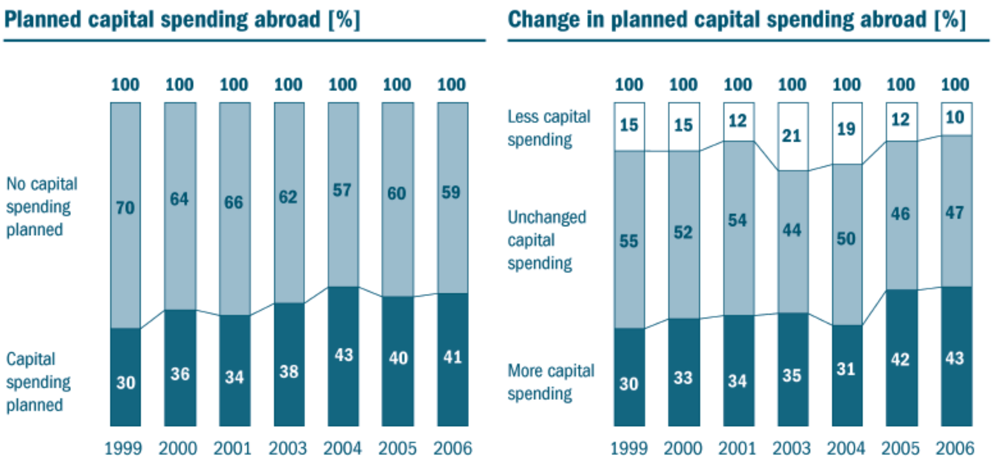
New sales markets for German makers of machinery and equipment

> Not all roads lead to China

Emerging markets seem to be the mantra of German industry right now. Many companies have transferred their production capacity to China in particular in an attempt to cut costs. Frustratingly, however, real gains often fall well short of original expectations. This is because turning to emerging markets merely to reap the benefits of low labor costs is too one-sided, argues **Ralf Augustin**, Principal. Drawing on examples in Turkey and India, Augustin shows that, for German engineering firms in particular, it is well worth committing to emerging economies – especially if these are seen as medium- to long-term sales markets.

A survey by DIHT, the German Chamber of Industry and Commerce, recently found that German companies are becoming more willing to invest abroad again. They are far from alone. For some years now, "low-cost countries" and "emerging markets" have been the magic words throughout the Western industrialized nations. China above all has captured the imagination of international players.

German industrial companies' plans for capital spending abroad



Most large, but also many small and medium-sized enterprises (SMEs) are taking a long, hard look at China. Most of them aim to slash payroll costs by manufacturing in the Far East instead of at home. All too often, however, this proves to be easier said than done. Hourly rates paid in China are obviously significantly lower than in Western companies' home countries. However, lower labor productivity, inferior quality and poor infrastructure can quickly turn the dream of a low-cost workbench into a nightmare. And then there can be the problem of local business partners who are not too particular about preserving their partners' intellectual property rights and who, guided by their own interests, cleverly exploit the inexperience of Western companies. In such situations, many enterprises soon wish they had never set foot outside the country.

Especially for mid-sized companies, such examples occur frequently. This naturally leads SMEs to question the sense in committing to emerging markets in the first place. Our answer is that, yes, such commitments can indeed make very good sense. This is true in particular for players who understand that today's emerging markets will, in the medium to long term, become important sales markets. In other words, the economic significance of these markets will increase for a long time to come. They are locked into a long-term rapid-growth trajectory. Logically, therefore, companies based in these markets will play a key role in the global economy of tomorrow.

The country in which German SMEs try their luck does not necessarily have to be China, however. Especially for makers of engineered products, two emerging markets in particular – Turkey and India – should definitely be regarded as sales markets and not just as production locations.

Turkey: Sound opportunities thanks to German industry's excellent reputation

The Turkish economy is growing very fast right now. Data from the German Office of Foreign Trade shows that that the country's GDP grew at a real year-on-year rate of 6.4% in the first quarter of 2006. Construction, which expanded by nearly 26% in this period, is the main driver of this growth.

Growth is expected to have slowed since the Turkish lira was devalued at the start of 2006. Structurally, however, the conditions for solid growth remain intact.

Turkey enjoys political stability, its consumption climate is upbeat, and rising real incomes are boosting domestic demand. Moreover, export-oriented industries in particular – such as textile firms, automotive manufacturers and tourism – are likely to benefit above all from the currency devaluation.

The country has established its position as a target for Western European investment. Retailers such as Migros and Carrefour, for example, are working hard to expand their store networks. Fiat too has a joint venture company, Tofas-Fiat, on the ground in Turkey. In addition, the Italian auto maker has invested a further USD 172 million to ramp up capacity at its Bursa plant as of 2007. For German mechanical engineering companies, Turkey is a very lucrative market. The Turkish engineering association MIB, for instance, reckons that demand for machinery will increase at 10 to 12% per annum from 2006 through 2013, with imports rising at an average of 15% per annum in the same period.

The construction industry is driving this demand for machinery. Demand is expected to grow particularly sharply for tool production equipment and metalworking machinery. The outlook is similarly bright for makers of plastics machinery.

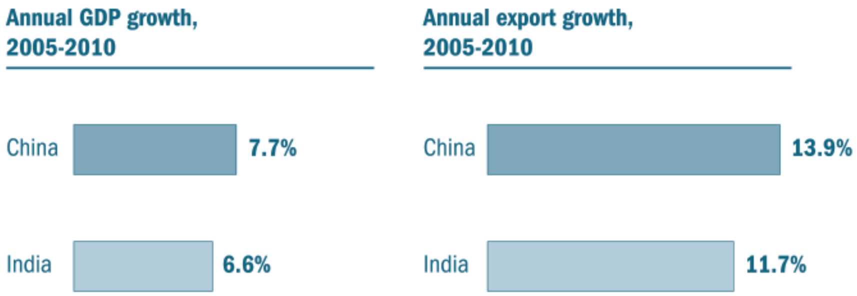
Experts believe the Turkish plastics industry will double its sales volume to USD 20 billion between now and 2010. Packaging, another key sector that is fueling demand, is benefiting from moves to modernize the food industry – another area in which large European groups are heavily involved.

With target industries becoming distinctly more choosy about quality, German machinery firms in particular can build on their excellent reputation and are faced with very good sales prospects.

India: Attractive opportunities as customers demand superior quality and precision

After China, India is one of the world's fastest-growing economies. Indeed, experts see the subcontinent on the verge of rapid economic expansion that could rival the development experienced by China over the past ten years.

Economic indicators in India and China



In India too, construction is one of the most powerful engines of growth and accounts for about 6% of GDP. Between now and 2015, planned public infrastructure programs should channel a further EUR 250 billion into this industry, fueling further growth of 9% per annum.

Most of this money is being used to lay roads, improve port facilities and build power plant. Siemens India, for example, is helping to build an industrial turbine factory in Baroda. A total of INR 3 billion is being invested in the new plant, which is due to go live in early 2007.

The manufacturing industry too – above all the fast-growing automotive segment and its upstream supply chain – is providing a constant stream of stimulus to the engineering sector. The automotive and supply industry is benefiting both from expansion of the road network and from more robust domestic demand as real incomes rise.

At the same time, India is gaining ground as a production location for Western car makers. Industry heavyweights such as DaimlerChrysler, BMW and Hyundai, for example, all have plans to create and/or increase manufacturing capacity here. MAN intends to commit to a joint venture that will make engines for commercial vehicles. Toyota has chosen India as the one location in its global production network that is to realize the lowest manufacturing costs in the world. Local producers too are raising their capacity in order to tap economies of scale and roll out more goods for export. All of which is driving demand for technologically sophisticated suppliers who can meet the quality and technology standards imposed by global players, and who already have experience of operating in value chains that are spread around the world.

As customers demand ever greater quality and precision, lucrative opportunities are opening up on the Indian market above all for technologically advanced engineering companies. This principle applies to manufacturers of toolmaking equipment and makers of plastics machinery alike. The latter are enjoying a windfall from current investment in public infrastructure projects (which require cables, tubes, pipelines, etc.), and from the stricter demands being placed on the packaging industry. More is also being expected of the food industry as Western-style supermarket formats become more widely established. In their turn, manufacturers of packaging and food processing machinery are benefiting from these changes too.

Clothing and textiles – perhaps the sector of Indian industry that is best known to European companies outside Germany – will remain an important sales market for European machinery companies in future. To the extent that the subcontinent's textile industry weans itself off mass production and begins to climb higher in the value chain, demand for higher-grade machinery will increase too. This demand cannot always be met by indigenous suppliers. Accordingly, necessary replacement investments can open up attractive opportunities for Western European manufacturers to exploit their technology lead.

Success factors for foreign companies in emerging markets

Roland Berger Strategy Consultants has been involved in a broad array of projects in emerging markets in recent years. The spectrum covers everything from identifying suitable suppliers to relocating production facilities and setting up local sales units. This experience has revealed five key factors that drive the success of foreign players operating in these countries:

1. Top management must demonstrate its commitment
Activities in emerging markets will only succeed if top management clearly and openly communicates a strategy built on long-term commitment rather than the desire to realize quick wins in the short term. Employees see themselves as part of a whole. So they want to know where that "whole" is going and what strategy it is pursuing.

2. Account must be taken of cultural differences in business and everyday life
Many promising activities in emerging markets fail because companies are quite simply ignorant of cultural differences. Language barriers often exacerbate the problem. Especially in order to underscore their long-term commitment, Western companies should therefore draw on external assistance and local expertise if they want to cultivate durable business relationships.

3. Sustainable, long-term structures must be established on the ground
Many European or US companies deploy only manpower from their home country when seeking to build structures in emerging markets. However, to keep the local organization in the target country highly motivated and to foster an entrepreneurial spirit, it is important to keep the number of expatriates as low as possible from the outset – and to further reduce it as time goes on.

4. State-of-the-art production technology is essential
Best-in-class enterprises that see emerging markets not only as sales markets but also as production locations will, when setting up offshore production capacity, deploy state-of-the-art technologies that align with the level of training and education available in that country. Advanced training can then further improve efficiency, while production can be adapted to local circumstances.

5. Research and development should be locally based
To cater appropriately to the needs of new sales markets, successful companies organize research and development activities on site in the foreign country. Only then can market trends quickly flow into product development. And only then can adequate provision be made at an early stage for local structural constraints and cost structures.

Long-term activities open up significant potential

German companies have in the past often equated emerging markets simply with low-cost countries. For many, however, the strategy of farming production out to countries where the greatest comparative cost benefits could ostensibly be realized has failed to deliver the hoped-for results. Especially in the context of relocations to China, cultural differences and the lack of ability to exercise close control (partly due to the sheer physical distances involved) have left many enterprises licking their wounds.

An emerging market is more than just an "extended workbench", however. Many of these markets can also be potential sales markets. Dynamic economies such as Turkey and India, but also Mexico and countries in the Commonwealth of Independent States (CIS) harbor vast potential for German engineering companies. Focal attention should thus be paid to these regions in future. Ultimately, the longer-term the horizon for such activities – and the more thorough the preparation – the greater the likelihood of lasting success. This naturally applies in any context. But it applies all the more so in emerging markets.