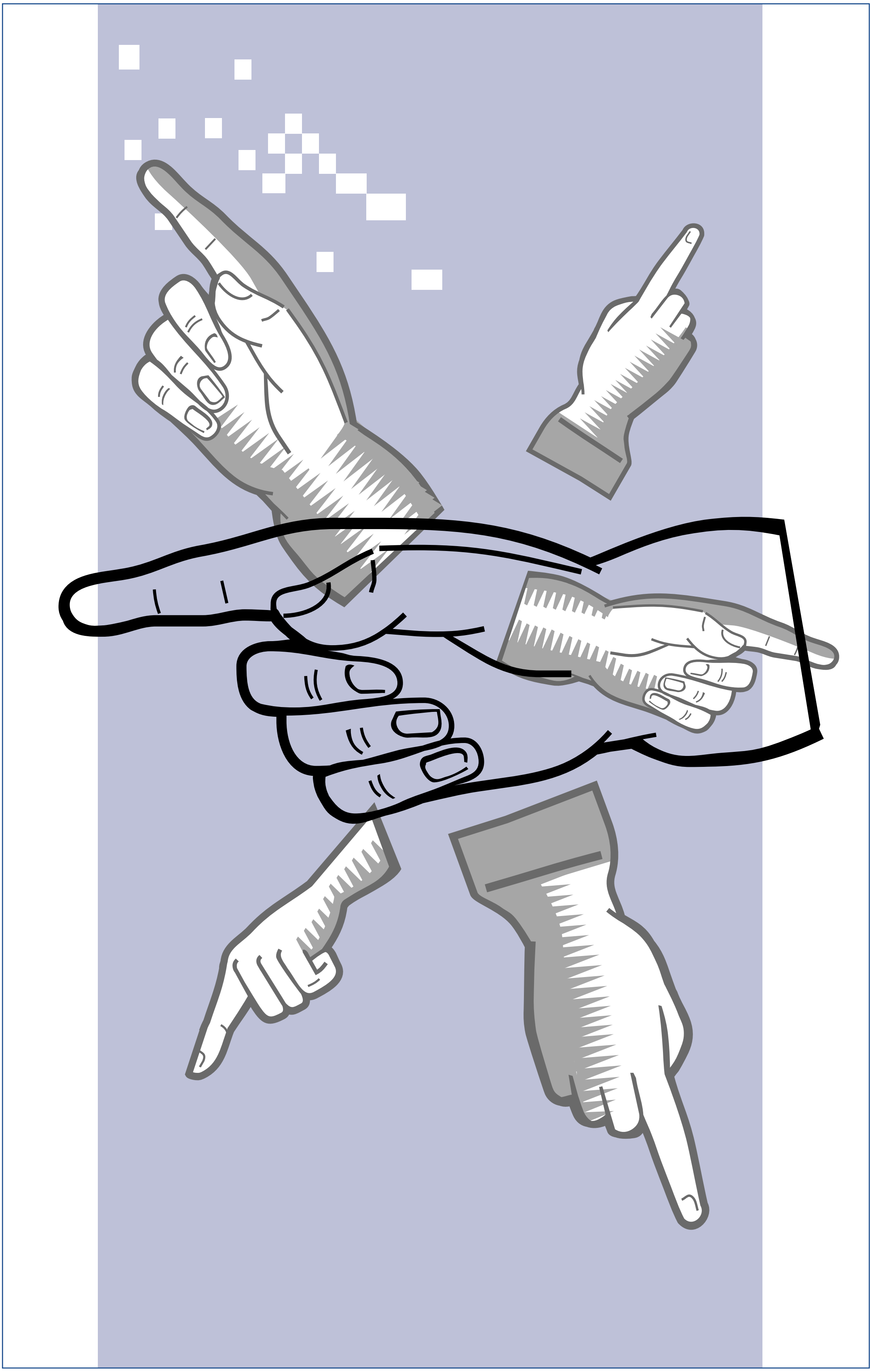
Prism

First Semester 2003

Arthur D Little

Back to Basics



Contingent Capitalism: Planning and Decision Making in Emerging Markets

Bernardo S. Sichel, Karim Taga, Mark Dougan

Emerging markets are commonly referred to as the next frontier for many multinational companies. The reason is simple: they represent growth opportunities often difficult to find in home markets, especially during recessions. Despite having operated in emerging markets for many years, multinational companies still find it extremely demanding to plan and make key strategic decisions under increasing levels of uncertainty. So what to do? Based on its Ambition Driven Strategy, Arthur D. Little has developed a four-step approach for multiple scenarios allowing multinationals to come to grips with ever-changing environments.

For many multinationals, their international operations represent an important part of their business (Exhibit 1). The results, though, are not always as expected. According to the Wall Street Journal, U.S. companies lost in excess of US$ 500 million in Latin America alone in 2002, with the reasons being manifold.

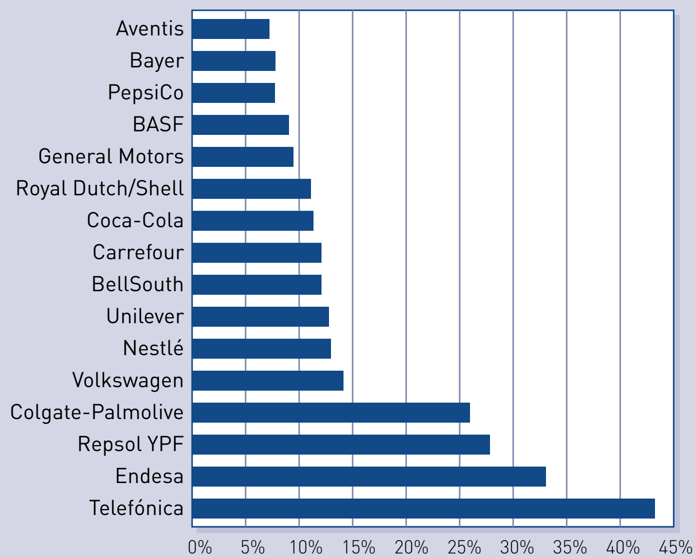
Part of the problem is the volatility of these markets. However, this phenomenon is by no means new to these regions and thus, despite the recent increase in volatility and perceived risk in some emerging economies (Exhibit 2), it cannot fully explain the results. The issue is more an internal one, specifically the way companies plan and make decisions under high levels of uncertainty.

Contingent Capitalism - Background

In 1998, Arthur D. Little introduced the Ambition Driven Strategy methodology. This methodology departs from typical condition driven approaches where the current resource base and competitive position are the sole basis for strategy development. It includes the understanding of the future and its uncertainties and the firm's ambitions as the drivers of the strategic exercise.

The current research builds on the Ambition Driven Strategy foundations and takes it one step further by enhancing the capabilities to make appropriate short and medium-term decisions in the presence of high environmental uncertainty. Whereas typical business planning attempts to reach the optimum strategic path based on the most probable future, strategic planning and decision-making under high levels of environmental uncertainty strives to provide the necessary flexibility by developing contingent strategic actions for each relevant future scenario.

Exhibit 1 **Percentage of Total Revenue Generated in Latin America for Selected Companies**



Source: Latin Trade and company reports

Most companies in emerging economies still use conventional business planning tools like forecasting and financial sensitivity analysis for dealing with highly uncertain environments. In the case of multinationals, this is in part due to standardized policies issued from headquarters, while in the case of local companies it is mostly due to a lack of knowledge of more efficient management tools like scenario-planning and road maps. In all cases, the results are plans that either do not reflect market realities or are not fully trusted by management and are seldom implemented.

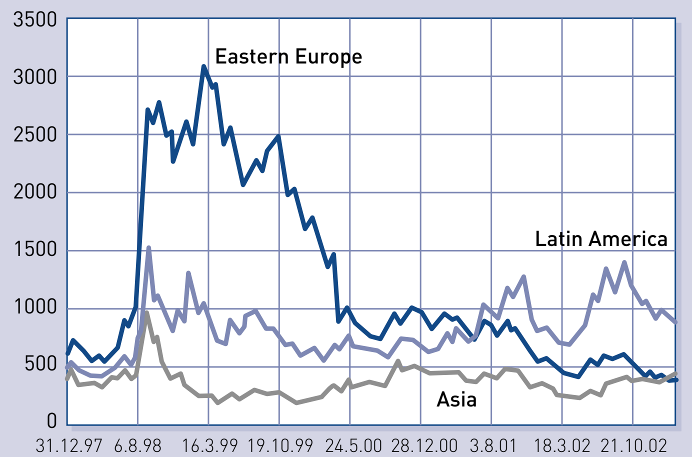
Furthermore, most companies still do not have a structured way of making decisions in highly uncertain environments - especially the type of uncertainty driven by environmental considerations like macroeconomics, politics, social issues. The results are delays in key business plan decisions and/or reliance on intuitive approaches.

Crucial Questions

Companies operating in emerging countries need to answer some basic questions if they aim to consistently thrive, and not only survive, in this type of environment:

- How can we operate with a business plan founded on tools and assumptions designed for more stable environments?
- How can we make more structured decisions under high levels of environmental uncertainty?
- How can we anticipate the future in order to build our strategies around the possible scenarios?
- How can we effectively monitor the environment to preemptively adapt to the changes?
- What principles and tools can we learn and adopt for future rounds of business planning?

Exhibit 2 Evolution of Sovereign Debt Spreads in Emerging Regions



Source: JP Morgan

About uncertainty

There is an extensive body of research on the role and classifications of uncertainty, but the comprehensive works of Amran and Courtney[1] capture the essence of what we are interested in: the sources of uncertainty and the levels they reach.

In a general sense, uncertainty can be found at the market or private level. The former is driven by exogenous forces and cannot be reduced in advance by learning or any other internal activity. An example is the uncertainty of the outcome of a regulatory decision. The latter, on the other hand, is endogenous and can be reduced with experimentation and/or other activities. Similarly, an example could be the uncertainty of the national demand for a new product, which can be reduced by conducting a local test market.

In addition, market level uncertainty can be further classified in environmental or industrial depending on its specific source. Environmental uncertainty is driven by country and/or regional forces, such as inflation, devaluation, social tension, or political crisis. It has an effect on all industries. Industrial uncertainty is driven by business specific forces like competition, technology, and customer preferences. In turn, it has an effect on one or a small group of sectors.

[1] Amran, Martha. "Value Sweep. Mapping corporate growth opportunities". Boston: Harvard Business School Press, 2002.

Companies usually deal more effectively with private and market-industrial uncertainties. This is due to the nature of their internal capabilities and current management-tool base. For the former, they often use test markets and other techniques to learn about future market performance. Consumer goods players are probably the best example. In the case of market-industrial risk, corporations have plenty of managers that are versed in industrial economics and tools used for standardized business planning and budgeting processes.

However, companies rarely deal well with market-environmental uncertainty. They usually call external advisors once or twice a year to receive forecasts on GDP, inflation and exchange rates for their financial models, but they seldom understand the true strategic implications of these variables or involve themselves in their monitoring for strategic purposes.

From ambiguity to clarity

But there are not only different types of uncertainty, but different levels as well: a clear future, a limited set of futures, a range of futures and true ambiguity [2].

The first level is characteristic of mature/declining industries and/or very stable economic environments that can provide a single view of the future. Somewhat stable environments, on the other hand, and/or growing industries - where regulations and technological standards are a norm - generally present a limited set of possible (or alternative) futures. Embryonic/growing industries and/or unstable environments instead show a range of possible outcomes. And finally, embryonic industries and/or truly unstable environments are by and large topped with true ambiguity where no range of futures is discernable.

This research and its proposed approach are aimed at firms operating in emerging countries where the type of uncertainty is usually market-environmental with a range of possible outcomes. However, uncertainty in these countries can reach levels of true ambiguity, as it is currently the case in Argentina and Venezuela.

[2] Courtney, Hugh. “20/20 Foresight. Crafting strategy in an uncertain world.” Boston: Harvard Business School Press, 2001.

About business plans

Typical business plans developed under stable environments are somewhat linear. They usually have forecasts of key demand variables from which sales and resource requirements are then derived. Frequently, they also have sensibilities of product demand and sales due to competition, changes in consumer preferences and technological innovations. However, key decisions concerning product launches, additional capacity and the like are only contingent on the outcome of these variables due to the relative level of stability of the environment. In a way, business plans are full of bets or commitments made by the firms based on a reliable prediction of what the future will be like.

However, under more unstable conditions affected by market-environment uncertainty, business plans should be much less linear and prescriptive. Not only should the future be envisioned as a range of complex possibilities, but decisions should also be fully contingent on how the future finally turns out to be[3]. In such an environment, business plans need to be built around strategic options that allow for flexibility and learning experiences.

Furthermore, while business planning in stable environments is carried out once a year and reviewed monthly/quarterly through budget meetings, the same process in unstable environments is a year-round activity where monitoring of key variables takes place almost on a daily basis. Thus, the ability to anticipate the future becomes key for the success of firms operating in highly unstable environments

What approach to take?

Since most companies competing in emerging economies cannot afford the luxury of completely remaking their strategies or business plans when facing high levels of uncertainty, a more pragmatic approach is called for. After all, multinationals cannot go back to their headquarters and simply change their assumptions and figures, nor do the local players have time or resources to do so. In close cooperation with our clients we therefore developed four stages to be performed:

[3] This is also true for other types of uncertainties (i.e. technological), but it is less frequent than in emerging countries battling with ever-changing environments.

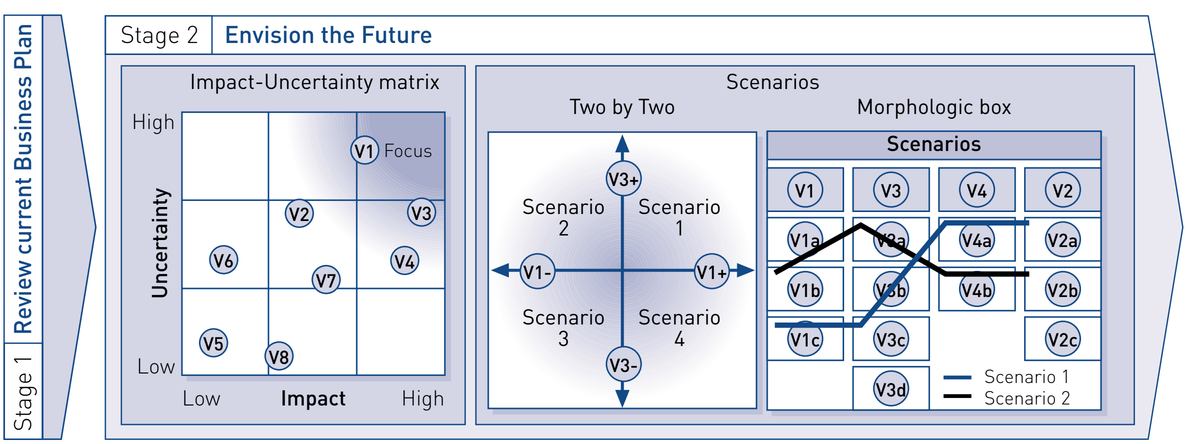
- Review the current business plan and select the key issues to be revised,
- Understand the type of uncertainty and envision the future,
- Develop contingent strategic actions based on relevant outcomes,
- Develop and implement a monitoring system.

Stage 1: Review the current business plan
The objective of this stage is to review the current business plan in order to understand its main drivers and assumptions and the key strategic decisions that are worhy of revision during the exercise.

In all companies we have worked with, there is always a set of decisions in the business plan with major importance concerning their impact and exposure. Should we relocate our manufacturing facilities and supply from other markets? Should we change our distribution model to outsource part of this activity? Should we launch a new product category in the market? These are the type of key decisions for consideration at this stage.

The more this process is connected to key decisions, the more applicable the results. By highlighting those key decisions, we can search for the uncertainties that are truly relevant for strategic purposes and build contingent actions around the different possible results.

Despite the high level of uncertainty, not all big decisions

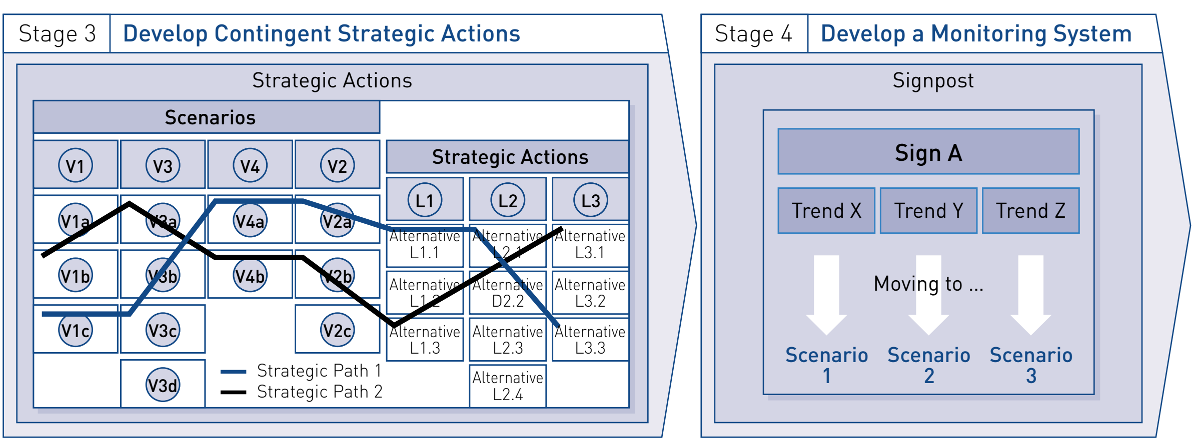


need to be called off or postponed. If, however, uncertainty is extremely high, we might want to come to a decision less risky in nature, which should give us more room for option-based strategic actions.

The activities carried out during this stage include a comprehensive review of the assumptions and strategic actions embedded in the business plan, as well as a set of interviews with the management team to sort out the key decisions that need to be continued. In order to ensure proper alignment throughout the exercise, the whole management team should participate in the validation of the key issues selected; this kind of participation is also required and assumed in the remaining stages.

Stage 2: Envision the future
Once we have reviewed the business plan and selected the key strategic decisions to focus on, we are ready to understand the type of prospective uncertainty affecting the firm. Hence, the objective of this stage is to build relevant future scenarios that will serve to test those strategic decisions.

A typical mistake at this point is trying to categorize the whole environment of the firm or including variables that do not have an impact in the short to medium term. This can prove too complex, unmanageable and most importantly, unnecessary for improving the decision-making process.



Focus should remain on the type of uncertainty that is affecting the firm in general and the selected strategic decisions in particular: What are the environmental and industrial variables that have the highest impact and uncertainty? What is the source of the uncertainty? What level of uncertainty are we facing?

We begin by selecting those variables that show the highest combined level of uncertainty and impact on the key decisions to be made in the future. It is useful to plot them in an impact-uncertainty matrix.

We can then envision the future outcomes possible for each variable. The timeframe selected should be a function of the uncertainty affecting the key decisions. A practical starting point given an environmental uncertainty with a range of possible future scenarios is to use a six to twelve month horizon. Additionally, the future outcomes should be limited to those that are relevant from a strategic point of view. By this we mean that the strategic decisions will vary accordingly.

Finally, we are ready to plot the scenarios. These are neither forecasts nor predictions, and finding the right one is less important than reaching relevant settings in which to test specific actions. Despite being initially designed for alternative futures, scenarios can still be used effectively under a range of possible futures as long as discrete and relevant possibilities are found for each of the variables.

As was the case in selecting the variables, simplicity is critical when developing scenarios. Arthur D. Little's experience shows that most of the time there are two variables with two extreme outputs that have the highest impact on the strategic decisions and the courses of action to be taken in the short term. Therefore, a simplified scenario version can generally be developed with four quadrants that representing the possible relevant futures.

If more than two variables are necessary to describe the future, as is often the case for longer-term scenarios, we need to find a way to work out a limited number of relevant strategic scenarios. Each additional variable exponentially increases the number of possible scenarios.

Usually, developing three is more than enough: a base scenario, which is the one most likely to take place and can be built by combining the variable outputs that have both

Case study - Rapidly Adapting to New Realities in Venezuela

Venezuela in June 2002 was one of the most uncertain times in the country's history. With daily changes in the political, economic and social environment consumer goods' companies were facing enormous situational and structural pressures.

The Venezuelan subsidiary of an important multinational food company with international sales in excess of US$ 50 billion required support in generating contingent strategic actions in the presence of different possible scenarios and developing a monitoring system to follow-up on the environment changes.

Working alongside the client, we developed three strategically relevant scenarios for the next 12 months: "Status quo", "Slight improvement" and "Crisis". Afterwards, we identified nine relevant strategic levers and developed their corresponding strategic actions to adapt the company's business strategy to the future scenarios. The strategic levers came from many areas, including manufacturing, distribution, marketing and finance.

When six moths later, in January 2003, the "Crisis" scenario came into full effect, the company had already anticipated the exchange and price controls resulting in important cost savings and realized sales vis-à-vis its competition. The monitoring system was key in anticipating the coming into effect of a new scenario and preempting competition. This was achieved expeditiously and without loss of management focus.

Finally, this approach to deal with environmental uncertainty helped the company move away from its traditional method of predicting the future to a more adaptive and flexible approach.

the highest probability of occurrence and the ability to coexist, as well as an optimistic scenario and a pessimistic one, both of which can be built by improving or worsening the outputs of each of the variables.

Usually, scenarios built in this fashion will lead to different sets of strategic considerations.

Stage 3: Develop contingent strategic actions
At the next stage, the contingent strategic actions that should be taken under each of the relevant future scenarios are developed and mapped out. Although there are several tools like decision trees and morphologic boxes for building road maps depending on the contingent decisions to be made and the uncertainty faced, the principles for developing contingent strategic actions are the same in all cases.

We start out by identifying the strategic levers that will be used to adapt the business to the different scenarios. Strategic levers are the main value drivers of a company. They comprise business processes, competencies and resources including assets. At this point we are interested in levers combining the greatest control over the business with the highest impact in the period under consideration.

Next the strategic actions for each of the levers in the base scenario are selected and developed. This is repeated for optimistic and pessimistic assumptions. Although some actions can be common to different scenarios, most should be specific to one of them. If not, the scenarios are not strategically different for the company and/or the strategic levers are not relevant for its adaptation to the changes in the environment.

The Rules of the Game

Having access to the necessary tools for developing strategic actions is important. However, it is not enough to assure that decisions made under each possible scenario are appropriate. Therefore, we provide several insights we have learned throughout our work with successful companies operating under high levels of environmental uncertainty:

- Large bets and commitments should be substituted by more option-like strategic actions that provide the needed flexibility and learning possibilities until new information is revealed. Brazil's Banco Itaú provides a good example. In a country where a single percentage point of market share can cost in excess of US$ 1,000 million, Banco Itaú has become one of the leading banks in the country by acquiring around 50 institutions in recent years.

- Preemptive moves are attractive due to competition's inaction, provided that the firm as a whole is not compromised. Benefiting from a financially weak Panamco and low market valuations, the Mexican Coca-Cola bottling company Femsa acquired its fellow anchor bottler in late 2002, thus becoming the largest Latin American Coca-Cola bottler and the second biggest one worldwide.

- Diversification inside the market is not attractive, since all industries are equally affected. However, diversification outside the market to stabilize cash flows and/or insurance-like diversification to cover for a worst-case scenario[4] is useful. In order to reduce its risk exposure to the local market, the Mexican cement giant Cemex diversified by acquiring several Spanish cement companies in the early 1990s. It is now one of the preeminent global players in the industry.

- Cooperation is often useful when it reduces the level of uncertainty. When the main challenge is the environment and not the competition, combining forces with competitors (i.e. lobbying) can reduce the level of uncertainty and influence government decisions. While interested in displacing the incumbent CANTV (Verizon) from its leading position, all other telecommunication players in Venezuela (BellSouth, TIM, others) came together to revise key aspects of the liberalization process with the government agency to ensure that transparent and non-discriminatory rules were in place.

[4] Insuring against all contingencies can prove extremely costly, even surpassing its benefits. This is the reason why insurance-like diversification should only be used to cover against worst-case scenarios.

Scenario Development - Envisioning the Future of Gas in Indonesia

Recently, a major upstream oil and gas company operating in Indonesia was interested in analyzing the alternative end-markets for its gas reserves. Due to the considerate uncertainty involved in forecasting demand and supply in Indonesia, we worked alongside the client to develop three medium term scenarios to evaluate the potential entry into a regional market.

After conducting the impact-uncertainty exercise, five variables were identified as having the highest influence in the decision, from which three were solely environmental: political situation, investment climate and economic performance.

Once the variables were chosen and its future relevant outcomes determined, three scenarios were built: a base case "Slow traffic", a high case "Happy days" and a low case "Lights out".

This exercise permitted the client to understand the risks and rewards under each scenario, deciding at the end to enter and actively market the product with highly successful results.

	Political Situation	Economic Growth	Investment Climate	Energy Sector	Infra-structure
High Case "Happy Days"	• Megawati succeeds	• 3% in 2002 • 5% in 2003/04 • 8% 2005-2015	• Foreign investment builds up significantly	• Subsidies removed by 2005 • Privatization	• No supply constraints by 2005
Base Case "Slow Traffic"	• Reforms occur slowly	• 3% in 2002 • 4% in 2003/04 • 5% 2005-2015	• Confidence slowly recovers led by ADB/JBIC	• Reforms occur slowly • Subsidies removed by 2007	• Investment led by ADB/JBIC • Some supply constraints
Low Case "Lights out"	• Unrest and instability continues	• 0% in 2002 • 3% in 2003/04 • 2% 2005-2015	• Very weak • Foreign investments stop	• Reforms stalled	• No further investment • Major supply constraints

Finally, by combining the strategic actions in each of the scenarios, it is possible to graph the different strategic paths of the company (see Exhibit 2). In a typical strategic planning process there is an optimum path. In this case, though, there are several optimum paths depending on the future environmental outcomes.

Stage 4: Develop a monitoring system
Developing a monitoring system will enable the firm to anticipate the advent of a particular scenario and implement the appropriate decisions on time. To this end, we recommend using signposts: signals that identify a change in direction of a particular variable, which are usually correlated with the main scenario and sometimes even drive their behavior[5].

The initial activity in this stage is to select the appropriate signposts for each variable of the scenario. They enable us to identify the outputs that signal the change of a variable from one outcome to the next. Finally, we build a "cockpit" in which we combine all the signposts to monitor the scenario in which we are operating, and possible changes in the near future.

The keys to an effective monitoring of the environment are: frequently going through the described screening processes, reviewing the validity of the signposts from time to time, and applying common sense. Signposts are developed to aid in the decision-making process and thus should not be used prescriptively. It is the combination of rigor and structure with experience and foresight that makes the difference.

Insights for the Executive

Emerging markets call for a different approach to planning and decision-making. To avoid delaying key decisions or using unstructured decision-making approaches under high levels of environmental uncertainty, companies must anticipate the future, develop contingent strategic actions and monitor the future to swiftly adapt to changes.

[5] The international reserves of a country make a good example of a signpost of the moves of its exchange rate. Usually, changes in the level of the reserves affect the appreciation/depreciation of a currency.

Firms, multinationals and local companies that understand the need and the value of enhancing their decision-making capabilities under high levels of environmental uncertainty will be the ones that will reap the benefits of emerging opportunities.

Spotlight Eastern Europe: Uncertainty in the Telco sector

Telecommunication companies operating in the emerging markets of CCE are currently facing a liberalization process. This condition is forcing many of them to act. However, the level of uncertainty is extremely high, both environmental and industrial. At the core of this uncertainty are several external forces.

Pressure on prices

It all started in Western Europe several years ago. After the liberalization process began, prices for voice services and particularly tariffs for international calls dramatically declined between 22 and 60 percent within three years in Austria, France, Germany, Italy and the United Kingdom. These phone companies are now interested in entering the Central Eastern Europe market but face the problem of predicting to what extent prices will decline. If a company banked on a maximum price decrease in the Czech Republic of for example 35 percent (as was the case in Western Europe) it would have experienced disaster. The reason is that when liberalization came in January of 2000, tariffs for international calls had already declined by 40 percent.

Other markets such as Croatia, where liberalization started in January 2003 are being closely followed but no action has been taken. Four months after liberalization, no new entrant had even formally applied for a voice license because entry barriers like license fees, required investment, legal framework and/or interconnection were still considerably high.

The CEE markets still have a low fixed penetration around 20 to 40 percent. At the same time the mobile penetration in some countries is about to reach 100 percent. It is hard to answer the question to what extent mobile cannibalizes fixed telecommunication. The impact on the new number of access lines and the broadband services in CEE is huge and may dramatically influence the market development and consumer behavior.

The privatization process going on in most of these countries is heavily affecting the market as well. There are many deadlock situations between minority shareholders and governments. In the Czech Republic for instance, there has been speculation about the option to either buyout the 49 percent stake in the Czech Mobile Operator Eurotel owned by AtlanticWest or to buy parts of the government owned 51 percent stake back. These are only two options among many other potentially viable ones. Whichever one will be given way will have a dramatic impact on the development of the mobile operator in the Czech Republic and the competitive environment.

Regulatory Changes

Mobile termination is part of the interconnection services, a sector where rates are regulated by national telecommunication authorities. The revenues for mobile termination account for a substantial share of the total revenues of mobile operators and can reach up to 25 percent. Hence, changes in the rates between operators set by the regulators have a dramatic impact on the bottom line.

In the CEE cuts on termination prices of up to 15 percent (e.g. Polkomtel and Era) will be common. However, regulators like HIF in Hungary or URTiP in Poland have voiced that they are considering adopting a cost oriented approach for mobile interconnection prices. Westel and Panon in Hungary have been both designated by HIF as having significant market power (SMP) in the interconnection segment, and are therefore required to publish an RIO (Reference Interconnection Offer) detailing their proposed costs of interconnection.

Regulators in these countries show signs that even stronger price decreases might be seen - maybe up to 40 percent as was recently seen in the Netherlands. There in 2002 the regulators twice forced a price decrease for interconnection, thus again jeopardizing the bottom line.

UMTS

Many of the operators in CEE have already obtained UMTS licences with the obligation to offer the service within a certain time frame. For instance, Centertel, owns such a licence in Poland and is supposed to launch UMTS by 2005 achieving a minimum coverage of 20 percent of the population. The roll out of such a network has substantial implications on CAPEX investments. There are currently discussions with the three mobile operators who prefer postponing the roll-out of the network until the demand in mobile broadband services is stronger. It remains questionable if the URTiP (the Regulatory Polish Body) will delay the deadline currently required for all mobile operators. Knowing that the investments could range between 300 million euros to over a billion euros, this kind of commitment may have a dramatic impact on the operator's performance, especially if the services do not take off due to lack of demand.

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