office in downtown Los Angeles, a move greeted with much fanfare by the media and political leaders. As California governor Arnold Schwarzenegger noted, "Like California, BYD is a company of firsts. They are leading China and the rest of the world into a cleaner, more sustainable future with their automobiles and renewable energy products while creating jobs and saving consumers money."

By establishing its headquarters in one of the most developed car markets in the world, BYD aims to leverage government incentives geared toward electric cars. The U.S. government offers up to US\$7,500 in tax credits for electric car owners and is investing millions of dollars to develop a network of charging stations.

California, the heart of the U.S.'s largest and greenest car market, offers a US\$5,000 rebate to electric car buyers and is home to half the nation's charging stations.

Already looking toward the future, BYD plans to use the U.S. as a stepping stone for expansion elsewhere. Paul Lin, BYD's corporate marketing manager, said in an interview that the company plans to enter Western Europe in the next three years while maintaining its market share in China: "We hope to be a top-three manufacturer in China by the end of the year and the world's largest manufacturer by 2025."

With plans to release its first lot of cars into the U.S. in late 2010, BYD has yet to overcome several large hurdles, including developing a branding strategy to meet the tastes of U.S. consumers and identifying a distribution network of dealerships. "We don't have a price set yet," Lin said, "but we're designing a car especially for the American consumer, with lots of space. Also, it needs to be more powerful to deal with hilly landscapes."

## The Challenges Ahead

Few remember that the Japanese automakers fought for decades to introduce successful products into the U.S. market. From the outset, many of these automakers, Toyota in particular, faced the obstacles of quality and brand recognition. Toyota's releases of the Toyopet in 1958 and the Crown in the 1960s were complete failures.

During that same period, Honda built a solid reputation around its sports bike production, pushing the entire British motorbike manufacturing industry into bankruptcy by 1983, according to *Automobile*, an industry publication. Honda's entrance into the U.S. car market in 1972 was slightly more lackluster, with sales of 20,000 for its Honda 600 model. However, the 1973 oil embargo served as a blessing in disguise for the Japanese automakers. As oil prices rose from US\$3 to US\$12, consumers began to put a premium on the fuel efficiency offered by cars such as the Toyota Corolla, which had a 1.2 liter engine and was significantly smaller than most American cars, with 6-8 liter engines.

Despite optimism from investors and an aggressive growth target, BYD's U.S. expansion presents challenges for the company moving forward. At the top of the list is developing a global brand in a highly competitive

landscape for emerging electric cars and confronting the test of low consumer confidence in Chinese-made goods. The company, better known for mimicking car designs than for innovating them, has often been criticized for its copycat models. As one top executive at a Taiwanese company said, “The joke about BYD is that when you buy a BYD, they give you a free Toyota logo. It looks just like a Toyota.”

BYD’s decision to enter the U.S. organically is a high-risk venture because U.S. consumers have different tastes than Chinese consumers. With this move, BYD exposes itself to the multiple challenges of not just understanding a new consumer type, but also having to learn an unfamiliar system for distribution. At the same time, its branding strategy is non-existent. The company’s low-cost manufacturing, which rests on human labor, may be difficult to accept for U.S. consumers, who value automation. At the moment, the company plans to maintain manufacturing in China and admits that quality control has a long way to go to meet U.S. standards. Lin noted that quality control is a greater priority than superior technology: “It is particularly important for us to obtain as high a ranking as possible to calm people’s fears about Chinese quality standards.” If BYD is to compete successfully in the U.S., it will have to leverage its cost advantage and proprietary battery technology to bring value to customers.

BYD’s entrance into a new market with a new product raises concerns about whether the company can gain ground in the domestic Chinese market, currently the world’s largest. Established brands such as Volkswagen and Ford, matched by a growing number of Chinese automakers, including BYD, sold roughly 14 million cars and trucks to Chinese consumers in 2009. The competitive landscape is growing increasingly crowded in China, as multinational automakers such as Nissan and GM team up with Chinese manufacturers to produce low-cost, compact cars selling for under US\$10,000 and marketed specifically for Chinese consumers. While hybrid EVs currently make up just a fraction of total sales, analysts predict that sales of hybrids in developing nations such as China will quadruple between 2010 and 2014.

Losing market share in China emerges as the ultimate danger of BYD’s ambitious expansion strategy.

Increasing market share in China is critical to success elsewhere because it provides the financial support the company requires to build its brand in new markets. China’s domestic market represents an enormous opportunity for BYD. The government has trumpeted electric cars as a future growth industry, allocating CNY10 billion (US\$1.47 billion) for the development of EVs, battery technology and related components over the next three years. The State Grid Corporation of China, the main utility provider, has built charging stations in nearly 30 cities, while aggressively replacing public buses and commercial vehicles with electric versions. This large-scale government initiative will make China one of the largest electric auto markets in the years to come, and BYD’s focus away from China could work to the benefit of its competitors.

In particular, Tianjin Lishen Battery Joint-Stock Co. (Lishen), a producer of lithium-ion batteries, has emerged as a key player in China’s EV market, with plans to expand into the U.S. by way of a joint venture with Coda Automotive, a U.S. electric car manufacturer. Through this partnership, Lishen is able to leverage the consumer, distribution network and marketing knowhow of the local partner. BYD, in contrast, must face a completely new set of consumers, dealership networks and branding hurdles on its own. The company also risks doing too much and none of it well, placing even its battery business in jeopardy. Its shift downstream raises key concerns about the firm’s ability to achieve and maintain leadership positions in both product markets. According to Yun Hai Shi, head of the EV group at competitor Lishen, “We do not have plans to enter the auto market. We are focused on our core expertise in battery technology.”

BYD’s success in the international market will depend on the company’s ability to jumpstart and implement a currently undeveloped strategy for global expansion. By solidifying the company’s brand and marketing plans, targeting markets with government support and maintaining a foothold in China’s growing electric car industry, BYD could be well-poised to become China’s first international automobile brand.

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## Meibutsu: The Economic and Cultural Significance of Traditional Japanese Products

*Foreigners visiting any airport or tourist destination in Japan are often impressed by the sheer quantity of colorful treats and souvenirs marketed to Japanese travelers. Why are there so many varieties of unique products, and why are they in such high demand? The answer lies in Japan's unique meibutsu economy, an integral part of the culture and a source of income for rural economies.*

Foreigners visiting any airport or tourist destination in Japan are often impressed by the sheer quantity of colorful treats and souvenirs marketed to Japanese travelers. Why are there so many varieties of unique products, and why are they in such high demand? Indeed, Japan's tradition of meibutsu, or famous regional products, is unique and unparalleled anywhere else in the world. Not only is it an integral part of the Japanese culture, but it also provides much-needed benefits to rural economies.

### The Meaning of Meibutsu

Japan's diverse cultural traditions, business structures, and regional economic clout are apparent through the country's primarily domestic meibutsu economy. While meibutsu means literally "famous item," in practice it refers to the widespread distribution and usage of various regional products and goods. But what exactly does meibutsu represent? In examining Japanese prefectures such as Kyoto, Hokkaido, Miyazaki, and Wakayama, it becomes evident just how varied these products are.

Kyoto, famous for its *nama-yatsuhashi* sweet bean confections as well as its traditional Japanese craftwork, differs completely from Hokkaido, which is renowned for its milk-based products, beers, and herbs such as lavender. Similarly, Miyazaki's mangos and oranges are

extremely popular, while Wakayama's *umeboshi* sour plum products can be found in almost any convenience store in Japan.

The *meibutsu* economy is uniquely Japanese and has characteristics that are very different from many other countries' takes on regional specialty goods. Each of Japan's 47 prefectures has its own unique *meibutsu* that enjoys continuously developing markets and consumers. In the U.S., for example, famous products are created for different popular tourist destinations. Furthermore, another unique aspect of *meibutsu* is its dynamic nature and its mix of old and new, which relates closely to broader themes in Japan's cultural, historical, and socioeconomic spheres.

While the term *meibutsu* does have certain nuances, it generally includes unprocessed regional agricultural products and crafts. Yutaka Mukai, a member of the Ise City (Mie prefecture) Chamber of Commerce and Industry, defines it more specifically: "In order to be *meibutsu*, something has to be a special product; it has to require specific skill or knowledge for creating it that is possessed by people in a certain region. This skill or knowledge is often passed down in families from generation to generation, thus preventing those from outside the region from gaining the ability to produce the *meibutsu*." For instance, the Yubari melons of

Hokkaido are some of Japan's most cherished. These flavorful melons require special growing techniques and are subject to strict regional collective trademark standards to prevent their cultivation and branding in other regions.

The *meibutsu* industry revolves around several groups of people. Producers range from farming cooperative associations to large consumer-goods manufacturers. In addition, government agencies — such as the Ministry of Agriculture, Forestry, and Fisheries — oversee quality control for processed products, while the Japan Patent Office helps producers comply with regional trademark policies. Consumers are generally domestic Japanese tourists who often perceive *meibutsu* as unique specialty items exhibiting high quality and other traits from the producing region.

Another concept that is essential for understanding the popularity of *meibutsu* is highlighted by the tradition of *omiyage*, or gift-giving. Many Japanese rely on *meibutsu* in their gift-giving culture, so these goods are often sold in major department stores and various souvenir shops located throughout even the most sparsely populated regions of the country. *Omiyage* is now written お土産, which literally means “earth product,” i.e., a product from a specific region. However, according to Mitsuhiro Okamoto, a Nara city cultural expert, *omiyage* used to be written as お宮下, which literally means “coming down from the shrine.” This alludes to the old tradition of people offering food and other goods to the temples of Shinto gods and then, after a few days, taking those same items back home to eat and enjoy.

The fact that the Japanese people have forgotten the origin of *omiyage* and have even changed how it is written to reflect only its regionality shows that the concept has changed over time. This may imply that the Japanese people are focused on, or even obsessed with, how *omiyage* and *meibutsu* are limited to a region, and that artificial value is created when regional limitation, as opposed to pure quality or taste, is valued so highly.

In addition to regional limitation, the popularity of various *meibutsu* products depends on many factors such as seasonality, advertising, and other economic issues. With regard to seasonality, some *meibutsu*

ingredients are most popular at certain times of the year, so consumers often flock to purchase them during their period of availability. For example, lavender blooms mainly in June and July in Hokkaido, so lavender-related *meibutsu* such as lavender-scented bath salts and incense benefit then from increased consumption. *Meibutsu*'s popularity is also affected by recent trends in advertising, specifically through the increasing numbers of “antenna shops” (satellite shops that sell regional items) in Tokyo and other major Japanese cities. These shops cater to a particular prefecture's *meibutsu*, selling only products related to that region. This has effectively increased the reach of various prefectures' *meibutsu* to a broader base in Japan.

### The Origins of *Meibutsu* — Tradition vs. Practicality

First-time visitors to a historic Japanese city might mistakenly assume that all the goods they buy reflect hundreds of years of the city's history and traditions. These visitors would be surprised to learn, for example, that the most popular Kyoto *meibutsu*, the *nama-yatsushashi*, has been around for only about 30 years. This illustrates how practicality often trumps tradition for many *meibutsu* products in Japan.

One *meibutsu* item that truly reflects centuries of Kyoto's traditions and its artisans' skills is *senshoku* (dyed textile), which includes products such as the *kimono* (literally “thing to wear”). *Senshoku* developed as a necessity for clothing the Emperor and the imperial family beginning in the Nara period (710-794 AD). However, for a modern tourist visiting Kyoto, buying a decent *kimono* made by Kyoto craftsmen would cost at least several thousand U.S. dollars, in addition to being difficult to transport and store given its fragility. What visitors to Kyoto opt to buy is not a true object of traditional Kyoto culture but rather a simple symbol of Kyoto that is cheap, simple to carry, and easy to give as a gift or share among friends. This has led to the development in the last few decades of Kyoto *nama-yatsushashi*. In Hokkaido, similar needs led to the development of Hokkaido *Shiroi Koibito* (white chocolate cookies), while other prefectures and tourist cities developed other inexpensive types of *meibutsu* that could be mass-produced.

According to Akinori Fujita, store manager of the Hokkaido “antenna shop” in Tokyo, “In actuality, anyone can attempt to label a new product as a *meibutsu*, but if it is not produced in that region, then it is unlikely that souvenir shops will stock the product because they do not see it as a legitimate *meibutsu*.” Still, new and creative *meibutsu* items are constantly being released. For example, some regions claim very non-Japanese items as their own *meibutsu*, such as the Yokohama Navy Burger or the blueberry cheesecake-flavored Nestlé Kit-Kat bar, found only in the Koushin region (famous for its blueberries). In short, with regard to *meibutsu*, most modern Japanese pay only marginal attention to the historical origins and traditional values, focusing much more on the practical and novel aspects.

### Social Impact

Such aforementioned traits, habits, and values of modern domestic Japanese tourists have shaped social norms within the country for decades and also carry significant potential for shaping the social economy and landscape even more. The most important social consequence stemming from *meibutsu* will most likely be the ways that its producers can help prevent the shrinking population problems facing rural Japan. First, it is necessary to understand the magnitude of this issue. Since the 1950s, rural communities have been plagued by the problems of internal migration. Urbanization — stemming from the migration of people from the countryside to the city and surrounding suburbs for better educational and employment opportunities — has led to severe depopulation in many rural areas. This has resulted in a large aging population, with few children or young people in the rural community. A continuation of this trend portends many troubling issues both for these rural communities and for Japan.

The increased promotion and sales of *meibutsu* can best help rural communities through increased employment opportunities, which can entice people to stay rather than move to the cities. Such opportunities will be available in both the agricultural and manufacturing sectors. Most agricultural *meibutsu* products are grown on small, family-owned farms. Thus, increased sales will lead directly to increased revenues for these small businesses. As demand increases, the farms will require

more employees to help with the agricultural production. In addition, businesses that specialize in *meibutsu* manufacturing should also see increased demand and thus be able to offer more employment opportunities. These factories offer the potential for employment growth in rural areas because many *meibutsu* items are produced in locales only a few hours away from the actual cities in which they are sold. For example, many of Kyoto’s renowned fabrics are actually made in factories in neighboring, and more rural, Fukui prefecture.

The increased employment opportunities are made possible because *meibutsu* plays such a large part in the Japanese social culture. The sheer number of *meibutsu* is directly related to the aforementioned tradition of giving gifts (*omiyage*) to friends, family, and co-workers after trips, whether personal or business-related. Any foreigner who vacationed with a Japanese friend will have noticed that the friend was constantly worried about buying enough *omiyage* to take home. The culture has evolved to the point where it is often socially unacceptable to not give *omiyage*, and some Japanese even travel secretly to avoid this social obligation. This activity is a major factor in *meibutsu*’s growth over the last few decades.

Various cities, prefectures, and regions have adapted their products to suit the unique needs of the visitors who are looking to buy *meibutsu omiyage*. The most popular *meibutsu* items are often small, easily packaged, and relatively affordable. They are sold not only at tourist attractions, but also at major transportation centers such as train stations. Therefore, not only is *meibutsu* a way to show you have visited a particular area, it is also a way for the recipient to enjoy a product that, through limited distribution, would otherwise be impossible or difficult to find elsewhere. Unfortunately, *meibutsu* also has negative consequences. According to Junko Kimura, the director of planning and sales at Kyoto-kan (an antenna store for Kyoto goods in Tokyo), “many *meibutsu* stores in Tokyo have seen patterns whereby married men and women come to shop for gifts for family to account for alibis of business trips to different cities. For instance, a weekend fling on the beaches of Okinawa staged as a weekend business trip to Kyoto can be accounted for by purchasing a box of *nama-yatsushashi*, a defining souvenir of Kyoto.”



Sales of *meibutsu* are assured as long as there are domestic travelers. And domestic travel within Japan is almost certainly guaranteed given the Japanese people's social and regional interests. The proliferation and importance of this tradition are most evident in the tests on the subject given to Japanese schoolchildren. Many of our interviewees recalled elementary-school quizzes in which regions on a map of Japan would be matched up with the appropriate *meibutsu* — e.g., Kyoto *yatsushashi*, Kishu *umeboshi*, and Hokkaido Yubari melon. In addition, Japan's widespread gourmet food culture has spawned many TV shows and magazine articles that detail the various regional specialties found throughout the country. In fact, TV shows focused on food account for a whopping 35%-40% of domestic programming in Japan. Specialties that are found only in a particular area are profiled and naturally spur discussion and interest in that region.

While *meibutsu* has increased social interest in various parts of Japan, it is also important to note how its producers have changed proactively to suit new cultural norms. For example, Pagong, a subsidiary of the famous Kyoto Kimono Yuzen Company, has a new spin on *yuzen*, a traditional method of dyeing fabric. Although *yuzen* has traditionally been applied to more formal Japanese clothing, in recent years Pagong has taken the lead in adapting these traditional patterns to eastern clothing, such as polo shirts. It is interesting to note how *meibutsu* evolves to fit social needs — in this case, combining the sophistication of the *kimono* with the easy-to-wear style of western clothing.

The aforementioned *nama-yatsushashi* is another example of how *meibutsu* has evolved. Originally, one of Kyoto's defining regional products was *yatsushashi*, a baked confection made from rice flour, sugar, and cinnamon. As the cultural capital of Japan, Kyoto has always played host to various tour groups, including middle school and high school students' week-long field trips. It is unclear how *yatsushashi* came to be sold in raw — or *nama* — form, but by the 1980s unbaked *nama-yatsushashi* was the most popular food souvenir from Kyoto in terms of units sold, especially among these students. In essence, school children pioneered the popularity of a new food, which has now become

the defining *meibutsu* of Kyoto for people of all ages. Thus, it is not far-fetched to anticipate new social issues changing *meibutsu* in other regions of Japan. As healthy eating habits and organic products become a priority for consumers, it is likely that new forms of healthy *meibutsu* may appear in various regions.

These examples illustrate how social norms affect *meibutsu* and how this tradition has changed and can continue to change as a result. In fact, the entire life cycle of *meibutsu* — from production within rural areas to sales at tourist sites — has the potential to affect not only the social norms, but also the social structure of Japan.

### 'Home of Wasabi'

The economic importance of *meibutsu* lies primarily in its ability to create identity and branding for local goods, thus allowing for comparably higher pricing, the creation of derivative industries, and direct contribution to regional tourism. These benefits have been of increasing importance for regional economies, where agriculture plays an important role as one of the largest employers. Even as Japan faces growing competition from foreign agricultural producers and pressure to reduce agricultural subsidies, the development of *meibutsu* has created a path to greater value and demand for goods that might otherwise be considered mundane. The case of Yakurai *wasabi* in the northeast region of Japan highlights these points.

The northeast region — comprising Aomori, Iwate, Miyagi, Akita, Yamagata, and Fukushima prefectures — is one of the regional economies most heavily reliant on the primary sector of economic activity, defined in Japan as agriculture, lumbering, and fishing. According to the 2005 census of Japan's working population, the region is home to approximately 5.9 million — or 9.6% — of Japan's 61.5 million working population. Although the majority of these residents work in the primary sector (compared to the national average of 4.8%), their contribution to regional GDP is only 2.7% of the total. Furthermore, it should be noted that the workers in this sector are, for the most part, from lower income groups. Specifically, agricultural families in the sector earn an annual average of 3.7 million yen (US\$43,400) versus the national average of 4.5 million yen (US\$52,800).



In essence, an improvement in the earnings and economic power of the northeast region's primary sector would clearly benefit the lower-income segment of the economy. And this situation is certainly not limited to this region. Yakurai *wasabi* is a particularly relevant example of *meibutsu's* benefits to the economy.

Yakurai *wasabi* has achieved success through strict identification with the area of production and brand image around the region's history. In addition, it emphasizes the fact that this *wasabi* is produced by local farmers. With the branding power thus afforded to it, its producers have been able to sign deals with restaurants that highlight the use of the product in their dishes. In addition, the products are sold in about 50 specialty stores, where the average customer spends approximately 10,000 yen (US\$117). The producers have also developed derivative products in the form of *wasabi* dressing and *wasabi* seaweed. Currently, a "Home of Wasabi" attraction is in development, focused on promoting tourism. Yakurai *wasabi* represents a case where the use of a local name and the image associated with it have provided a company with the opportunity to upgrade its image. This is a unique situation, given that *wasabi* is not indigenous to Yakurai, but is actually from Sendai.

Another example of *meibutsu's* importance for promoting otherwise mundane goods can be seen in the case of Ishiya, a sweets manufacturer from Hokkaido best known as the maker of the aforementioned *Shiroi Koibito*. Although there is no reference in the name of the cookie nor any ingredient unique to the region, the company has chosen to associate the brand with Hokkaido and to sell *Shiroi Koibito* and its other products as Hokkaido *meibutsu*. Ishiya's shining-star logo is said to be a reference to Hokkaido, and even the company's mission statement ("With reliability and safety as our first priority, we put our heart and soul into the creation of Hokkaido sweets") is careful to distinguish that it wants to produce "Hokkaido Sweets" rather than just generic sweets. Ishiya's commitment to Hokkaido helps distinguish the company from other sweets manufacturers, even as its commitment also benefits Hokkaido itself. Moreover, Ishiya, with over 9.2 billion yen (US\$109 million) in annual sales, employs more than 400 people (plus temporary workers), all of whom are based in Hokkaido. Because of all the interest

in Ishiya's products, the company has built a miniature amusement park (*Shiroi Koibito* Park) that has already become a major tourist attraction, increasing the market for its *meibutsu*.

Cases like Yakurai *wasabi* and *Shiroi Koibito* have been noticed by both the national and local governments, which have taken steps to improve and develop the legal and business environments for *meibutsu*. This collaboration has come about with the support of groups like the regional farming cooperatives and enterprise cooperatives.

In 2005, the regional farming cooperatives and enterprise cooperatives began working toward developing legal protection for regional brands, registering 52 brands when the law was enacted in October 2006. Upon trademark registration, only farmers who are members of a given cooperative can produce goods with the official name. The law specifies what can or cannot be termed, for example, an Aomori *ringo* (apple). In addition, the law defines what types of products can be branded and the scope of a given brand name, and has made it possible for regional goods to gain identity and branding power while simultaneously reducing the risk of brand infringement and quality issues from copycats. As a result, local businesses have been able to expand the scope of their product offerings and create derivative industries.

As an example of an actively managed brand, in the latter half of the 20th century, Wakayama farmers developed a breed of *ume* (a Japanese fruit, related to an apricot, that is an important part of Japanese cuisine), whose thick, soft flesh is well-suited for producing *umeboshi* (pickled *ume*). The popularity of this new breed of *ume* was transformational for the region's agricultural profile, as *ume* sales rose from 2.8 billion yen (US\$32.9 million) to 15.5 billion yen (US\$181.9 million) annually between 1980 and 1990, moving from the tenth to the second largest agricultural product in the prefecture. The farmers also began to sell the processed version. Sales of *umeboshi* in Wakayama rose from next to nothing to 5.1 billion yen (US\$59.8 million) by 1995, but declined to 1.8 billion yen (US\$21.1 million) by the time the Regional Branding System was developed.

According to Souji Yabumoto, chief economist for

Wakayama's Department of Agriculture, Forestry, and Fisheries, "after the Wakayama *ume* became popular, there were a lot of producers from outside Wakayama that started giving their products brands like Kishu *umeboshi* [which implies that they were made in Wakayama, historically known as Kishu] even if the product didn't have anything to do with Wakayama. This competition from other places in Japan as well as from foreign imports was bad for the sales of *umeboshi* by Wakayama farmers." *Ume*-producing regional farming cooperatives in Wakayama's towns of Minabe and Tanabe cooperatively registered the Kishu *umeboshi* brand name with the Tokyo patent office. The towns were not only able to distinguish their product from their competitors, but they were also able to start marketing and licensing the brand more effectively. Today, the Kishu brand can be seen on *umeboshi* (e.g., rice balls) and *umeboshi*-flavored products (e.g., potato chips, candies, and soft drinks).

Cooperatives across Japan have been very enthusiastic about the government's trademark policy, registering 347 regional trademarks since 2006. Although the

government's protection of regional brands is a relatively recent development, it recognizes *meibutsu's* importance to different regions. Continued protection of regional brands is expected to be helpful in supporting regional economies. This policy is of particular interest to regions struggling with shrinking populations or lack of cost and strategic advantages within local industries.

The unique culture of *meibutsu* has significant implications for Japan's economic, social, and cultural future. Its potential to affect various facets of Japanese society include not only increased demand for products via branding, but also increased employment, especially in rural areas, which can help stabilize or increase the overall population of those regions. It is evident that *meibutsu* is more than just a souvenir or a food. It is a social and economic tool that can be used to benefit Japanese culture and society for generations to come.

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## Risky Business: Private Equity in China

*China's private equity (PE) market grew at a rate of 40% per year from 2003 to 2008, reaching a value of US\$9 billion, and is expected to continue growing at an annual rate of 20% to 25% through 2015. Much of this growth has been driven by foreign funds entering the market, accounting for an estimated two-thirds of the total market share by deal value in 2008, with several larger deals topping US\$200 million in size. While these figures make China a very attractive market for foreign private equity (FPE), there are still risks for foreign funds. How can one manage these risks while benefiting from China's rapid growth and dynamic markets?*

China's private equity (PE) market grew at a rate of 40% per year from 2003 to 2008, reaching a value of US\$9 billion, and is expected to continue growing at an annual rate of 20% to 25% through 2015. Much of this growth has been driven by foreign funds entering the market, accounting for an estimated two-thirds of the total market share by deal value in 2008, with several larger deals topping US\$200 million in size — such as CVC Capital Partners' 2007 purchase of a 29% stake in bottle maker Zhuhai Zhongfu for US\$213 million.

These figures make China a very attractive market for foreign private equity (FPE). Despite this rapid growth, however, the Chinese market is still fraught with hazards for foreign funds, as Carlyle experienced in its failed 2009 bid for the Xugong Tractor Company. To succeed in China, one needs to examine carefully the major legal, accounting, and political risks to FPE, and design strategies for managing these risks while benefiting from China's rapid growth and dynamic markets.

### **Key Risks: The Law, the Books, Getting In and Out, and the Party**

*Entering the Regulatory Melee:* The complex Chinese legal environment can pose significant obstacles for foreign firms investing in China. In addition, the regulatory system can be confusing: Targets for

acquisition are often not in compliance with regulations, the courts are ineffective, and rulings are rarely enforced.

As a unitary state with 23 provinces, five special autonomous regions, four self-governing municipalities, two special administrative regions, and a hierarchy of departments at all levels, China has myriad bodies with legislative and enforcement powers that can influence foreign firms' operations. Combined with the fact that, according to John Garnaut in the *Sydney Morning Herald*, "officials enjoy unfettered administrative power without transparency," it can be near impossible to navigate the Chinese bureaucracy; efforts to do so can sometimes border on the absurd. In a story related by one entrepreneur, conflicting requirements between the fire department and the health department led him to install a fire door on Monday before the fire official visited, only to take it down on Thursday when the health official visited.

According to one Shanghai-based lawyer who specializes in the acquisition of local firms by FPE, "no firm is 100% in compliance with regulations." In fact, a common phrase in Chinese business circles is, "while the top has policies, the bottom has countermeasures." This attitude presents problems for foreign investors, since it means that any target for acquisition is likely to have failed to

comply with government regulations. While the target's countermeasures may have been successful to date, there is no guarantee that the top will not enforce the regulations later and possibly retroactively. This poses a significant legal risk for foreign investors.

Moreover, because the Chinese court system is weak, few foreign investors expect its decisions to be effective or fair. In general, litigation in China for foreigners is a perilous business plagued by judicial incompetence, local favoritism, and a lack of international enforceability. Judges often have no professional legal training. Court decisions rarely favor foreign parties and are often subject to the local government's influence, which is one of the central reasons for the failure of enforcement in China.

Furthermore, traditional Chinese culture and current political policy place a heavy emphasis on preserving social harmony. Throughout its long history, Chinese society has been ordered more by moral precepts, socially enforced value systems, imperial edicts, and mass movements than by positive public law. This is translated into a legal and political system where dispute resolution focuses on mediation and conciliation in order to preserve social harmony, rather than hard enforcement of legislation that will preserve the integrity of the law. This lack of enforcement creates a situation where formal regulation fails to provide sufficient predictable and compelling incentives to ensure that economic actors and local officials comply with legislation.

*Counting Contracts:* The Chinese market is riddled with fake accounting records. As the managing director of a leading VC firm in China notes, "A lot of accounting and financial data is faked. It is common for firms to maintain two sets of books, and many have three — one set for tax authorities to minimize profitability, a second set for prospective investors to maximize profitability, and a third private set for the firm's managers showing actual profit and loss."

Chinese business contracts are similarly opaque. They are often viewed as preliminary indications of goodwill and intent rather than enforceable and mutual commitments by each party. They are rarely as detailed as foreign firms are accustomed to and lack specific technical and legal vocabulary. As a result, foreign investors run the risk of not actually getting what they think they are buying

or, alternatively, taking on unforeseen and potentially ruinous liabilities as part of a deal.

*Entry and Exit:* The inability of FPE to freely convert the renminbi (RMB) into other currencies has two major implications. First, in terms of entry, foreign entrants must obtain special permission from the Ministry of Commerce (MOFCOM) to make investments in China using foreign-currency-denominated funding pools. This approval may require specific deal structures — such as JV arrangements — and can take months to complete. In fast-moving industries such as high-tech and green-tech, this time lag can be enough to sink a deal. Furthermore, although infrequent, the possibility that MOFCOM might not approve a specific foreign investment project cannot be ruled out, particularly when a foreign investment is considered to be sensitive, or not in line with the state's interest or national policy.

Some FPE firms have begun to raise RMB-denominated funds in China to avoid this need for special MOFCOM approval. Several firms have even adopted the practice of using both foreign currency and RMB denominated funding pools in tandem. Under this approach, the RMB-denominated funds are first used to make a small initial investment, allowing the FPE firm to "seal the deal" quickly while awaiting MOFCOM approval to draw on the larger, foreign currency denominated funds to complete the investment. However, according to a Shanghai-based PE lawyer, "although the concept of foreign-controlled RMB funds is largely welcome and even encouraged by the Chinese government, the nature of these funds remains to be clarified under the Chinese legal regime. [Should they be] labeled as 'foreign' [in the future], they would also be subject to MOFCOM regulation."

Second, in terms of exit, the lack of free RMB convertibility means that foreign funds need to address how to get their profits out of China. Again, MOFCOM approval is needed to transfer equity in Chinese companies and convert/repatriate the proceeds out of China. These approvals are granted largely at the discretion of individual MOFCOM officials, subject to their interpretations of the regulations.

*Politics Matter:* China's government maintains an active role in the marketplace and can move quickly to act on



its political agendas. This introduces unpredictability for the foreign investment environment in China, as regulations and enforcement shift with changes in the political winds.

For example, in 2006, concerned over the flight of capital through round-trip investments — the most popular investment method at the time — the government effectively eliminated this practice through new regulations. Similarly, favored industries can quickly lose their regulatory backing if the government is satisfied with their development and moves to support other industries. As the director of a major Shanghai growth capital fund notes, “when the government suddenly decided the solar industry was oversaturated, our exit strategy became complicated and regulatory approvals for IPOs suddenly became very difficult.”

While the intersection of politics and the regulatory environment at the macro level has far-reaching implications, there is also a political risk at the deal level. Without a case-law system, officials in the provincial bureaus often interpret regulations as they see fit; and there is no guarantee of consistency across deals, even among those of similar sizes and types. An individual official’s importance to a deal cannot be overestimated. One experienced PE lawyer notes that the vast majority of officials are conservative and limited in knowledge, so it is difficult to gain approval for innovative deal structures. However, in one deal in which she participated, the official in charge had a personal vested interest in the development of the relevant industry, which was also a core development focus for the province. As a result, the official was willing to interpret regulations loosely and allowed her client to gain a majority stake in a company, which would have been impossible under a strict interpretation of the regulations.

An extreme example of politics influencing deals is Coca-Cola’s recent attempt to acquire HuiYuan. With a negotiated price tag of US\$2.4 billion, the acquisition of HuiYuan and its nearly 40% market share of the Chinese juice market appeared set to form the core of Coke’s product expansion strategy in China. Despite lengthy negotiations, MOFCOM — citing concerns over fair competition — ruled against the acquisition, making it the first to be struck down under China’s anti-monopoly law. Despite the published rationale, many analysts

saw the ruling as a reflection of growing nationalism in China: There was tremendous controversy when the acquisition was announced, with public outcry centering on the loss of a very successful domestic brand to foreign control. In the words of one analyst, “that deal was dead the minute it made the headlines in the *South China Morning Post*.”

## Risk Management

*The Role of Relationships — Guanxi:* It is often said that nothing can be accomplished in China without *guanxi*. While this may be an exaggeration, *guanxi* can make the difference between identifying a truly stellar company for acquisition and one that is stellar only on paper.

*Guanxi* refers to relationships based on mutual obligation, goodwill, and personal affection, with an emphasis on family and shared experiences. With *guanxi*, both parties express an implicit trust and understanding to help each other when requested, including performing favors and sharing information. However, *guanxi* is also a form of political capital, and the give-and-take must remain in balance, although not necessarily in kind. Failure to return favors or demonstrate a willingness to go out of one’s way can irreparably harm *guanxi* and potentially dissolve the relationship.

In China’s murky regulatory and business environment, *guanxi* offers clarity to foreign investment firms. Local industry contacts can provide detailed information and context to help verify or discredit financial statements that appear too good to be true. In one instance recounted by a Shanghai-based private equity player, a foreign firm was able to back out of a highly sought-after deal when industry contacts discredited the target company’s reported profit margins. Although the information was obtained through informal phone calls, it involved privileged operational data from the contact’s firm, which could not have been obtained without *guanxi*.

*Guanxi* also plays an important role in interactions with the local government. The deal approval process has lengthened in recent years as competition continues to grow and more applications clog the already highly bureaucratic process. Local officials prefer familiarity and are known to shuffle applications around, making *guanxi* an important tool to ensure prompt or early review. Informal dinners and deep *guanxi* with officials

also act as political barometers, providing off-the-cuff comments on specific industries or internal party politics that could guide deal-sourcing strategies.

*Adapting to Local Conditions:* While relationships are fundamental to business success in China, they should be reinforced by appropriate legal-risk-management practices. In the best interests of all the parties, the method of dispute resolution should be specified clearly in the contract. Chinese contracts usually include provisions for resolution through voluntary methods such as negotiation and mediation. However, because these methods are often unsuccessful in resolving serious disputes, it is necessary to have clear procedures for non-voluntary measures such as litigation and arbitration.

Although some commentators have confidence in Chinese courts, foreign firms should not rely on them for impartial and competent adjudication. Thus, arbitration is the preferred method of dispute resolution: It is usually faster than litigation, it is internationally enforceable and procedurally simple, and the arbitrators are more likely to be competent and impartial.

Because Chinese law allows for foreign arbitrations and enforces arbitral awards in accordance with its New York Convention obligations, parties have the option of arbitration outside mainland China. The Hong Kong International Arbitration Commission and the Singapore International Arbitration Commission are common choices. Another option is arbitration in Taiwan. Chinese authorities are particularly keen on enforcing Taiwanese arbitral awards as a political statement of Taiwan's unity with the mainland. This can be used to the foreign firm's advantage.

However, it may be more advantageous for the foreign party to accept arbitration in Beijing at the China International Economic Trade and Arbitration Commission (CIETAC) in exchange for other concessions in contract negotiations.

Although it was established in 1956, CIETAC remained ineffective until its rules were thoroughly revised in 2005. As a result of the dramatic improvement in its arbitration process, it is now generally well-regarded by foreign firms in China. In fact, limited statistical evidence suggests that foreign firms fare particularly well in CIETAC arbitrations. According to the international

law firm Minter Ellison, "the key advantages CEITAC has over foreign arbitration commissions are its favoured position with Chinese parties and its experience with Chinese business."

Chinese parties favor CIETAC arbitration as the method of dispute resolution. This preference can be turned to the foreign parties' advantage: The latter may agree to CIETAC arbitration as a bargaining chip to induce the Chinese Communist Party to concede other points in the negotiations. This may be achieved at minimal cost to the foreign firms, as CIETAC arbitration is generally satisfactory.

However, foreign parties should be mindful that a provision in the Civil Procedure Law allows Chinese courts to refuse to enforce CIETAC awards that are deemed to be "against the social and public interest of the country." This renders these awards vulnerable to local protectionism and refusal of enforcement on broad, vague, and exploitable grounds. The adage "go with the Communist Party" takes on particular relevance in this situation. Foreign firms should adapt to local conditions and be wary of crossing the Party.

*Structure the Deal Creatively:* To address accounting risks, structuring the deal and conducting proper due diligence are critical. The scale of accounting problems in China, combined with the difficulty in securing legal remedy, suggests that particular attention to detail is needed in the due-diligence phase. As part of this phase, measures that may be considered extraordinary in other markets are both prudent and commonplace in China — e.g., going through the detailed language of individual business and real estate contracts, with an eye for any unforeseen obligations or irregularities in property rights and conducting on-site, detailed physical inspections of all significant individual operations. One Hong Kong-based venture capitalist states that he would even "hire private investigators to thoroughly evaluate the background of potential business partners and target company executives."

The last point is particularly critical: It is not enough to just audit the books, supported by high-level spot checks of flagship operations. As one prominent venture capitalist with decades of experience in China notes, although a Chinese firm may claim to have an extensive

sales network in third-tier cities, many of those outlets may not be built or operated to the same standards as the company's flagship outlets in Beijing or Shanghai, while some may not be operational at all and others may not even exist.

Deal structuring is just as critical as due diligence. Several legal and industry experts have recommended the following practices:

**Have a trial period:** As part of this arrangement, the investor arranges to pay only 30% to 60% up front, with the balance postponed to a later date (e.g., six months later) and conditional upon a termination clause. This arrangement is aimed at keeping any potential partners honest for the critical period immediately after the company's handover, as well as allowing FPE firms to back out if any additional material accounting problems are discovered.

**Do an asset deal:** Where possible, instead of buying the old company, FPE firms should consider setting up a new JV instead to buy all the old company's assets. Funds can thus potentially avoid taking on unforeseen liabilities. However, regulations do place some limits on this practice: for example, assets cannot be transferred between firms at undervalued prices, and state-owned assets cannot be transferred to private firms at all.

**Keep the managers:** Even after a total buyout, it is particularly important to keep the previous management on in a consulting role for one to two years, with the appropriate incentives in place to keep their interests aligned with the company's continued success. Corporate success in China is due as much to personal *guanxi* as to institutional strength. If a key manager leaves to join a competitor, he may be able to take the entire client base and supplier network with him.

*Follow the Party and Keep a Low Profile:* The best way to avoid unforeseen political complications in China is to simply stay off the political radar. This involves not only pursuing investment strategies that fit with the Communist Party's objectives, but also avoiding large deals that could draw unwanted attention and scrutiny from the government.

According to private equity participants and observers, much can be accomplished in China as long as you "go with the Communist Party." The government authority's tight grip means that actions and strategies must align with the Party's political objectives. To do otherwise, as Google did recently with reports of Chinese-sponsored cyber-attacks, is to risk failure. According to an experienced executive from a competitor, Google's clash with the government severely damaged the company's relationship with the Chinese government, putting Google under intense scrutiny going forward. Conversely, another major online player's neutral stance on the issue has increased its political sway and afforded it greater room to maneuver. In the words of an executive from that company, "they can do almost anything now; they're on [the government's] good side."

### What Does All This Mean?

The risks and ambiguities inherent in the Chinese PE environment may seem daunting at first, but they also present an opportunity. Unpredictable legal enforcement or shady accounting can all be mitigated through local knowledge and networks; those firms best able to exploit this knowledge will have a competitive advantage. Combined with a hands-off approach from headquarters, local offices are empowered to act quickly within the often short window of opportunity.

China has just overtaken Japan to become the second largest economy in the world. And, despite the global financial crisis, China's GDP growth is projected to exceed 9% for both 2010 and 2011. While these risks and ambiguities are daunting, there is no doubt that China will remain an attractive market for foreign investment firms seeking growth in an increasingly slowing world. Those firms that embrace local knowledge and networks and that build and empower local offices will be best positioned to succeed.

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## Multinational Retailers' Quest for Gold in China's Tier 2 and Tier 3 Cities

*Since China's re-emergence onto the global economic stage initiated by Deng Xiaoping's landmark Southern Tour in 1992, four Chinese cities have epitomized the nation's unprecedented growth and development: Beijing, Shanghai, Guangzhou, and Shenzhen. For most foreign corporations, historically these so-called Tier 1 cities have been logical entry points into the Chinese market. Their uncontested dominance, however, appears to be waning amid an increasingly diverse urban landscape that is marked by the rise of numerous Tier 2 and Tier 3 cities, a trend that is expected to accelerate over the next two decades.*

Since China's re-emergence onto the global economic stage initiated by Deng Xiaoping's landmark Southern Tour in 1992, four Chinese cities have epitomized the nation's unprecedented growth and development: Beijing, Shanghai, Guangzhou, and Shenzhen. For most foreign corporations, historically these so-called Tier 1 cities have been logical entry points into the Chinese market. Their uncontested dominance, however, appears to be waning amid an increasingly diverse urban landscape that is marked by the rise of numerous Tier 2 and Tier 3 cities, a trend that is expected to accelerate over the next two decades. Corporate leaders must grapple with the strategic reality of China's urbanization and the sheer size and potential of these emerging urban centers.

Multinational retail corporations are at the forefront of the push into China's Tier 2 and Tier 3 cities, locked in a race to deploy their brands on an unprecedented scale as they seek first-mover advantage and try to build lasting consumer loyalty. Today's "gold-rush" mentality is rooted in undeniable opportunities tied to the secular trends in China's urban and consumer development. Nevertheless, as retailers unwittingly pursue similar expansion strategies, they face execution challenges as well as tough decisions about how to balance the speed and depth of their expansion.

### Unprecedented Urbanization

Urbanization is perhaps the single most inescapable reality of China's current economic development. Among emerging markets, urbanization is certainly not unique to China; but where China stands out is in the sheer scale of its transformation. McKinsey speaks of "China's urban billion" by 2030, predicting nearly 400 million new urban residents (an increase from 47% of the total population to more than 64%), exceeding the population of the United States.

Even more fundamental is the relatively diffuse nature of future urbanization, which motivates research analysts' desires to tease out differences in urbanization potential through the categorization of cities into Tier 2, Tier 3, and beyond. For example, Jones Lang LaSalle has identified "China's 40 rising urban stars," a collection of 15 Tier 2 cities and 25 Tier 3 cities, representing largely provincial capitals. Specific categorization methodologies, however, do differ. For instance, McKinsey prefers a categorization into 22 city clusters based on industry structure, government policy, population characteristics, and consumer preferences. Bain, on the other hand, adopts the government's potentially less useful classification into 330 Tier 2 cities.



Yet researchers fundamentally share the view, expressed by Euromonitor International, that “it is the rapid rise of ‘second-tier’ cities that is changing the urban landscape.” Indeed, the current four Tier 1 cities are likely to experience a decline in relative demographic and economic importance as future development and investment spread to a broader group of cities — over 200 of which exceed the one million population mark compared to 35 such cities in Europe, according to McKinsey.

The rapid growth of Tier 2 cities and beyond is driven by a variety of factors, including cheaper costs and deliberate government policies. While labor costs have historically been a dominant factor in attracting corporate investments, land costs are emerging as a new driver. Indeed, rising land costs are a growing push factor out of Tier 1 cities, encouraging businesses as well as individuals to “reverse migrate” to provincial capitals where economic opportunities are increasingly perceived to be more attainable. CBRE notes Beijing’s average housing prices rose 89% from 2006 to 2008, while prices in Guangzhou increased 69% during the same period. It is not surprising, then, that the Chinese media are filled with growing anecdotal evidence of Tier 1 city dwellers seeking economic refuge in Tier 2 cities, disillusioned with Tier 1 city housing prices so unaffordable that buying a house can equate to 50 years or more of salary for middle class workers.

Beyond cost drivers, the government (particularly at the local level) is a central actor in China’s Tier 2 urbanization, setting investment decisions and coordinating actions with state-owned enterprises. McKinsey observes that “today, the decisive actors in China’s urbanization are city governments themselves, [resulting in] very little evidence of conformity in the pattern of urbanization because of policies imposed from the center.” This has important implications for business leaders seeking to expand outside Tier 1 cities, particularly in terms of the need to adapt to local practices and urban characteristics.

### **Retail’s Gold Rush Toward Tier 2 Cities**

The consumption implications of the demographic growth of Tier 2 and Tier 3 cities (along with the correlated rise in income levels) compel multinational retailers to forge ever deeper into China. McKinsey

estimates that “the incremental growth alone in urban China’s consumption between 2008 and 2025 will amount to the creation of a new market the size of the German market in 2007.” The speed of the growth of China’s affluent and middle classes is staggering, even over shorter time frames. According to Bain, China is currently the world’s second largest luxury goods market (US\$9.6 billion in sales in 2009, or 27.5 % of the world total) and is expected to grow by 52% over the next five years, becoming the world’s largest luxury market. Separately, McKinsey estimates that 75 million urban households will enter the middle class between 2008 and 2015 (defined as RMB50,000 —RMB120,000 [US\$7,500 – US\$18,000] in annual household income).

In conjunction with the growth of the middle class in demographic terms, what excites foreign retailers is the emerging shift toward consumerism as a way of life, offering a potential windfall to retailers able to tap into new consumer trends. David Hand, a retail analyst at Jones Lang LaSalle in Beijing, articulates this bullish view to the newspaper *The National*: “The Chinese love shopping, they love brands, and they love international products, even though the average income is low. New shoppers are born every day. We won’t run out of them.”

However, the uneven geographic distribution of middle-class consumption presents challenges for retailers. McKinsey estimates that 25 of the 100 top Chinese cities will see consumption double between 2008 and 2015, while the other cities will grow more slowly. Broadly speaking, many Tier 2 and Tier 3 cities have been growing substantially more rapidly than Tier 1 cities (up to 5% faster, according to Jones Lang LaSalle), signaling a catch-up effect. Illustrating this trend, Ogilvy Discovery estimates that the top eight Chinese cities will account for only 33% of affluent households (defined as more than RMB80,000, or US\$12,000 in income) in 2012, a dramatic drop from 70% in 2003.

As a result, multinational retailers are tracking the spread of China’s growing affluent and middle classes into increasingly unexpected geographies. Louis Vuitton, one of the longest-established international luxury brands in China, recently opened a store in Hohhot, the provincial capital of Inner Mongolia, an area that is undergoing a mining boom. Perhaps even more surprisingly, Louis Vuitton also has a presence

in Urumqi, the capital of Xinjiang, China's western-most province. These two stores rank among 24 Louis Vuitton stores located across Tier 2 and Tier 3 cities, outnumbering the brand's nine Tier 1 city stores by nearly three to one.

In addition to the pull effect from rising consumption across China's dispersed urban centers, multinational retailers' expansion away from Tier 1 cities increasingly reflects the tough competitive environment in Tier 1 markets, including signs of market saturation, high costs of retail space, competition for attractive locations, and high costs of advertising.

### Multinational Retailers' Expansion Strategies

As multinationals increasingly turn to Tier 2 cities and beyond, multinational retailers typically rely on a number of core expansion strategies. Multinational corporations included in our study comprise retail and retail-focused companies, such as luxury brand Coach, education company English First (EF), and mall developer Ivanhoe Cambridge. These corporations have implemented geographic expansion strategies that share a common pragmatism to cater to the realities of the Chinese market. As they make strategic decisions regarding geographic reach within China, multinationals are also reassessing their entry modes, reducing reliance on franchising and licensing in favor of greater control over local operations. Being closer to the ground means multinationals must learn to work increasingly with local partners and, perhaps most importantly, with local governments across a wide array of jurisdictions.

In expanding its geographic reach in China, Coach, a U.S.-based luxury retailer, initially focused on creating brand equity and goodwill in affluent Tier 1 cities. The company is now actively leveraging these footholds in support of its foray into Tier 2 cities. This corresponds to a move from what Harvard Business School Professor John Quelch and China Europe International Business School researcher Maria Ibanez Gabilondo refer to as a "beachhead" strategy to a "disperse" strategy in an article published in the *South China Morning Post*.

Concretely, by establishing a recognizable brand in its core markets, Coach has been able to take

advantage of halo effects, which facilitate the spread of brand awareness from established markets into new, neighboring markets. As such, Coach built stores in a sequential manner that simultaneously expanded the company's reach and fortified the brand, moving to newer markets such as Chongqing only after core markets were firmly established in Beijing and Shanghai. Of Coach's 28 stores currently in operation in China, 12 are located in Tier 1 cities and 16 in Tier 2 cities or beyond, with many of the latter stores representing recent openings. The company opened 13 new locations in fiscal year 2010, representing a square-footage increase of 50%. Going forward, Coach plans to continue to grow its footprint aggressively, adding 30 new locations in fiscal year 2011, representing an overall square-footage increase of 60%. This expansion includes opening flagship stores in new cities in order to launch the brand's presence in provincial markets, despite the lower profitability of flagship stores.

EF, a leading provider of English language and cultural training to young professionals, has also utilized a "beachhead" strategy, first establishing a proven service model and brand presence in Tier 1 cities. Now, it is beginning to expand outward with a plan to enter several Tier 2 cities, leveraging cluster effects around existing strongholds to drive synergies on management overhead and marketing. However, Peter Winn, president of EF China, notes that expansion in Tier 2 markets hardly precludes continued growth in Tier 1 cities. In fact, he believes that "primary cities still have huge potential to develop."

While some research has focused on corporations that have made use of a "beachhead" approach, other corporations use different expansion methods that align with their corporate strategies. For instance, Quelch and Gabilondo identified fast-food retailers such as KFC and McDonalds, which use a "penetrate" strategy that focuses on expanding quickly and comprehensively throughout China. This strategy allows the fast-food retailers to generate a first-mover and low-cost competitive advantage through scale. Quelch and Gabilondo also cite retailers, such as Ermenegildo Zegna, that may already have channels in place across the country from their manufacturing processes and directly adopt a "disperse" strategy to leverage this

network. Lastly, the researchers identify multinational retailers that decide to expand extensively within Tier 1 cities and not look outward toward Tier 2 cities for growth. Starbucks, for example, has executed a “focus” strategy that centers its expansion on deepening market penetration in Tier 1 cities, perhaps recognizing that Tier 2 markets may not be ready to adopt its products.

As they pursue their latest expansion round into Tier 2 cities, retailers have also learned from past missteps in China, such as the problematic experiences of brands that relied on licensing agreements early on and encountered brand dilution and intellectual property issues. Accordingly, multinationals are reassessing their entry modes and opting for greater control over local operations. Polo Ralph Lauren, for instance, acquired its Southeast Asia license from Dickson Concepts International in 2010. Also in 2010, Burberry and Longchamp planned to regain control over their Chinese operations, with Burberry buying back its network of 50 stores in 30 Chinese cities from its franchisee and Longchamp buying out its Chinese distributor. Managers at EF China and Coach are also demonstrating their commitment to reduce reliance on franchising and licensing to further their development objectives. According to EF China president Peter Winn, “Providing service quality in China is difficult to control even internally, let alone through franchises. Our customers are high end and demanding, and it is difficult to find good franchise partners. Ultimately we will plan to run our own businesses.”

Similarly, Coach initially entered the China market in 2003 through several licensee agreements, but later found the profit opportunity too striking to license away. In 2009, the company bought back all of its locally managed retail outlets. Direct control of its China operations is central to Coach’s current strategy of pushing further into China. However, direct control also requires greater responsibility and management attention. Speaking to the unique needs of the market, the company has partnered with local market research groups to determine the right product mix for its customers in China. For example, Chinese consumers seem to prefer conspicuous brand markings in apparel and accessories products, leading management to tailor different products for the local market.

The question of whether, and how, to link up with a local partner — one that not only understands the Chinese market, but also has the necessary local connections to an area’s business leaders and government — is equally integral to a multinational’s success in Tier 2 cities.

Given the juxtaposition of China’s relationship-based business culture (i.e., *guanxi*) with the complex approval process for any retail project, multinational corporations emphasize the importance of securing local partners in targeted Tier 2 or Tier 3 cities.

This is particularly evident in the retail mall development industry. As Guy Poulin, a senior executive at Ivanhoe Cambridge, a mall developer and investor active in China, has noted: “If you don’t have a partner, forget the site. The site will not make sense if you don’t have a partner. And your partner has to be local. If he’s not local, he’d better be a well-connected Asian partner. Otherwise you will not be able to develop anything.” The partner is, therefore, considered as important — if not more so — than the specifics of a particular development opportunity. Expanding multinationals also perceive the long-term importance of these local relationships, since a good partner can work with the multinational through multiple projects.

The overarching partner and guide it seems, however, is the government. A prominent Shanghai-based private equity investor affirmed that, above all, investors must heed the motto “follow the government” if they want to succeed in China, while Poulin confirmed that this is “the first rule here [in China].” The Chinese central government and the local governments, to an even larger extent, play an essential role in guiding the direction of urban development. At the macro level, the central government’s emphasis on maintaining a “harmonious society” drives the country’s push for economic development in the form of sustained rapid GDP growth. These fundamental tenets are woven into the central government’s five-year planning process, which sets specific urbanization priorities, signaling to businesses and multinationals which cities have the potential to undergo transformative development.

The explosive yet concentrated growth of the high technology industry in Tianjin stands as a prime example of such a governmental directive (spurred

by the 11th five-year plan, spanning 2006 to 2010), which repositioned Tianjin as the “economic center of north China.” On the other hand, as noted earlier, city governments retain even greater influence over urbanization at a local level, given the highly decentralized nature of China’s administrative structure. Inevitably, multinationals must navigate carefully through the government’s influence over business affairs, with one source at a retail development firm citing concerns that “the government is doing everything it can to limit the entrance of foreigners in the shopping center business.”

## Expansion Risks

Unfortunately, as multinationals race to deepen their reach into China’s Tier 2 and Tier 3 cities, they also encounter a profound execution challenge. With alluring growth figures and promising charts touting deep pools of untapped market potential, it is easy to understand why so many multinationals have flocked to dive into the Chinese market. Yet, the realities of expansion are more complex, particularly when expanding beyond the comparatively more internationalized Tier 1 cities to the newly emerging Tier 2 centers. As Poulin observed, “foreign investors first perceive it shouldn’t be that difficult to succeed in China. The retail business is booming and local governments are looking for international developers, especially in second and third tier cities, so everything should be fine. Unfortunately, that is not the case, and the reality is sometimes brutal.”

In hindsight, it is easy to point to some brands that have entered China’s Tier 2 cities and failed for a myriad of reasons, including improper timing (too early), insufficient control over management and franchising agreements, and ineffective local partner relationships. In 1999, British-based Kingfisher Group entered China by rolling out B&Q China, a furniture-maker and seller, modeled on Kingfisher’s successful B&Q megastores in Europe, with the aim of capitalizing on the nation’s housing boom. Encouraged by promising financial indicators, Kingfisher quickly tried to expand its depth and breadth of stores. In 2007, however, the housing market reversed course as the Chinese government tightened lending criteria, causing B&Q China to recognize a £60 million (US\$93 million) loss in fiscal year 2008-2009. As yearly growth upwards of 40% was

replaced by declines of at least 15%, the retailer was forced to scale back dramatically and restructure its store footprint. As of early 2010, B&Q China had 43 outlets in operation, down one third from 63 at its peak.

In addition, mall-based retailers face the challenge of identifying suitable locations among numerous mall projects of widely varying quality and viability. Mall industry experts point to developers’ lack of accountability and misaligned profit incentives, as residential-focused developers often develop malls for mixed-use projects primarily as a way to acquire land from local governments on more favorable terms. This mismatch of interests has resulted in a number of high-profile mall failures, such as New South China Mall, located in Dongguan, a large industrial city in the Pearl River Delta. Built in 2005, during the boom years, this development aspired to be the world’s largest mall, holding over 1,500 stores in a lavish setting, including a mock Venetian canal, an indoor roller coaster, and a replica of the Arc de Triomphe. However, as of late 2009, approximately 99% of its stores stood empty.

Dick Groves, a Hong Kong-based retail development consultant, lists the many factors that combine to drive mall failures: “Preoccupation with residential development, failure to understand the complexities of retail development, hubris and gigantism, inappropriate designs based on Hong Kong and Taiwan malls, no accountability for capital, pressure to support GDP growth targets, and a corrupted system for securing sites.” Most importantly, he believes that mall failures are destined to continue because “the retail chain-store industry in China is years away from having the critical mass to fill megamalls, but developers don’t understand that bigger is not better, that they need to account for smaller numbers of stores,” particularly in Tier 2 cities. Even as professional mall developers such as CapitaLand, Swire, and Ivanhoe Cambridge build viable mall projects in Tier 2 cities, “the pace of change is very slow because easy credit continues to support poorly conceived projects,” says Groves.

The continued lack of quality mall space remains a core area of concern for retailers seeking expansion across China. In a retail game where location is key, prominent international chain stores such as Zara,



H&M, and Uniqlo enjoy prime spots at attractive rates as anchor tenants, giving them a competitive edge. In contrast, Groves believes that current mall designs, often characterized by too many levels and poorly planned circulation, pose the greatest challenge to less prominent retail chains because “lesser brands are having to look at inferior shopping spaces” deeper and higher in commercial centers where business prospects are low.

In this context, today’s retail entrants face high execution hurdles and run the risk of repeating past failures, but on a much grander scale given the larger and faster scale of expansion and capital expenditure. For example, Coach, in its Q4 2010 corporate earnings conference call, cited China as its “largest geographic opportunity.” To that end, the company is rapidly investing funds to more than double retail sales, targeting US\$250 million by fiscal year 2012, up from US\$100 million in fiscal year 2010.

In addition, beyond the financial risk of suffering from underperforming stores, brands run the risk of longer-term damage to their image in these new markets if they

mismanage their entry strategies and execution. We believe that while the blank-slate consumer markets of Tier 2 and Tier 3 cities are a tremendous opportunity for first-movers to establish a sustained lead over their global competitors, their newness also creates room for major missteps by brands overreaching into unknown territory. It remains to be seen whether a track record of successful entry into Tier 1 cities will be a good predictor of success in Tier 2 and Tier 3 cities over the next few years. Multinational retailers rushing to tap the gold mines of China’s Tier 2 and Tier 3 consumer markets certainly promise to offer revealing lessons on how to build strategic advantage in rapidly urbanizing markets. Meanwhile, these retailers’ successes — or failures — will also illuminate the true appetite for global brands among China’s burgeoning middle class

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*This article was written by Stephane Lesaffre and Amy Wang, members of the Lauder Class of 2012.*



## Beyond Yao: The Future of Chinese Basketball

*During the 2007 NBA All-Star Game, the player who received the most votes was neither LeBron James nor Kobe Bryant. It was Yao Ming, the hero of Chinese basketball and the first Chinese-born athlete to play successfully in the NBA. Yao entered the NBA as the number one draft pick of the Houston Rockets in 2002, and his success overseas has brought about a paradigm shift in Chinese basketball. What are the forces now shaping the future of basketball in China, how are businesses positioning themselves in response, and what implications does this have for the Chinese government's role in the sport?*

During the 2007 NBA All-Star Game, the player who received the most votes was neither LeBron James nor Kobe Bryant. It was Yao Ming, the hero of Chinese basketball and the first Chinese-born athlete to play successfully in the NBA. Yao entered the NBA as the number one draft pick of the Houston Rockets in 2002, and his success overseas has brought about a paradigm shift in Chinese basketball.

What are the forces now shaping the future of basketball in China, how are businesses positioning themselves in response, and what implications does this have for the Chinese government's role in the sport?

Basketball has enjoyed a long history of popularity in China. The sport was invented in Springfield, Mass., in 1891 by James Naismith to promote his vision of “muscular Christianity” around the world. The following year, YMCA missionaries journeyed to Tianjin, China, carrying “The Thirteen Rules of Basketball.” By the 1920s, there were more foreign missionaries in China than anywhere else in the world; in 1935, basketball was declared a Chinese national pastime.

The Chinese government estimates that 300 million people currently play basketball in China, roughly the population of the U.S. The NBA reported in 2009 that 89% of Chinese people ages 15 to 54 are more aware of the NBA than of the World Table Tennis Championships,

the European Champions League, and even the FIFA World Cup. China has become the NBA's largest international market, and the NBA's revenue in China is growing at a rate of 30% to 40% per year. Perhaps more importantly, the Chinese government views sports as a projection of soft power, as reflected in the concerted effort put into ensuring strong Chinese performances during the 2008 Beijing Summer Olympics.

With respect to basketball, Beijing's primary concern is to raise the standing of the national team. To this end, every five years the China State General Sports Administration (*Guojia Tiyu Zongju*) — with input from the National Development and Reform Commission (*Fagaiwei*), the Administration of Industry and Commerce (*Gongshan Guanliju*), and the General Administration of Sport (*Tiyu Zongju*) — updates the “National Policy Framework.” This doctrine outlines the government's long-term plan for national sports development. The government views basketball not only as recreation but also as a significant industry impacting both society and its commerce.

To protect this growing and “strategically important” industry, the government limits the activities of private enterprise within the country's basketball industry. However, over the past few years, the government has gradually allowed corporations like Nike, Li-Ning,

and the NBA to play an increasingly greater role in developing the market and the basketball talent. These decisions have broad social and economic implications and serve as an indicator of China's controlled and piecemeal privatization.

### **A Reward for Good Grades**

With insufficient commercial incentives to develop players and lukewarm government interest in collaborating to grow basketball as a sport, sports-apparel companies operating in China have focused primarily on the low-hanging fruit: peripheral businesses such as retail and entertainment. Identifying China as a key market and the popularity of basketball as a conduit to the largest youth population in the world, Nike moved quickly to support local basketball and to build its brand in China. The company sponsored the Chinese Basketball Association (CBA), China's first professional basketball league, upon its founding in 1995, paying \$2.5 million to outfit all eight teams over the first four years of the competition.

Beyond the apparel sponsorships and basketball camps, Nike has done little to develop Chinese basketball talent. The company is focused ultimately on growing mass-market demand for its products rather than raising the level of play. After Yao Ming elevated awareness of basketball in China, Nike no longer needed to rely on local stars to market its products and has successfully built ubiquitous recognition of its Western star-studded sponsorship portfolio among Chinese consumers. The most popular sneakers in China are not Yao's or Yi Jianlian's, but rather Los Angeles Laker Kobe Bryant's "Kobe V" and Boston Celtic Kevin Garnett's "Kevin."

William Haitink, general manager of Nike China, credits the company's relationships with top-flight stars as a primary pillar of its brand prominence in China today. As he noted: "We leverage our unchallenged sports marketing portfolio with athletes that only Nike has — Kobe, LeBron, Jordan." Nike has marketed itself as a lifestyle brand in China that represents not just basketball, but also youth, energy, and style. According to Terry Rhoads, a former marketing executive for Nike China, sneakers have become a common reward for Chinese students when they perform well on exams. Adolescents who spend more time studying are, therefore, able to

afford the high-end Nike shoes. More serious basketball players, without the support of their parents, are often able to purchase only the lower-end products.

Li-Ning, founded in 1990, is China's largest domestic sportswear apparel company. It utilizes a brand development strategy similar to Nike's and, in the last two years, has signed two-time NBA All-Star Baron Davis and 2010 second overall NBA draft pick Evan Turner. While it does not have top-flight stars like those in Nike's portfolio, Li-Ning's lucrative marketing contracts have created a buzz among NBA agents looking for endorsements. This heightened interest is likely to help the company secure future sponsorships with even more recognizable athletes. Like Nike, Li-Ning leverages its endorsements primarily to grow its retail brand rather than to develop the sport of basketball. It appears that Chinese sports-apparel companies do not need "another Yao" to sell shoes.

### **The NBA in China**

The internationalization of basketball over the past two decades and the allure of 300 million basketball players ultimately led the NBA to China. According to David Yan, vice-president of business development and marketing partnerships for NBA China, "Today, NBA programming airs on 51 stations. It reached more than 1 billion viewers last season and we are on pace to break that record again this season." However, China was not as welcoming when NBA Commissioner, David Stern first arrived in China in the late 1980s, offering free basketball programming to the state-run television monopoly. No one at CCTV headquarters even knew who he was. Relations have improved dramatically over the past 20 years, and the NBA's strategy since then has been to grow the sport of basketball through a series of exhibition games, promotional tours, and coaching clinics. The NBA has taken a slow and considered approach in navigating the Chinese market and government, which not only controls broadcasting but also directly controls China's professional league.

Both the NBA and the government want basketball to succeed in China, but for different reasons. The government views basketball as a projection of national ambition and, given the significant captive audience, as a means of maintaining social harmony. The NBA

wants to capitalize on the sizable business opportunities in China, capturing the full array of basketball-related revenue streams it has in the United States, which includes television broadcasts, digital media, merchandising, events, and games.

The NBA has long-held ambitions of creating an NBA-affiliated league in China. According to Deputy Commissioner Adam Silver, the NBA is continuing its discussions with the CBA but has offered no specific timetable. However, such a league would represent competition to the CBA and challenge the government's control of the development of basketball in China. As Tim Chen, CEO of NBA China, put it, "It is critical because we (the NBA and CBA) both have to do well to succeed." Consequently, the NBA-CBA relationship to date has involved mainly coaching and player-development programs as both sides seek to strengthen their business relationships. For now, because the development of an NBA league in China is impossible, the NBA is focused on expanding every other aspect of its business model there, while ensuring that all its initiatives are aligned with the government's goals.

In January 2008, the NBA established the entity NBA China, an affiliate with local operations and management. Since then, NBA China has built its business aggressively through a broad media play, along with sponsorships, promotions, events and an arena-management venture. NBA China now represents half of the NBA's international sales, and annual revenue is estimated at around \$150 million to \$170 million. Since 2008, sales have grown at double-digit rates annually, and the business has expanded to over 150 people with offices in Beijing, Shanghai, Hong Kong, and Taipei.

While the NBA continues to broaden its appeal, several social and policy issues are limiting the full potential of basketball in China. The current identification and selection process of prospective athletes limits talent development among Chinese basketball players to those few children who the government predicts will be exceptionally tall. In addition, the Chinese education administration is structured in a way that precludes massive adoption of extracurricular activities such as athletics. Finally, infrastructure to support professional basketball development is largely undeveloped in China

and is one of the main reasons for NBA China's venture into the arena-management business.

The current process for selecting athletes in China is very different from that found in Western countries. The Chinese government has adopted the Soviet "womb-to-tomb" model, identifying potential athletes at an early age and sending these children to specific training schools where their athletic development is as important as their academic performance. This model is intended to harness China's competitive advantages in sports — a large population and the increased control that comes with treating sports as a profession from an early age. The schools employ a strict, drill-based approach. Many Chinese families, particularly low-income households attracted by the potential for stable government jobs for themselves and guaranteed health care and education for their children, enthusiastically pursue professional athletic careers for their offspring.

Yet the Chinese training and selection process is still lacking, according to a former professional Chinese basketball player who now coaches at the elementary level in a government-run athletic academy in Guangzhou. According to a coach, who wished to remain anonymous, the attempted identification of talent at such an early age is an insufficient predictor of future basketball performance. In roughly half the annual enrollments, the selection process is still influenced by relationships — *guan xi* — rather than talent. As a result, children of parents with government connections are overrepresented within the system.

Further limiting the development of young Chinese basketball players is the lack of talent-development opportunities outside the government-run sports education system. Many Chinese coaches feel that the player-development network in the U.S., from the NJB youth leagues to the NCAA, produces a far superior talent pool. While some express an interest in emulating the Western school-based system, they still believe the government will remain the primary force driving Chinese basketball for the foreseeable future.

Finally, most children in China have one chance to improve their future socioeconomic standing: by doing well on the *gao kao*, China's college placement exam. The education system and the test-based college-admissions



process exacerbate the obsessive focus on academic preparation. Primary-school students are known to have full schedules teeming with extracurricular tutoring in English, advanced mathematics, and Chinese literature. Sports, including basketball, while viewed positively in a physical-fitness context, are considered secondary to academics.

Further adding to the pressure on Chinese students is the “one-child policy” the Chinese government enacted in 1978. Culturally, with limited social safety nets, Chinese children are expected to provide for their parents. The “one-child policy” pressures children to pursue lower-risk careers in government and business rather than pursuits of passion such as basketball. Rhoads believes these two effects have resulted in a bottleneck in developing talented athletes in China. Without athletics in the education system, children do not have as much time to experience competition and develop “game IQ,” something that cannot be taught through precision drilling.

### **Founding of the CBA**

Modeled after the NBA, the CBA is “basketball with Chinese characteristics.” Brian Goorjian, head coach of the Dongguan Leopards (a basketball team in the CBA’s south division) and a previous advisor to the Chinese National Team, describes this different culture as “full-on, full-time professionalism,” where the coach has complete control over the team. The style of play is also very different, with a heavy emphasis on practice-makes-perfect perimeter shooting. Former *Newsweek* writer and Yao biographer Brook Larmer describes the players of the early CBA as “Soviet-era automatons performing out of a somber sense of duty.”

Despite the efforts of the Chinese government, basketball in China has many hurdles to overcome before it can be competitive on both the professional and international levels. Traditionally, the Chinese National Team has done well against its Asian counterparts, but has only recently become competitive vis-à-vis Western teams. Furthermore, since the late 1970s, the Chinese team has never ranked better than eighth in either the Olympics or the FIFA World Championships. Recent results have not been encouraging. China lost (70-52) to Iran, a country not known for its basketball prowess, in

the finals of the Asian Men’s Basketball Championship in 2009, a serious loss of face for the host country and the first time China had ever lost a gold-medal game in FIBA Asia Championship’s history.

The CBA is struggling to stay relevant in its own market as it faces overwhelming competition from the NBA. Many Chinese fans prefer to watch the NBA, as they find the style of play faster, more athletic, and, most importantly, more entertaining. To elevate the level of play, in 2007 the CBA raised the limit on the number of foreign players per team from one to two. Because these changes caused operating costs to skyrocket during the 2008-2009 season, the league took a loss of 115 million RMB (approximately US\$17 million). In addition, the rules have made evident the lag in talent development: The two foreign players per team have dominated, such that former Dallas Maverick Zhang Yiyi was the only Chinese player during the 2009-10 season to place among the top 20 scorers in the league.

In addition to cultivating competitive domestic talent, another hurdle in developing basketball in China is the lack of infrastructure. While the government has committed to building 800,000 courts across the country, these primitive playgrounds fall far short of the modern arenas required to attract fan attendance and publicity. Commissioner Stern has cited the lack of sufficient facilities as one barrier to the NBA being more active in China. A survey conducted by China’s General Administration of Sport in 2004 found that only 8% of sporting venues were located in villages and towns, highlighting the concentration of resources in urban areas. The Chinese government has taken note and is investing in more facilities, partly by cooperating with foreign entities, such as a partnership with the NBA and AEG.

### **The Government Opens Up**

Faced with a chronic shortage of sports funding and the consistently weak performances of Team China, Beijing over the last 10 years has slowly opened basketball to outside influences, in much the same way it has opened other strategic industries to foreign investment. The challenges facing the development of competitive Chinese national basketball teams came to a head in 1997. Team China failed to qualify for FIBA and, along

with the youth squads, was soundly defeated in a series of world basketball competitions. In response, Beijing called a National Basketball Conference in 1999, which resolved to “learn from other countries and transfer their experience of developing professional basketball to our own situation.”

In 2003, Li Yuanwei, the new director of the China Basketball Management Center (CBMC), China’s governing body for basketball, traveled to the U.S. to learn about the NBA and NCAA systems. He used that knowledge to implement the “CBA 10-year Reform Project 2005-2014,” in hopes of turning the CBA into the second-largest professional basketball league in the world and breaking into the top three rankings for the women’s team and the top six rankings for the men’s team at the 2008 Olympic Games. Neither team achieved these targets.

After placing 8th at the Olympics and 15th in the last FIBA World Championship (2006) and failing to place in the top three in the East Asian Games (2009), Beijing recognized the need for more international experience in its coaching ranks. The national team, led by American coach Del Harris in the 2004 Olympics and by Guo Shiqiang in 2008, returned in 2009 to an American head coach, Bob Donewald, Jr. Donewald was hired after leading the Shanghai Sharks to the final four of the domestic league in his first season in 2009, the first time Shanghai had qualified for the semifinals in eight years.

Can foreign enterprise begin to move into the more strategic and sensitive areas of basketball? In addition to its media business, one of NBA China’s notable recent business initiatives has been its joint venture with AEG to develop and manage arenas throughout the country. It is a move that Commissioner Stern sees as a way to further enhance the NBA’s business in China and provide the necessary facilities to offer NBA-quality events. The Chinese, by and large, welcome the involvement of foreign basketball corporations. A Guangzhou government basketball coach noted that the Chinese basketball community is impressed with the NBA’s commitment to the development of the Chinese market, citing the NBA’s decision to import the same floorboards used in U.S. arenas for newly constructed Chinese stadiums to ensure international-level quality.

NBA China was established with five strategic investors purchasing a combined stake of 11% of the company for \$253 million, valuing the business at \$2.3 billion. Among the investors are a number of influential Chinese organizations, including Bank of China, Legend Holdings, Li Ka Shing Corporation, and China Merchant Investments. The NBA recognizes that its success in China depends on the alignment of its goals with those of the government.

Three years may be a short window from which to draw any definitive conclusions, but the proliferation of media and sponsorship deals, the steady increase in fan interest, and the increasing sales of Kobe Bryant jerseys signal the NBA’s growing influence. While few question the NBA’s strategy, many experts in China believe the prospect of an NBA-affiliated league is important for accelerating long-term growth. As Rhoads observed, “Media-wise, NBA China is doing a wonderful job, but to really capture a large fan base and more sponsors, the NBA [must] have more live programming.... Having a few exhibition games is not the answer because all it does is whet the appetite. How the NBA gets involved is the big question.”

According to Tim Chen, CEO of NBA China, “[a partnership] is something that we have discussed with the CBA and talks are ongoing. It’s not clear whether it could be a co-branded league or whether [a partnership] manifests itself with a tournament or a series of tournaments. It is in the future, but not in the immediate plans.” Investors such as Yao already own and manage individual CBA teams, although the league itself remains state-run. In 2010, American Kenny Huang invested in the alternative China National Basketball League (CNBL), observing, “This is the first time private enterprise has been given the chance to reform a Chinese league.” Huang is excited by the prospect of introducing management practices from successful overseas leagues. His company will co-manage the league with the CBA. The league hopes to become more market-responsive than the CBA and more focused on local talent development.

The Chinese basketball authorities, previously fearing that players who go abroad will never return, now encourage players to get overseas experience. In 1999, Beijing forbade Wang Zhizhi leave to play in the NBA.

But five Chinese players had played in the NBA by 2009, all of whom had trained at the United States Basketball Academy before being drafted. In addition, increasing numbers of Chinese players have been recruited into the NCAA as China looks to raise its level of international competitiveness. In 2006, China signed a contract with ISM, the exclusive global marketing partner for China's national basketball teams, to increase competition opportunities to 30 friendly international matches per year against American and European opponents.

Transitioning basketball in China from a planned Soviet-style system to a commercialized mass sport will take time, but even the stickiest social factors are changing. The rags-to-riches tales that attract many young basketball players also make basketball more palatable to their academically focused parents. Yao has signed two contracts with the Houston Rockets worth a total of \$94 million since 2002. His sponsorship deals are now worth \$150 million. When his life is compared with the hard, monotonous lives of professional athletes in earlier eras, a chance at professional basketball suddenly seems worth seeking. Sponsorships from private enterprises such as Nike enable schools to establish recreational leagues, widening the "talent bottleneck" Rhoads described.

Will these changes lead to the development of another Yao? Goorjian, the leading candidate to coach the

Chinese national team during the 2010-2011 season, believes the level of play is improving swiftly. "It seems to me ... that this is the number one team sport.... We have European and American influences coming in here, as coaches, as camps. They're flying kids to the States, they're flying kids to Australia.... [N]aturally you're going to start seeing some benefits from those programs. In the last five years, I've seen a huge change in the development of Chinese players. The Chinese are getting experience from outside and taking it seriously."

Perhaps Yao was only a catalyst for the acceleration of basketball's export to China, and going forward, organic growth in basketball interest will generate revenues even without more Chinese superstars. The private-sector commitment to the sport is finally converging with a rapid relinquishment of government control. One can only wait and see if world-class basketball remains a spectator sport or becomes a sovereign national passion in China, and if the transition to "basketball with Chinese characteristics" will prove successful.

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*This article was written by Fay Bou, David Chen, Sarah Guo, Frank Han and Mark Liao, members of the Lauder Class of 2012.*

The Lauder Global Business Insight Report 2011

# ON THE MOVE: ADAPTING TO A NEW GLOBAL ECONOMY



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