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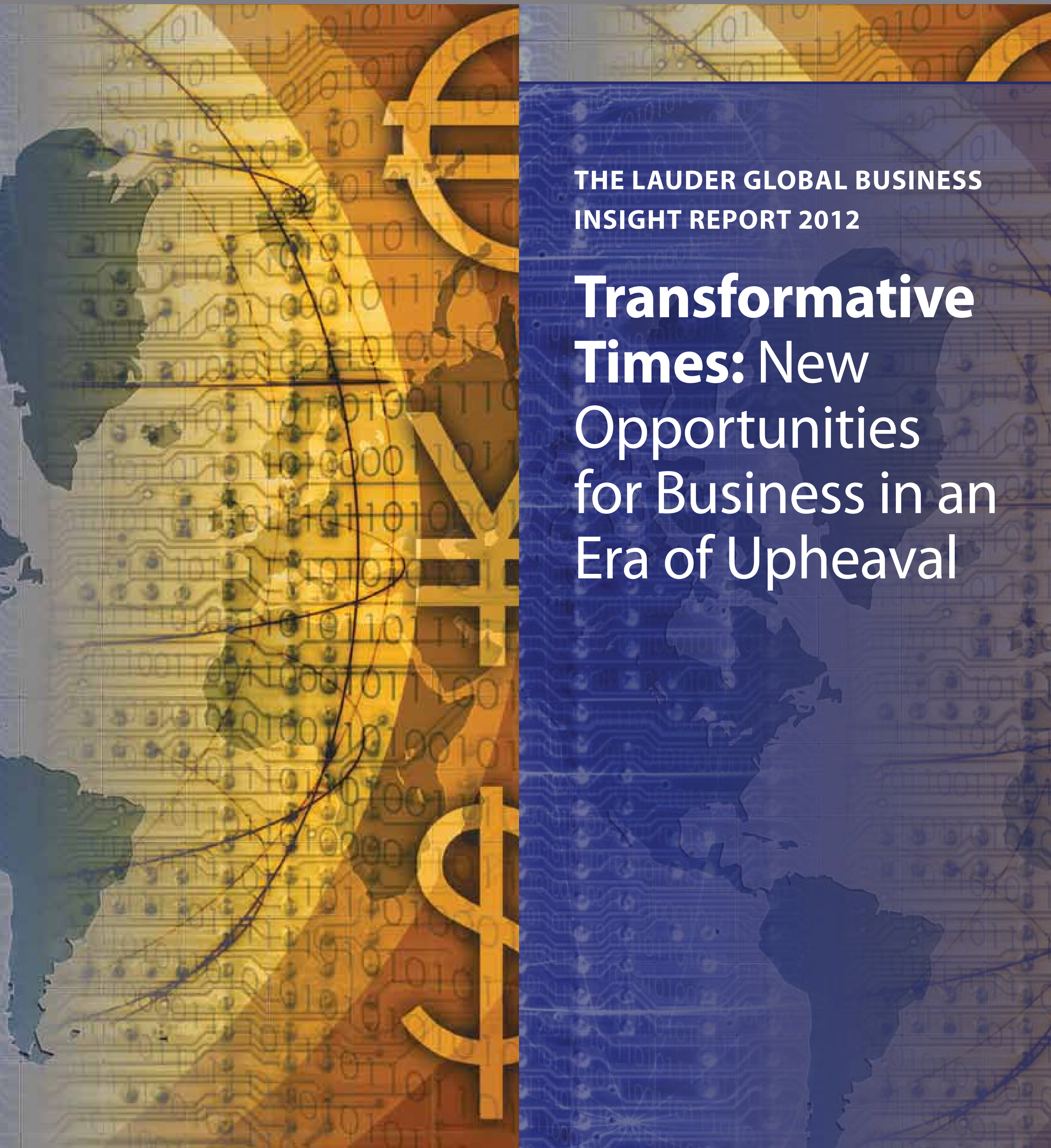
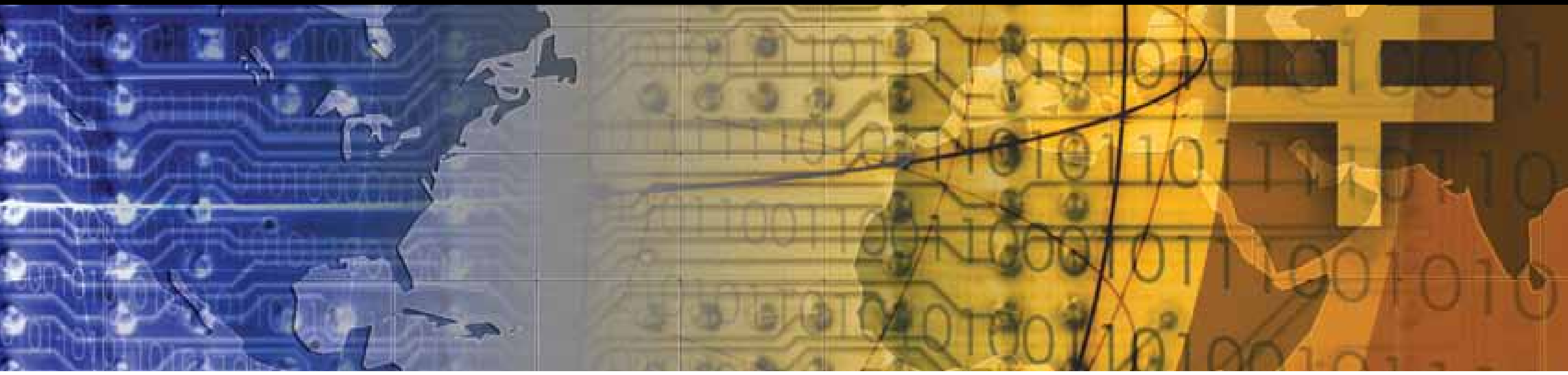


THE LAUDER GLOBAL BUSINESS INSIGHT REPORT 2012

Transformative Times: New Opportunities for Business in an Era of Upheaval



Introduction

THE LAUDER GLOBAL BUSINESS INSIGHT REPORT 2012

Transformative Times: Change and Upheaval around the World Bring New Opportunities for Business

In this special report, students from the Joseph H. Lauder Institute of Management & International Studies explore the many ways that the business community has responded to changes in our global economy. They look at individual companies and industry trends, and analyze how startups as well as established firms are taking advantage of transformative events around the world.

One article studies investment prospects in countries affected by the Arab Spring; another describes Japan's use of alternative energy sources in the wake of the country's nuclear accident last March. A third describes the challenges facing multinational companies trying to attract and retain local talent to help run their ventures in China.

Consumer goods and services are also covered in this report, including the increasing presence of Bordeaux wines in China, the popularity of the Louis Vuitton brand in China's luxury consumer goods market, McDonald's success in winning over demanding French restaurant goers, and the challenges faced by the group discount model in China. In addition, we offer separate stories on two thriving industries in Colombia — tourism and flowers.

In the cultural arena, articles look at a new venture in France aimed at serving independent music artists and promoting cultural sustainable development, the modernization and globalization of the French horse racing industry, and a particular etiquette challenge posed by the German language. The international expansion of Spanish wind turbine manufacturer Gamesa and the reenergized cement industry in Colombia are analyzed in two other articles.

In the public policy realm, articles explore the ethical challenges of doing business in India, improvements taking place in Brazil's *favelas* (slums), the need for Arab governments to establish vocational education and training for their young people, the shortage of qualified labor in Brazil, what companies in China can do to develop reputable brands abroad, and why it is so difficult for small- and medium-sized businesses to thrive in Russia.

These 20 articles identify the major challenges facing companies around the world as they try to take advantage of new opportunities in our increasingly connected global community. The articles are part of the Lauder Global Business Insight program.

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The Groupon Effect in China

In January 2011, Groupon, the world's fastest-growing company, launched its online coupon business in China, the world's fastest-growing economy. At that time, more than 2,000 Chinese group-buying clone sites were already competing aggressively in a highly saturated market. While Groupon might have pioneered the group-discount model in the Western world, the concept of group-bargaining already existed in the Chinese culture. What forces helped shape such rapid growth in this industry in China? How are group-buying companies responding to the competitive landscape? And what are the implications for Chinese consumers today?

Group-buying, or *tuangou,* became popular in China as early as 2005. Chinese consumers formed groups that would bargain for goods ranging from household supplies to automobiles. According to Han Zhen Hua from Beijing Foreign Studies University, a local participant, groups of individuals interested in group-buying auctions would gather in homes or conference rooms to bargain with vendors, purchasing items in large quantities to receive substantial discounts. Han once participated in a *tuangou* for home construction materials where food and tea were served to all. The crowd cheered whenever negotiations heated up and evolved into yelling matches between the negotiators and suppliers.

Although news of group-buying activities initially spread through word-of-mouth, online forums and blogs soon became the main form of communication. The concept of *tuangou* took off in China due to both the Chinese culture of bargaining and the burgeoning number of online users.

Group-buying reached the U.S. in 2008 when Groupon launched an online portal promoting coupons with group discounts. The company's rapid growth spurred its international expansion and subsequent entry into China in 2011. Some in the news media have labeled this phenomenon a "boomerang" of group-buying from China to the U.S. and now back to the country of its origin, where a host of online competitors have already put down roots. CNBC's Cris Prystay writes that "[T]here appears to be a huge demand for [an] Americanized version of *tuangou*." Today, the Chinese group-buying market has ballooned to nearly 5,000 sites, with several U.S.-based companies also looking to take advantage of the growing Chinese consumer appetite for *tuangou*.

Group-buying in China Today

How does the *tuangou* model work? Group-buying enables large groups of consumers to purchase vouchers online that offer up to 90% discounts at local vendors, ranging from restaurants to movie theaters to hair salons. Vouchers are also offered for a wide variety of products, such as skincare items or dietary supplements. These vouchers are available for only a limited period of time (the window can be as short as 24 hours), thus creating a sense of urgency to buy. The time limit and the attractive discount often induce impulsive purchases. Vendors also benefit from group-buying, which can attract new customers. In addition, group-buying bridges offline and online commerce by serving as a new type of Internet advertising channel for brick-and-mortar retailers.

In China, consumers are drawn to *tuangou* not only by the discounts, but also by the unique types of deals available. Chinese sites offer coupons on jewelry, automobiles and even real estate, items that are rarely featured in the U.S. The range of products and services available in the Chinese group-buying arena is constantly expanding. Online raffles and other innovative tactics are also employed to incentivize consumer purchases.

The first of Groupon's Chinese clones came online in March 2010. Since then, the number of *tuangou* companies has exploded. Estimated to be more than 1,800 at the end of 2010, group-buying websites more than doubled to 4,800 during the first half of 2011, suggesting that, on average, just over nine new sites were established each day.

Group-buying companies in China fall into three main categories. First, there are the third-party independent websites backed by venture investors. Top market players in this genre include Meituan, Lashou, Groupon.cn (a domestic clone site unaffiliated with Groupon.com) and Chicago-based Groupon's JV venture, Gaopeng. The second group comprises *tuangou* channels that span leading social networking sites, e-commerce and life-services portals. Taobao, Renren, Dianping and 58.com (China's Amazon, Facebook, Yelp and Craigslist, respectively) each operate their own group-buying businesses and enjoy huge market shares, given their large number of existing users. Third, deal aggregators consolidate coupon information from hundreds of group-buying sites.

Although the Chinese group-buying industry has been in existence for only 18 months, it has already attracted millions of dollars from venture capitalists. In 2010, 12 fundraising drives raised more than RMB 637 million (US$100 million). With Groupon, the largest of the global group-buying companies, completing an IPO in November, Chinese rivals have also intensified their chase for cash. Lashou, the leading Chinese deal site by revenue, completed its third funding round of RMB 700 million (US$110 million) in April 2011 and plans to go public in 2012. Meituan, the first coupon site established in China, completed its second round of financing in 2011, raising RMB 318 million (US$50 million) in July and even attracting Alibaba Group, the world's largest B2B platform, as an investor. 55tuan, a major rival of Lashou that expanded into 150 cities during 2011, claims to have collected RMB 1.3 billion (US$200 million) in funding in March 2011.

It is not hard to see why the group-buying market in China is drawing so much attention. While some research firms put the estimated sales volume in billions of dollars, most of the data suggest that *tuangou* sites generated somewhere between RMB 955 million and RMB 1.9 billion (US$150 million and US$300 million) in revenue in 2010. According to a Chinese market report by tuan800.com, China's group-buying market size is projected to expand tenfold in 2011, topping RMB 15.9 billion (US$2.5 billion) and rivaling the U.S. market, where industry revenue is expected to increase by 138% to RMB 17.2 billion (US$2.7 billion) in 2011. In addition, the group-buying user base in China has also expanded significantly, surging 125% during the first half of 2011 to reach 42.2 million users, or roughly 10% of all existing Internet users in the country.

A Perfect Storm for Growth

In addition to China's inherent bargaining culture, an improving telecommunication infrastructure and a rapidly changing social environment have formed the foundation for explosive growth in the group-buying industry.

China boasts the world's largest Internet market. In 2006, only 123 million Chinese used the Internet, representing a penetration rate of less than 10%. By 2010, usage had ballooned to 31.8%, equivalent to 420 million users. However, given the country's still relatively low penetration rate, user growth is expected to continue. Current estimates suggest that China is adding approximately 80 million new online users each year.

While many users access the Internet from homes and offices, China has a large number of cafés where patrons can go online for less than US$1 an hour. In fact, about a third of the entire Chinese online population surfs the web at such establishments. College students, most of whom are avid group-buying users, often frequent these cafés.

The proliferation of smartphones and upgrades to China's mobile web network has spurred *tuangou* activity by enabling consumers to group-buy on their mobile phones. Although China's current smartphone penetration (10%) is relatively low compared to that in the U.S., Germany and Japan, this rate still translates to a sizable 90 million smartphone users. In addition, Chinese mobile vendors offer simple web-enabled phones at attractive prices, and mobile operators provide affordable mobile data plans.

For example, China Mobile provides monthly mobile data services of 200MB for as low as RMB20 (US$3.13). By June 2010, 277 million mobile users were surfing the web using their handsets, and this number is growing rapidly. The availability of affordable phones and data plans allows users to browse online and participate increasingly in group-buying. A popular trend among college students is to microblog about group-buying deals with their mobile devices. *Tuangou* websites incentivize mobile microblogging by offering additional discounts or free vouchers to consumers who solicit the most comments on their microblogs for a particular deal. "My friends and I like to browse each other's microblogs for the best deals," says Pei-yun, a Shanghai *tuangou* user.

The increasing spending power of the "Little Emperors" also contributes to the robust online group-buying sector in China. This term describes the generation born under the one-child policy. They have no siblings with whom to compete for parental attention, and they inherit wealth from both parents and four grandparents — or, in sum, "six pockets." However, the term is somewhat misleading, as this generation is now no longer "little": Most are in their twenties or thirties and generating income of their own.

The approximately 250 million "Little Emperors" have different consumption patterns than those of the previous generations. They are more willing to spend on impulse and use e-commerce for their shopping needs. In 2010, there were approximately 140 million online shoppers in China, which was on par with the U.S. By 2015, this figure is expected to reach 520 million. Online sales generated RMB 4.4 trillion (US$684 billion) in 2010 and are estimated to grow at a compound annual growth rate (CAGR) of 50% through 2015.

In addition, herd mentality is a common characteristic among the "Little Emperors." Cora Han, a young professional who uses *tuangou* frequently, explains that in "today's fast-paced environment, the quickest way to fall behind in conversations with friends is not doing what everyone else is doing." These behavioral and consumption habits are rapidly shaping the e-commerce market, which, in turn, fosters a solid foundation for online group-buying.

According to industry data, globally the most common group-buyers are college-educated professional women between the ages of 18 and 34. China is no exception. It is common to see young Chinese women at web cafés or in the office surfing the web in search of *tuangou* deals. Piao Mo, a price-conscious college student, purchased a RMB 75 voucher (US$11.70) for a RMB 150 (US$23.50) skin cream to sample a more expensive product normally beyond her budget.

Chinese men in their twenties and thirties are quickly becoming a core target demographic for group-buying. Kenneth Dai is a middle-class, 25-year-old Chinese professional who browses *tuangou* websites on a daily basis. He enjoys purchasing restaurant coupons through popular sites such as Lashou and Dianping. He recently spent RMB 100 (US$15.70) for a RMB 300 (US$47.10) voucher for a high-end hotpot restaurant in Beijing. The *tuangou* enables him to dine at restaurants that he would otherwise be unable to afford. Mo, Dai and a growing number of Chinese consumers view *tuangou* websites as a way to access higher-end goods and services at an affordable cost.

Boom or Bust? The Uncertain Future of *Tuangou*

While thousands of Chinese group-buying firms scramble for market share, the top 20 sites account for nearly 90% of all sales volume. In June 2011, the top 10 companies took in 74.8% of the total revenue, up from 69.3% the previous month. As larger and better-funded companies absorb smaller competitors, market consolidation is one factor driving the increasing share among the top players. Nevertheless, there is no consistently dominant player in the fierce group-buying battlefield, with dramatic shifts in power so commonplace. The top Chinese *tuangou* website, Lashou, dropped to a 5.1% market share and 10th place in June, just after it topped the sales chart (14.4% share) one month earlier, while QQtuan took the lead with a 10.0% market share, up from sixth place.

The heated competition in China has driven down the profit margins of *tuangou* companies significantly. In the U.S., Groupon generates a 40% to 45% gross margin with a 1:1 revenue share with vendors. In comparison, group-buying companies in China had an average gross margin of 15% to 18% in December 2010. This figure has plummeted to 5% in recent months, according to an industry report.

Despite razor-thin profit margins, companies continue to spend heavily on marketing campaigns. These campaigns are most noticeable during one's commute to work. Advertisements for Chinese group-buying companies appear prominently in subways stations and bus stops. Along one exit in Shanghai's Guoquanlu station, the only advertisements one can see are those for Groupon.cn, Meituan, Lashou and 55tuan. This comes as no surprise, as the five major group-buying companies announced they would spend up to RMB 1.3 billion (US$200 million) in marketing fees in 2011. Groupon.cn is the most aggressive of the five, allocating nearly RMB 573 million (US$90 million). Following close behind are market leader Lashou and third-place Nuomi, which announced that they would spend up to RMB 318 million (US$50 million) and RMB 191 million (US$30 million), respectively. These aggressive marketing tactics, combined with traditional word-of-mouth, continue to encourage group-buying behavior.

Given the intense competition in the saturated *tuangou* market, industry analysts have a dim view of the future viability of the model in China, as these companies have yet to demonstrate their ability to generate sustainable sales. The month-over-month sales increase was flat in May 2011 and 17.4% in June, a huge drop from the 26.2% figure in April and below the 19.8% monthly growth rate during the first three months of 2011. Revenue growth continued to soften, with total YTD sales at RMB 4.1 billion (US$650 million) by the end of July, significantly short of the RMB 15.9 billion (US$2.5 billion) industry revenue forecast for 2011. According to the most recent industry reports, revenue growth in Q4 is expected to drop further, to 21% from its record high of 65% in Q1.

Renren, the largest Chinese social networking site, which went public in the U.S. in May 2011, operates a group-buying portal that generated RMB 5.7 million (US$900,000) in revenue but recorded operating expenses of RMB 29.3 million (US$4.6 million) and a net loss of RMB 23.6 million (US$3.7 million) during Q1. Renren CEO Joseph Chen said it was not alone and that "at least 20% of the [group-buying] companies are losing money on their businesses." At the other extreme, Nuomi CEO Shen Bo Yang speculates that "right now, everyone is operating at a huge loss. No one can claim to have reached profitability yet. The revenue is not even enough to pay for the marketing costs." The CEO of Meituan, Wang Xing, predicted that 90% of the *tuangou* companies would shut down by the end of 2011. Li Kai-Fu, a prominent figure in the Chinese Internet sector and ex-president of Google Greater China, also suggested that when the group-buying war comes to an end, only about 10 firms would remain.

The entry of Chicago-based Groupon (Gaopeng) into China was met with great fanfare, as the Chinese media reported Gaopeng's aggressive plan to hire thousands of employees in its first few months of operations in the early part of 2011. However, the company recently announced a broad set of layoffs and plans to shut down unprofitable branch offices. As a former employee at Gaopeng commented, "if group-buying companies are not able to generate sustainable margins, many sites will need to close their doors in China."

Faced with the many unique challenges of the Chinese group-buying market, *tuangou* companies depend on their fundraising ability to survive. Some have already experienced major setbacks. 55tuan recently abandoned its plan for listing in the U.S. because it was rejected by investment banks such as Merrill Lynch, Credit Suisse and Goldman Sachs. The banks were concerned that lax accounting for the dozens of small regional coupon sites 55tuan had acquired would put its financials in question.

As the group-buying industry in China experiences consolidation and growing pains, the *tuangou* model will continue to develop and play a major role in the online retail market. “People are getting used to online *tuangou* as it evolves into one of the many ways consumers can shop, just like going to the supermarket,” says Serena Zhang, a recent college graduate in Beijing and an experienced group-buyer. “While *tuangou* may not be the dominant shopping channel, it is becoming a part of our daily lives.”

This article was written by Tae-Hyung Kim, Kevin Lam and Christopher Tsai, members of the Lauder Class of 2013.

Talent Management at Multinational Firms in China

Developing the Chinese market is a top priority for many multinational companies. Across industry sectors, however, they face a common obstacle — attracting, developing and retaining the local Chinese talent needed to accomplish this goal. Global firms realize the importance of having local leadership in tune with the idiosyncrasies and rapid shifts of the Chinese market. In a recent interview with The Wall Street Journal, Pierre Cohade, the Asia-Pacific president of Goodyear, confirmed that the number one challenge in China "is absolutely the fight for talent." Goodyear is hardly alone: Over the past 13 years, the American Chamber of Commerce has conducted annual surveys of U.S. companies in China and frequently cites management-level human resource constraints as the top business challenge.

Localization: Why Bother?

Global companies are driven to hire staff from within each target market primarily to gain access to knowledge of new regions. In China, for example, this has driven many multinationals to reduce the number of non-Chinese staff. Pankaj Ghemawat, a business school professor at IESE business school, has researched the impact of "cultural distance" on business and has found greater challenges where companies operate across regions that lack historical and cultural overlap, as is true with North American and European companies in China. Successful practices abroad may not transfer well: Companies that lead in other markets, including Best Buy and The Home Depot, have floundered in China due to an insufficient understanding of Chinese consumer habits and local conditions.

"Cultural distance" has inspired significant changes in the business practices of multinationals in China, from marketing and product design to government relations. KFC, for example, developed a Peking duck-flavored sandwich, and Microsoft's Bill Gates met with President Hu Jintao to discuss rampant software piracy. Beyond simple focus groups and market studies, companies require senior talent who can understand the local needs, run the business accordingly, and work in tandem with the headquarters and business units around the globe.

Although lower labor costs are commonly cited as a benefit of staff localization, this is often true only for entry- and mid-level roles. At Procter & Gamble, for example, one executive indicated that a local Chinese hire typically represents only one-third the cost of an expatriate. However, following the rise in average income and the appreciation in the Chinese currency, this gap has begun to close. With the competition for top local talent intensifying, the best Chinese managers may eventually become just as expensive as their foreign counterparts.

Qualified Talent: The Top 10%

Despite acknowledging the clear need to localize, multinationals struggle to achieve this due to a shortage of qualified labor. McKinsey, a management consultancy, recently referred to this as "the supply paradox" because it is difficult to find acceptable hires despite having so many college-educated applicants. In 2005, the company predicted a looming war for talent based on research, suggesting that "fewer than 10% of job candidates, on average, would be suitable for work in a foreign company [across selected major industries]." Recruiting is also difficult because some find that the best students do not always make the best employees. As John Holden, former president of the National Committee for United States-China Relations, has noted, "Some MNCs prefer not to hire recent graduates from the elite Chinese universities, electing to go with candidates from second-tier and regional universities who have more real-life experience and, perhaps, ambition."

The quality of management talent is on a path of significant improvement, which can be attributed to broader educational and employment opportunities. First, more Chinese are studying abroad: In 2010, the number of Chinese students abroad was roughly 200,000, including a 30% increase over 2009 for those in the U.S. Second, management education is both improving and becoming more aligned with established practices: The China Europe International Business School recently lured its new dean from Harvard Business School in an effort to reform its faculty, fundraising, branding and school culture. Similarly, Peking University's Guanghua School increasingly uses course materials from London Business School and Harvard Business School. Finally, with the growing presence of multinationals in China, the pool of local managers familiar with multinational practices has expanded. As a result, both the quantity and quality of management talent in China are improving.

Yet demand for top talent continues to outpace supply for three main reasons. First, more foreign companies are deepening their commitment to, and presence in, the China market. Second, multinationals are seeking to increase the proportion of local staff in their organizations. According to Brian Newman, CFO of PepsiCo China, "we are now almost fully localized, with the exception of a few C-suite positions." Third, taking advantage of the rapidly growing Chinese market often requires a breakneck pace of expansion, requiring more managers of increasingly higher caliber.

Chinese Companies: Heating up the Talent War

The competition for top talent is not simply a battle fought among multinationals. Both state-owned and private Chinese enterprises are snapping up a greater share of the top talent pool by means of compelling offerings, often at the expense of multinationals. The latter's traditional advantages in attracting talent — prestigious brands, higher compensation and career-development opportunities — are eroding. According to a survey of Chinese job seekers conducted in 2010 by Manpower, a human-resource consultancy, the number of respondents identifying Chinese privately owned companies as their primary choice is up by 5%, with foreign companies down 10%, compared to four years earlier. Primary drivers for this change are better long-term career development opportunities and better compensation. A Procter & Gamble executive echoed this point, commenting that "compensation in China is very good, with a tripling of one's salary three years out. That's not including housing allowance, company car or interest-free loans you get as you get more senior. We're not being cheap, but we simply can't compete with the ridiculous stock options Chinese companies offer when they want a new marketing head."

The abundance of aggressive local ventures in a booming market, coupled with substantial cash from retained earnings and venture capital, has translated into a fierce local poaching of top talent. With the right qualifications, a middle-level Chinese manager at a multinational would likely find higher pay and increased responsibility at a local company. For example, an assistant manager in a large corporation might become the general manager of a publicly listed company or the junior partner at a private equity fund, helping growth-stage companies run their operations. As Richard Sprague, a Beijing-based Microsoft executive, commented, "Our employees know they can go to Baidu [a Chinese technology company] or other companies and get a big chair with a hundred people under them." For proven managers, there is often a generous selection of alternatives driving higher turnover.

The attractiveness of outside opportunities is exacerbated by the frustrations that Chinese employees sometimes feel while working for a multinational. Given that they are often reporting to foreign managers of regional or global business units who are less familiar with the rapid changes and business practices in the

Chinese market, local employees feel much of their time is spent "translating" for foreigners. For example, many multinationals have stringent internal controls to prevent the embezzlement and fraud that can be significant risks in an emerging market like China. Gifts for government officials and business partners — often labeled "kickbacks" — have strict guidelines in terms of value and appropriateness, even for important Chinese holidays, when such practices are common. As one expatriate executive observed, locals feel that these regulations, set by foreign leaders, are "cramping their style, making it impossible to do their jobs." External opportunities can become more enticing if local hires feel limited by operations that are inefficient and/or insensitive to local needs.

An executive education program director at a leading Chinese business school framed this challenge another way: "The fundamental issue is trust; does the headquarters trust you? When the local employees don't see that [trust], they will leave. The problem with many multinationals is that systems to promote locals are still ad hoc. Without a formal support system in place, the process of identifying one or two top candidates a year, sending them abroad and hoping that they can build the necessary trust doesn't work. The systems that do exist are still immature." As a result, local employees may at times see a glass ceiling that restricts their promotion opportunities within a multinational. Along with the increasing competition for top local talent, these issues of trust, communication, work style and career trajectory are major challenges in trying to build a strong local management team.

Hurdles for Multinationals: China's 'Cultural Distance'

Language is a commonly cited barrier for multinationals in China. With English still considered the international language of business, multinationals often find Chinese managers must improve their English language skills to be able to function effectively — and express themselves persuasively — in a non-native tongue. While many leaders excel with these soft skills in a first language, it is significantly more difficult to carry the same leadership presence in one's second, third or fourth language, further detracting from the confidence of company heads in their multinational's home country.

Cultural norms and work styles are equally important. Chinese managers tend to operate more comfortably in clearly hierarchical structures, as opposed to more open and flatter collaborative office environments. As one executive with Microsoft noted, "Chinese managers might have trouble managing upwards within multinationals when needing to challenge authority, express divergent opinions and take risks."

Finally, multinationals in China point out difficulty with geographic mobility. Family ties and cultural obligations to care for one's parents may cause staff to oppose relocation. P&G, for example, is able to recruit heavily from universities in Beijing and Shanghai, but struggles to staff positions in North China. Chinese, while seeking international exposure, are sometimes reluctant to leave China due to rapid changes in the market and fear of "missing out" on the growth. Rotating assignments across geographies, considered crucial in career development at some multinationals, often incurs high career and family opportunity costs for local talent.

Leadership Development, Global Exposure and 'Cool Projects'

In response to these challenges, leading multinationals have developed internal initiatives to address these hurdles and become even more attractive career-development places for top local talent. GM, Microsoft, P&G, PepsiCo and other multinationals use a variety of programs to lure and retain China's best and brightest. These initiatives include, among other things, global rotations, internal training, monetary incentives and collaborative curriculum-building with local universities,

Microsoft, for example, uses two methods to give Chinese managers international exposure: The first brings top U.S. managers to China to work side-by-side with local employees and provide developmental coaching. The second — sometimes referred to as a "reverse expat" program — sends Chinese managers to the U.S. for several months to gain a deeper understanding of headquarters operations and to absorb valuable experience working in a foreign environment. Microsoft's Sprague suggests that "retention is less of an issue, I think, partly because we have so many developmental programs like these."

According to an executive at GM China, "critical thinking and creative problem-solving — two fundamental skills of a manager or staff member at all levels within a multinational — are a clear development area in the Chinese education system." Indeed, many firms note their involvement with local universities, either through collaborative curriculum-building and/or sponsoring or participating in industry events, such as case competitions and panel discussions. Companies also consistently point to their advocacy for more rigorous general management training.

Beyond training and development, Chinese employees — like everyone else — are acutely concerned about compensation when making career decisions. As mentioned above, one of the challenges multinationals face when addressing this topic with Chinese employees, particularly executives and business-development professionals, concerns a major difference in how multinationals and local Chinese companies get deals done in China — kickbacks. Chinese professionals view kickbacks as perfectly normal and an integral part of the Chinese business culture, while multinationals, regardless of their view, must comply with the standards in place in their home country and, if public, the laws where they are listed (e.g., the Foreign Corrupt Practices Act in the U.S.).

Often times, Chinese managers at multinationals feel this puts them at a disadvantage when competing for deals with their counterparts at Chinese companies, creating tension and potentially a reason to leave. To combat this, the multinationals can choose a variety of tactics to focus on. They can be transparent about kickback policies upfront, they can try to give employees a career path with clear direction on promotion opportunities and they can keep the workload interesting. One executive at Microsoft commented that "our employees get to work on cool, cutting-edge technology projects with sophisticated software development processes. From our internal review process, we know this is [as important], if not more important, than their salary."

Multinationals are clearly emphasizing the significance of localizing their organizations in China, but the talent management challenges are formidable. Top local talent is scarce but critical. Chinese companies, rather than multinationals, are becoming more attractive places to work. In addition, China's "cultural distance" from the home countries of many multinationals operating in the country is great. Several multinationals have left China because they could not navigate these issues successfully. For the multinationals that remain, talent management — specifically recruiting, developing and retaining top local talent in China's large, complex and rapidly growing economy — has been over the past decade, and will undoubtedly continue to be, a major focus for success.

This article was written by Phillip Dodyk, Alexander Richardson and Michael Wu, members of the Lauder Class of 2013.

Louis Vuitton and the Traveling Chinese Consumer

When it comes to the market for luxury goods, "China is the rising star," according to Claudia D'Arpizio, a Milan-based partner with Bain & Co., the consultancy. Luxury sales in China currently represent 10% of the global market. CLSA, a leading Asian investment bank, estimates that by 2020 China will be the largest domestic market for luxury goods in the world and will account for 44% of global demand. Consumption by Chinese consumers abroad has helped fuel this growth in more mature markets in Europe. CLSA and other firms estimate that currently more than half of Chinese luxury spending occurs overseas. Some Chinese tour groups travel to France and Italy for the sole purpose of luxury shopping.

"After decades of deprivation and conformism, Chinese consumers regard expensive consumer goods as trophies of success," reported *The Economist* magazine. "In public, they show off. In private, they pinch pennies." The demand for luxury goods has increased for a number of reasons, including rapidly increasing disposable income, the increasing sophistication of Chinese consumers, and rapid urbanization and growing wealth in second- and third-tier cities.

Still, the typical Chinese luxury consumer differs greatly from his or her counterparts in more mature luxury markets. Luxury items in China are generally purchased as status symbols and not necessarily because of taste, sophistication or service. CLSA estimated that in 2010, 16% to 17% of Chinese consumers bought luxury goods as gifts, with handbags, clothing, watches and jewelry being the most popular. Within the accessories segment, 37% of purchases were made for the purpose of gifting, a far greater proportion than in other markets, with only the newest and most expensive products being acceptable.

According to a recent article in the *Hurun Report* (a Chinese publication similar to *Forbes*), the average Chinese millionaires are 15 years younger than their counterparts in other parts of the world, and their number has been rapidly increasing — by 6.1%, to nearly one million in 2010. Finally, China's luxury goods market was previously dominated by men, due to the importance of the gift-giving culture in business. As more women have entered the workforce, the proportion of luxury goods they purchase has risen to more than half the market total.

Why Chinese Consumers Shop Abroad

Despite the increase in Chinese luxury goods consumption, luxury brand boutiques in China attract much less traffic than managers would like. Compared to the crowded Apple store next door, Louis Vuitton's (LV) flagship in Shanghai is empty. More and more, Chinese luxury consumers are choosing to do their luxury shopping abroad. In recent studies, Bain found that more than 50% of luxury goods purchases by Chinese consumers in 2010 were made overseas. A study by PATA/Nielsen found the average Chinese tourist in Europe purchases US$1,359 of goods per trip — more than any other nationality.

This is especially striking considering that most economists believe the renminbi is significantly undervalued. According to Xiao Qianhui, general manager of the Shanghai-based Spring International Travel Agency, most Chinese tourists consider shopping for luxury goods the main purpose of a trip to France. "Sometimes one Chinese tourist will even buy up to 20 Louis Vuitton bags at one shop," he said. A recent survey commissioned by travel service company Global Blue found that many Chinese tourists complained about not being able to spend everything they had planned to when they were abroad.

The main reasons Chinese consumers cite for shopping abroad are lower prices due to China's high luxury taxes, better selection and greater "show-off" value. China's import tax for luxury items ranges from 20% for luxury bags to 50% for cosmetics, which, when combined with additional local taxes such as the 17% value-added tax, leads to a significant premium on these goods. Accordingly, the prices of LV products sold in Shanghai are about 35% higher than those sold in Paris. The Chinese government is considering reducing luxury tariffs on the mainland to spur domestic consumption, seen as necessary to reduce China's dependence on exports. In the meantime, China has sought to address this price differential by more strictly enforcing existing legislation that imposes retroactive taxes on luxury purchases made outside China. However, the country still loses billions in U.S. dollars annually on uncollected customs duties.

Chinese consumers also prefer to shop outside China due to a perception of greater brand availability and better product selection. Interviews with shoppers at Beijing's China World Mall — which houses popular luxury brands such as Louis Vuitton, Hermes and Gucci — showed that many female shoppers prefer to shop abroad because they believe the same store abroad will carry, not only a broader range of products, but also newer products. Many Chinese also believe that the luxury shopping experience is better abroad due to superior customer service and a greater selection of brands, including many not yet available in China, such as Alexander Wang and Christian Louboutin. However, LV stated that it offers the same product selection regardless of location. In interviews, an LV executive noted that products offered in China are the same, and only the quantities stocked are adjusted for the Chinese market. Despite the uniform product offerings, Chinese consumers still believe the selections in Chinese stores are inferior to those of stores abroad.

Finally, traveling has become part of the luxury lifestyle in China and is considered a status symbol: There is greater caché in being able to say you purchased your bag at the place of origin in Paris rather than at a branch in Tianjin. The Chinese National Tourism Administration noted that in 2010, more than 57 million Chinese traveled abroad and spent US$48 billion at overseas destinations, a figure that is expected to grow 17% annually over the next decade. Key forces behind this growth include increasingly convenient transnational payment methods and a stronger Chinese currency, which have made outbound tourism and associated overseas purchasing easier and cheaper. In particular, with the resources to travel overseas, many newly rich Chinese are eager to show off their wealth through high-value consumption.

The Appeal of Louis Vuitton

Louis Vuitton, in particular, is a favorite shopping destination for Chinese abroad. In fact, Chinese consumers have become LV's largest consumer group worldwide. While this influx of demand has been a welcome growth stimulus for LV Europe, it has also presented its own unique challenges.

At LV's more well-known locations, such as those at Galeries Lafayette and Avenue des Champs-Elysées in Paris, it is not uncommon to find queues of more than 20 tourists from China waiting to purchase merchandise. This number swells dramatically with changing exchange rates, which, when combined with Chinese consumers' different shopping habits, have led to significant challenges for LV Europe in managing inventory. In the summer of 2010, when the renminbi was at its strongest against the euro, LV France burned through three months of inventory in just one month. As a result, through the end of November, LV was forced to limit to two the number of leather goods customers could purchase daily so that the store could save stock for the Christmas season. Several key Paris locations, including LV's flagship, began closing an hour early to slow sales.

In addition to their numbers, the shopping habits of this large new consumer group differ greatly from those of LV's traditional customers. More than 95% of Chinese tourists arrive on tour buses, leading to a quick spike in customer volume and posing a challenge for staff charged with providing premium service to each individual shopper. Also, while LV has traditionally posted its strongest sales during the fourth-quarter Christmas shopping season, the increase in Chinese consumers shopping abroad has caused sales to shift heavily toward the weeks leading up to the Chinese new year in late January or early February, resulting in a massive spike in sales in the first quarter. This has created challenges to LV as it tries to manage the supply-chain implications of a shift in seasonality.

Blistering Chinese demand, combined with factors such as purchasing limits and the high luxury tax at home, has also led to the growth of a large gray market for LV products. Managers at LV's Galeries Lafayette location were recently dismayed to learn that the two young Chinese women who held the top two spots on their VIP list, each spending more than €500,000 (US$700,000) per year, were selling them at a profit on Taobao.com, China's version of eBay.

Quite naturally, the droves of Chinese shoppers who purchase LV products overseas are of concern to LV China. LV China wants China's new luxury consumers to shop at home, not only to increase domestic revenues, but also because the company feels it can better control its "touch" in the home market: Having more Chinese staff with a better understanding of how best to serve Chinese shoppers makes LV better equipped to shape the customer experience it wants its Chinese customers to have.

In the meantime, LV has moved quickly to adapt to, and better serve, this growing customer segment. At its Paris locations, Chinese shoppers can find numerous Chinese-speaking staff, all of whom have been trained to better meet Chinese needs and better handle the spikes of tour-bus traffic. According to July Azoulay, marketing manager of LV, the LV flagship located on the Champs-Elysées hired multilingual (Chinese, Russian) staff to meet and greet its clients.

At home, LV China has developed innovative ways to strengthen its relationship with this high-priority customer group. In Shanghai, three stores exemplify LV's customer segmentation and targeting strategy: The LV flagship on bustling Huaihai Road attracts young, aspiring buyers and prominently displays lower-priced "accessible luxury" items. Across the river in Pudong, LV's location in the main business and financial district has a "more masculine décor," as described by some LV employees, and caters more directly to businessmen shopping for gifts. In Plaza 66, Shanghai's premier luxury shopping mall, LV is building its largest store worldwide, a Maison store, focused on educating shoppers. It will feature the first LV *atelier* workshop outside France, providing an ultra-premium shopping experience where craftsmen from Europe will demonstrate the traditional methods used to create LV trunks, watches and bags. In 2011, in addition to experiencing LV in stores, people in Beijing queued for hours to learn about the history and evolution of the brand at LV's *Louis Vuitton Voyages* exhibit at the National Museum of China.

Other initiatives LV has taken to strengthen its relationship with Chinese consumers at home include investing heavily in staff training to provide customers with a premium shopping experience and demonstrating its commitment to its Chinese customers through a new advertising campaign featuring the Taiwanese-Canadian model Godfrey Gao — the first time LV has used an Asian male to showcase its products.

Going forward, LV and other similar luxury retailers need to continue to focus on their ability to connect with customers in China. LV's segmentation strategy in its brick-and-mortar stores in cities such as Beijing and Shanghai is a good start. For those customers already shopping abroad, LV would benefit from sharing customer data across regions so that a VIP shopper in Europe is recognized when he or she enters a local LV store in China.

LV can further strengthen its ability to connect with young Chinese shoppers via its online marketing efforts. Just as luxury brands in China generally have chosen not to tailor their products or store designs drastically to the local market so as to preserve the perceived authenticity of the brand, they generally have not tailored their online presence to better suit this new media market. However, the role of the Internet is far more important in the young Chinese consumer's shopping process than it is in other markets.

A study by Bain found that the number of Chinese consumers who rely on the Internet — especially social media such as bbs forums and microblogging — as a means of researching luxury goods and brands has increased by 30% since 2006. In addition to learning LV's history and brand message, young Chinese shoppers want to know how to use and wear the latest styles and to discuss trends with their peers. Incorporating the educational and interactive components of LV's Maison stores into its websites — e.g., through a well-designed style guide — can help LV connect with and influence customers earlier in the purchasing process. Simple directions as to where these items can be purchased locally will also help mitigate the misperceptions of inferior selection and older products at home.

The number of Chinese traveling and shopping abroad will only continue to grow, and LV's global operations should continue to adapt accordingly. With the increasingly competitive luxury market in China, LV China will need to work harder to maintain and grow market share by winning the loyalty of new waves of young Chinese luxury consumers.

This article was written by Jane Fung, Charlotte MacAusland and Grace Chang Mazza, members of the Lauder Class of 2013.

The Trials and Tribulations of Japan's Energy Policy

The March 2011 nuclear accident in Japan epitomizes the promises and perils of an energy source that once provided a measure of autonomy for import-reliant countries. As an energy-thirsty economy with few indigenous resources, Japan must find ways to make more extensive use of alternative and renewable sources, such as solar and wind. As Hideaki Tanaka, senior executive director of the Japan Energy Association notes, "Consumer and public sentiment toward nuclear is negative, while there are high hopes for renewable energy."

An island nation poor in natural resources, Japan historically has been heavily reliant on imported energy sources. In contrast to the U.S. and China, which produce more than 70% of their energy needs, Japan must import more than 80%. The country's overreliance on foreign sources was revealed in 1973, when an oil embargo by petroleum-exporting countries caused a dramatic increase in fuel prices. Japan's dependence on foreign sources forced the nation to reassess its energy policy. Unlike the industrialized countries in Europe that are similarly dependent on foreign energy, geographically isolated Japan has "chosen to invest heavily in nuclear power," says Kuga Iwata, director of the secretariat at the Japanese Wind Power Association.

Another major influence on Japan's nuclear strategy has been its commitment to the Kyoto Protocol. As a signatory and a vocal proponent on the world stage for curbing greenhouse gases, Japan has committed itself to a 6% carbon dioxide (CO_2) reduction from 1990 levels over the five-year period of 2008 to 2012. Moreover, the low cost of producing nuclear energy — when compared to alternative "green" sources such as wind and solar — has been an important factor in its adoption.

Japan's focus on becoming an energy self-sufficient nation, its commitment to the environment and its economic considerations for affordable energy contributed to its prioritization of nuclear energy. In 2009, 29% of Japan's electricity was produced by nuclear power, while 61% was produced by a combination of different combustible fuel sources such as coal, oil and liquefied natural gas (LNG). Hydropower and renewable energy accounted for 8% and 1%, respectively. Until recently, the Japanese government aimed to increase the percentage of nuclear power in Japan's energy portfolio to 50% by 2030. However, the March 2011 earthquake and tsunami have forced Japan to reevaluate its nuclear program, as evidenced in former Prime Minister Naoto Kan's statement: "If there are risks of accidents that could make half the land mass of our country uninhabitable, we cannot afford to take such risks, even if we are only going to be playing with those risks once a century."

Earthquake, Tsunami, Nuclear Crisis

On March 11, 2011, a 9.0-magnitude earthquake caused a tsunami that devastated the Tohoku coastline in northeastern Japan and left 25,000 people injured, missing or dead. The tsunami caused meltdowns at three reactors at the Fukushima Daiichi nuclear power plant — an incident that served as a huge wake-up call to the dangers of nuclear energy for Japan and many other nations.

Within two months, Germany announced it would shut down all of its nuclear power plants by 2022, Italy abandoned plans to build new nuclear power plants and Switzerland decided it will likely retire existing reactors when they reach the end of their normal life cycles.

In Japan, 10 nuclear reactors (including the seven at the Fukushima plant) were shut down, resulting in a 20% reduction in total electricity generation capacity. Consequently, a host of energy-saving measures were encouraged across the eastern part of Japan's main island so that summer demand would not outstrip the reduced supply. Many offices maintained an indoor temperature of 82° Fahrenheit, and some manufacturers operated on Saturdays and Sundays to avoid potential weekday blackouts. This admirable forbearance among the Japanese people — called *setsuden* (energy conservation) — in the months following the quake minimized the disruption from the immediate energy shortfall. As effective as these measures were, however, they were widely acknowledged to be only short-term responses to a long-term problem. According to Tanaka, "*Setsuden* measures, such as turning off lights or reducing air conditioner usage, is a short-term solution which relies on consumers' perseverance and tolerance. On the other hand, *sho-ene* [another term for energy conservation] is a long-term solution and involves investments in energy reduction technologies, such as switching lights from incandescent to LEDs."

In the aftermath of the nuclear disaster, heavy criticism was leveled at Tokyo Electric Power Company (TEPCO), the operator of the Fukushima Daichii nuclear power plant. The sluggish response by the Japanese government, currently led by the Democratic Party of Japan (DPJ), was also severely criticized. The accident exposed the coziness of the decades-long relationship between TEPCO and the government, and the mistrust felt by the Japanese public has only grown since.

The continuous reports of radioactive contamination in dozens of foods (ranging from beef to rice, the national staple) have further highlighted the far-reaching consequences of the accident and have underscored the authorities' lack of effective countermeasures. A heightened fear of radioactive pollution has fueled antinuclear sentiment that has been increasingly vocalized since the disaster. In his inauguration speech on September 2, 2011, Prime Minister Yoshihiko Noda responded by expressing his support for gradually phasing out nuclear energy over the long term: "In the future, we will become a society that does not rely on nuclear energy."

Impact on Japan, Inc., and Beyond

Prior to the nuclear crisis, Japan's main governing party, the DPJ, was facing a number of serious problems related to the country's economy. With a rapidly aging society, an export-hindering strong yen and the highest public debt per capita of any major economy, the embattled party is now tasked with the most expensive clean-up and reconstruction efforts in the nation's post-war history — an estimated JPY25 trillion (US$325 billion). How deftly the DPJ handles these measures will play a major role in determining Japan's economic growth prospects.

Japan is now expected to undertake significant changes with respect to its energy program. Some corporations view the nuclear crisis as an opportunity for strategic expansion. For example, General Electric Energy Japan is focusing on meeting the increased demand from small businesses for individual power generators. Furthermore, a new energy bill was passed recently for feed-in tariffs (FITs), mandating that by mid-2012 power companies purchase all renewable energy at an above-market price set by the Japanese government.

Still, such measures do little to mitigate business leaders' concerns about Japan's global competitiveness. In an interview with *Asahi Shimbun*, Hiromasa Yonekura, chairman of Keidanren, an influential consortium of Japan's large businesses, shared his criticism of the government's handling of the recent nuclear accident, warning that "[t]he Japanese economy will collapse if we deal with the accident the wrong way."

Electricity producers have indicated that price hikes will be necessary, as TEPCO aims to file with the trade ministry for a 10% rate increase in spring 2012. Combined with a soaring yen (reaching a record high of JPY75.9 against the U.S. dollar in late August 2011), rising costs are prompting speculation that more Japanese manufacturers will soon relocate production facilities abroad — a move that would greatly affect the domestic economy.

Japan and Renewable Energy

As of late August 2011, only 15 of Japan's 54 nuclear reactors are in use. The rest are offline either for safety concerns or for mandatory inspections required every 13 months. Restarting the reactors requires approval from the prefectural governments. However, in the public backlash against nuclear power, local politicians have not been able to make a firm decision, adding to the nation's growing energy concerns. According to Masaaki Kameda, general manager of the Japan Photovoltaic Energy Association, "Japan is divided on the issue of nuclear; for example, the incumbent Aomori governor supports nuclear but most of the public is against it."

Japan's growing interest in renewable energy to replace nuclear energy can be illustrated by an August 2011 *Asahi Shimbun* poll of 2,000 adults. When asked to choose among various sources, 85% of the respondents preferred renewable sources, such as wind, solar and geothermal. Yet renewable energy currently generates only 1% of Japan's electricity, of which 0.3% and 0.4%, respectively, comprise solar and wind power.

Widespread adoption of renewable energy has not taken place in Japan for three main reasons: its high cost, the electric companies' monopoly and an unaligned regional power infrastructure. The cost of generating electricity sourced from renewable energies is estimated to range between 37 and 46 yen (US$0.48-$0.60) per kilowatt, in contrast to 5 to 6 yen (US$0.06-$0.08) for nuclear energy (not including clean-up and waste-disposal costs). With renewable energy costing six to seven times more than nuclear energy, the broader adoption of renewables historically has been highly dependent on government programs and subsidies. In the wake of the crisis, the Japanese government has set up a committee to recalculate the cost of nuclear energy (factoring in the costs of reparations and plant decommissioning), with the aim of dispelling the myth that nuclear power is a "cheap energy source" and increasing the prevalence of renewable energy. Yoshihisa Murasawa, a professor at the University of Tokyo, estimates that the true cost of generating nuclear energy — factoring in the costs of natural disasters, nuclear waste disposal and the prevention of terrorist attacks — is actually similar to that of solar.

In addition to the cost, the Japanese power companies' existing structure is an impediment. Japan's electricity is generated by 10 regional power companies, each of which has a monopoly on power generation and distribution. Iwata argues that dividing the power companies' generation and distribution rights will lead to more competition. He is not alone among energy experts. Makoto Iida, a professor at Tokyo University, notes that this situation is exacerbated by the Renewable Portfolio Standard (RPS), a 2003 law mandating that 1.3% of Japan's electricity must come from renewable sources. "The objective is so small that the power companies have already achieved it and have no further incentive to purchase more."

Another issue is that Japan has two different standards for electrical cycles. Eastern Japan runs on 50 Hz and western Japan operates on 60 Hz, and there are two separate power grids. This set-up dates back to the Meiji period, when the eastern section imported generators from Germany's AEG that ran on one standard, while the western section utilized generators from the U.S.'s General Electric Company, which used the other standard. Although there are three plants that can transfer electricity between the two grids, the process is both expensive and limited, resulting at times in bottlenecks of unexpected shortages. This situation is complicated further when renewable energy comes into play: The supply of renewable energy is naturally uneven (e.g., solar energy cannot be harnessed at night). As Iwata states, "Japan's power grid is small, unlike that of the United States, so it cannot easily support additional fluctuating sources of power."

Alternative Solutions

Japan stimulated solar panel uptake by subsidizing the cost of home installations until 2005, when the government program was discontinued. In 2009, Japan was third in solar power generation with 483 megawatts (MW) generated — after Germany (3,845 MW) and Italy (723 MW). That same year, Japan reintroduced the subsidies for solar panel installations and began a FIT program for power companies, which entailed purchasing surplus electricity generated by households at a higher-than-market price of JPY42 per kWh

(US$0.55) as of April 2011. This price is offset by a monthly surcharge of up to JPY100 (US$1.30), paid by customers without solar panels.

Solar energy has been popular in Japan, especially with the government subsidy. Kameda has observed that applications for solar panel subsidies in May and June 2011 were up 30% over the same period the previous year. The many merits of solar power include no CO_2 emissions, matching peak output and peak consumption periods, and no transmission loss (i.e., energy is not wasted between generation and consumption).

Despite these advantages, many issues remain. The growth of solar energy is highly dependent on government support to reduce costs. Even with the government subsidy for installation and the FIT, says Kameda, it still takes the average household 10 years to recoup its installation expenses. In addition, solar energy's greatest shortcoming is its uneven output. Fluctuating output from PV cells can disrupt the power grid's supply and cause problems with its quality. Currently, there is no affordable storage battery large enough to store surplus energy on the grid for later release.

Wind power is another steadily growing renewable source in Japan. It is appealing due to its zero emissions and energy-generation cost of JPY10-14 per kWh (US$0.13-$0.18), which is lower than that of solar. However, in 2010, Japan ranked twelfth in the world in terms of wind-power capacity. Unlike Germany, the U.S., and Canada, Japan has not yet introduced incentives, such as subsidies or FITs, specific to wind power. In addition, as Iwata has noted, "Japan has limited land [and] people are dispersed all over the country. This reduces the amount of usable land for wind farms." Wind power is also unpredictable as an energy source. Moreover, reports of adverse health effects, such as insomnia, headaches and irritability stemming from infrasound (low-frequency sound), are a concern. Bird strikes — birds dying after colliding with wind turbines — is a point of criticism from conservationists. Iida also notes that the "power companies' process of selecting wind farm suppliers is problematic, since it is mostly based on a lottery. Wind power adoption is stunted because there are many organizations and companies that are not selected and, thus, turned away."

Given the country's mountainous landscape, Japan has little choice but to look offshore, where winds are more plentiful. However, the country's seabed descends quickly, which "creates a technically and economically challenging situation for wind farm development," according to Tanaka. Yet some potential exists: TEPCO is currently conducting an experimental offshore fixed wind farm off the coast of Chiba prefecture.

A Complicated Future

Considering the multiple obstacles facing the two most widespread renewable energy technologies in Japan — wind and solar — it is clear that it would be nearly impossible for the country to abandon nuclear power. "Abandoning nuclear energy is probably not possible," suggests Satoru Kushida, deputy head of the Secretariat at the Japan Coal Energy Center. "Rather, what is most likely is that existing nuclear plants will continue to operate and that no new ones will be built. Of course, as Japanese, we have high hopes for renewable energy, but we still need a base, steady energy supply." Indeed, recent opinion polls conducted by *Tokyo Shimbun* in June 2011 show that, while an overwhelming 82% supports Japan's move away from nuclear energy, most respondents recognize the need for it and favor a gradual phasing-out of nuclear power instead.

Some may wonder why, unlike Germany, Switzerland and Italy, Japan has not decided to discontinue its nuclear program. Iwata says it is important to consider society, manufacturing and lifestyle as factors in Japan. "Renewable energy's unsteady supply is probably fine for an agrarian society, but as a manufacturing society, we need to ensure a stable electricity supply." Indeed, in his same inauguration speech, Prime Minister Yoshihiko Noda declared that "we will decommission reactors at the end of their life spans ... but it is also impossible to immediately reduce our dependence to zero."

The general view among industry insiders is that the short-term response is most likely to be an increased emphasis on CO_2-polluting resources, such as LNG and coal. Since March 2011, formerly idle oil and gas generators have been restarted, confirming industry predictions that Japan may face an approximately 20% increase in coal-fired generation. Michiaki

Harada, general manager of the Japan Coal Energy Center, says that "in the near term, coal plants will be in full operation to prevent blackouts." The Japanese government now faces the difficult task of meeting its Kyoto Protocol target by 2012, while simultaneously rebuilding the affected areas and improving the country's economic situation.

Going forward, Japan will need to reconcile its industry needs with popular sentiment. "Thinking about the 'best mix' of energy resources is crucial," notes Kameda. "We need to diversify our energy sources to mitigate the impact of crises and issues in other countries, while keeping CO_2 emissions in mind." Iida emphasizes the importance of a paradigm shift among consumers, stating that "consumer lifestyles need to change so that energy consumption does not increase even in the face of high renewable energy adoption."

The natural and nuclear disasters of March 2011 have compelled Japan to reexamine its energy matrix. This new debate could pave the way for a greater adoption of renewable energy there. It is time for alternative energy to be more than just an alternative.

This article was written by David Cheong, Miwa Gardner-Page and Stephanie Hagio, members of the Lauder Class of 2013.

Uncorking China's Wine Market

Although China's bustling metropolises and staid Bordeaux may seem worlds apart, the two are becoming increasingly intertwined. Indeed, China recently overtook the traditional strongholds of Germany and the United Kingdom to become Bordeaux's largest export destination. This transformation is particularly remarkable given the country's short history of mass wine consumption. Historically, beverages such as sorghum-based baijiu and beer have dominated Chinese alcohol consumption, with wine only recently gaining wide acceptance.

Bubbling to the Top

In the past few years, China, the world's second largest economy, has risen to become one of the world's most important wine markets, offering both high growth potential and generous profit margins. By volume, the country is currently the seventh-largest consumer of wine, with expected sales of 1.6 billion bottles in 2011. In contrast, the U.S. and France, the first and second largest consumers of wine, are expected to consume 4.0 billion and 3.9 billion bottles, respectively. Since 2006, the Chinese market has experienced more than 20% annualized growth, and experts predict it will further double by 2014 to become the world's sixth largest.

Collectively, three major domestic producers account for nearly half the total wine sales in China. The largest brand, Changyu Pioneer Wine, is a unit of the major state-owned conglomerate China National Cereals, Oils, and Foodstuffs Corporation (COFCO). Changyu and the other two primary producers, Great Wall Wine and Dynasty Wine, focus on domestic consumption, with 98% of their production remaining in China.

Foreign wine imports are also growing rapidly. In 2010, imports grew to more than 20% of total wine consumption, a four-fold increase since 2005. Reductions in tariffs following China's accession to the WTO have been one factor in this growth. Currently, an estimated 20 million adults drink imported wines on at least an occasional basis. Given that this figure is a fraction of the overall estimated 200 million plus people who have the purchasing power to buy imported wine, the future for foreign wine appears bright.

In China, domestic wines are sold primarily at the lower end of the pricing spectrum, while imported wines are sold at the mid-to-higher end. The average retail price at the lower end is RMB20 to RMB30 (US$3-$5) per bottle. Midrange wines sell for RMB30 to RMB80 (US$5-$13) per bottle and are aimed at consumers with higher disposable incomes and more exposure to wine. Premium wines sell for RMB80 (US$13) and up per bottle. Imported wines typically range from RMB80 to RMB400 (US$13-$66) per bottle and are in direct competition with high-end domestic wines.

A Chinese Taste for Wine

Numerous factors have driven the growth of the overall wine market in China. In particular, the government's promotion of wine as a healthy alternative to *baijiu* and other spirits, declining tariffs on wine imports, and consumers' increasing purchasing power have given rise to an increased interest in wine.

Consumption still centers around entertaining and gift-giving occasions, with two major holidays — the

Chinese New Year and the Mid-autumn Festival — accounting for about 60% of annual wine sales. As one customer in a wine store in Beijing noted, "I'm not too familiar with wine, but I know it makes a great gift." Consequently, consumers are interested primarily in purchases that convey a suitable level of prestige, status and respect, all of which are important components of Chinese culture. Pairing wine with food is still a developing concept, especially given the family-style custom of Chinese dining.

Despite rapid growth, however, the Chinese market remains fairly immature. Customer preferences are driven heavily by advertising, with top producers running extensive mass-marketing campaigns to build brand awareness. This brand-driven environment, with a lack of emphasis on taste preferences, has also affected the market for foreign wine. Regardless of brand or vintage, Bordeaux and Burgundy wines enjoy strong recognition among Chinese consumers. High-end consumer demand for first-growth French wines, such as Lafitte and Latour, has caused a tremendous jump in prices. Although consumer appreciation and knowledge of wine have improved in recent years, purchases continue to be driven primarily by brand-conveyed prestige and status.

Beyond the emphasis on brand, consumer preferences have also driven the market to supply a narrow range of products. Given the limited consumer appreciation for white wine, red wine accounts for more than 90% of the wine consumed. This preference is related to numerous cultural factors, including associations with sophistication, heritage and health.

Regardless of the product category, Chinese customers often have enduring "country-of-origin" biases, and wine follows this pattern. The association between wine and France is particularly strong, with domestic brands mimicking French imagery on packaging and vintage naming conventions. On the import side, French labels account for almost half of all wine imported into China. When pressed about their perception of brands and vintages, many consumers said their perception of France as the leading wine country is a primary factor in their purchase decisions. According to the manager of Scarlett, a prominent wine bar in Beijing, "The Chinese are big fans of Bordeaux and not very curious about other wines."

In response to changing customer perceptions of wine, domestic firms have begun to adjust their marketing strategies. While domestic wine brands have traditionally focused on lower price tiers, producers are increasingly looking to move further up-market, investing in world-class equipment and seeking out international best practices. Some Chinese-produced wines have already received international recognition for their efforts, with one producer recently winning *Decanter* magazine's "Middle East, Far East & Asia" category for red wines. At the same time, with the increasing spread of wealth beyond the largest coastal cities, China's wine market is now expanding into smaller markets across the country.

Both Chinese nationals and foreign investors are seeking ways to capitalize on the booming Chinese wine market. Within this market, the relative unsophistication, yet increasing purchasing power, of the Chinese consumer presents tremendous investment opportunities with multiple means of entry. Recent examples of entries into this sector include Chinese purchases of foreign vineyards, full-service distributors catering to the unique qualities of the Chinese market, and high-net-worth Chinese investing in wine as part of their wealth management strategies.

Investing in Terroir

Most attention-grabbing among these modes of market entry, however, has been Chinese investors' acquisition of foreign vineyards. Among the first was the 2008 purchase of a Bordeaux chateau by the Cheng family of Qingdao, China.

After an extensive search, the Cheng family chose Chateau Latour-Laguens, a 150-acre property in southeast Bordeaux. Although the Chengs had been historically involved in importing wine from other global wine centers, such as South Africa and Australia, their search for property focused exclusively on Bordeaux. Family member Daisy Cheng noted France's strong reputation in the Chinese market as the key factor in the selection: "The Chinese consider French wine to be the most authentic."

Since purchasing Latour-Laguens, the family has transformed the vineyard's strategy to focus exclusively on exporting to the Chinese market. To drive name recognition back in China, Cheng said that the family has done extensive newspaper advertising in target markets. In addition, the winery received a tremendous amount of attention within both the Chinese and international press for the acquisition, providing significant exposure. The family has subsequently worked to upgrade the winery. As Cheng noted, "we have invested in the most advanced equipment in order to produce the highest quality wine. We have also restored the historic premises."

Following the 2008 acquisition and with the continuing strength of the Chinese economy, other Chinese parties have made foreign purchases. Perhaps most significant was the 2011 purchase of the Bordeaux property Château Viaud by COFCO. This RMB100 million (US$15.2 million) deal, by the owner of China's high-volume Great Wall domestic wine brand, was seen as legitimizing overseas acquisitions. Property agents in Bordeaux report an increasing number of inquiries from potential Chinese investors, sparking talk of a wave of Chinese purchases in coming years.

While Bordeaux has received the greatest attention, Chinese entities are broadening their scope to other major wine-producing regions. COFCO also purchased a high-volume Chilean winery in 2010. In addition, deals have taken place in other wine production centers such as California's Napa Valley and New Zealand. In 2010, Dynasty Wine announced plans to spend up to RMB900 million (US$150 million) to acquire vineyards overseas, although it has yet to make a purchase. After the Chilean and French acquisitions, Wu Fei, COFCO's wine and spirits branch head, discussed the company's commitment to additional purchases, noting that "the next purchase might happen in Australia or the United States, and we are also eyeing other places."

While this growing trend of overseas purchases shows no sign of abating, some wonder if resistance to Chinese ownership will grow. Past peaks in foreign acquisitions elicited significant protectionist concerns. In the Chinese context, however, issues have thus far appeared relatively muted and limited to minor cultural challenges, e.g., a misunderstanding between Chinese investors and a French vineyard over which nation's property laws should apply to the acquisition. Instead, Chinese investors — and, even more importantly, Chinese consumers — were cited as the "saviors of Bordeaux" by *The Financial Times,* helping to revive a region struggling through declining demand from recession-battered developed markets as well as increasing New World competition.

Bringing Wine 'In'

Further along the value chain, distribution is another channel through which businesses and individuals can enter the Chinese wine market. However, consumer education is the key to success for this burgeoning industry.

Major distributors in mainland China include ASC Fine Wines (majority-owned by Suntory Holdings), Aussino World Wines and Summergate Fine Wines, all founded in the 1990s and currently marketing themselves as both purveyors of fine wine and educators. This informational aspect of distribution is necessary, given the relative immaturity of the Chinese wine market. For instance, ASC runs its own wine school, which the company promotes as suitable for "wine lovers from all walks of life." This program helps ASC target and guide consumers to its own imports. At the same time, ASC builds credibility as one of the first organizations in China to certify wine professionals.

Within this environment, new distributors also need to emphasize education. Altruistic Boutique Wines (ABW), based in Hong Kong and Beijing, imports boutique wines primarily from California. The company's founder and CEO, Rai Cockfield, considers wine education an integral part of his distribution strategy, particularly given the lack of awareness of New World wines. The Chinese wine market is where the U.S. wine market was 30 years ago, but "China will catch up faster," says Cockfield, who is expecting an enhancement in Chinese consumers' global wine awareness. Regarding the domestic product, Cockfield has already sampled many Chinese wines and believes the Chinese domestic wines will eventually rival some of the top wines in the world as Chinese vineyards come of age in the next few decades.

As part of its efforts to promote American wines, ABW has organized major events in Hong Kong to showcase U.S. boutique wines. The company also plans to hold similar events in Shanghai and Beijing. However, Cockfield notes that Hong Kong is a more sophisticated market, and mainland Chinese consumers will require more active guidance. When asked about ABW's different approaches to mainland China and Hong Kong, he said that tastings in China need to be "more casual and educational, focused more on making clients feel comfortable judging wines."

A Palatable Investment

Beyond the traditional business opportunities in production and distribution, China's developing wine market has also given rise to secondary investments. Because Chinese nationals face limited investment options of all types due to heavy government regulation, new opportunities like wine investment are particularly attractive.

In August 2011, the Chinese government approved the launch of the nation's first private wine investment fund. The Dinghong Fund (also known as the De Rouge Fund) will raise RMB1 billion (US$156 million) to invest solely in vintages from Bordeaux and Burgundy. For a minimum investment of RMB1 million (US$160,000) and a lock-in period of five years, fund managers are promoting a potential 15% annual return. According to Ling Zhijun, the fund's founder and manager, Dinghong expects to raise its first tranche of RMB200 million (US$320,000) easily by the end of its first month. The difficulty will be limiting the number of enthusiastic investors.

The excitement around the Dinghong Fund is easy to understand in the Chinese context. Unlike countries with more mature financial services industries, China has a scarcity of private wealth management vehicles. Until recently, many wealthy Chinese invested their capital in the booming real estate market. But, with growing fears of a housing bubble, there is a push for alternative asset classes. Fine wines and other luxury assets (e.g., art or rare gems) are perceived as being more stable investments and having a low correlation with traditional commodity markets. With an annual expected return of 15%, the Dinghong Fund offers high-net-worth Chinese a stable and desirable hedge against domestic inflation.

Also in August 2011, Changyu, the country's largest domestic producer, partnered with Bank of China to issue a new wine investment product that would give investors an opportunity to buy a stake in Changyu's new vintage, Century Cellar Ping Zhong Li Quan. For a minimum investment of RMB1.08 million (US$168,804) and a lock-in period of 18 months, investors are guaranteed a 7% annual return, double the current one-year bank deposit rate. Like the Dinghong Fund, the Changyu investment product has found eager investors — nearly all the initial release was subscribed within three days of its issuance.

Considerable differences exist between these investment choices. However, whether purchasing a vineyard directly, expanding distribution or investing in wine funds, the outlook appears strong. China's growing demand for luxury experiences, its rapidly developing economy and the limited investment alternatives have combined to create an ideal climate for wine investments.

Today, many industry experts note the relative lack of sophistication in China's wine industry, particularly when compared to the West. Yet the market has shown rapid development in the past 10 years. Educating consumers and developing wine knowledge take time, requiring both purchasing power and customer desire. Just as appreciation of, and demand for, wine in the U.S. has grown over the past few decades, the Chinese wine market should continue to develop in the coming years. With the right blend of investment strategies and a little patience, it should be easy to uncork the tremendous potential of the Chinese market.

This article was written by Ulysses Auger, Jeanne Chen, Catherine Ho and Andrew Rowe, members of the Lauder Class of 2013.

“Thanks, But No Thanks” to Made in China?

Ambitious Asian firms have long been interested in penetrating the global market and have done so using several methods. In the 1980s, Japanese companies such as Toyota and Honda succeeded in the automobile industry and were well-known for efficient management practices and superior product quality. Other Japanese companies soon followed, making a global name for themselves in the consumer electronics and diversified technology products markets. In the 1990s, companies from the small but formidable Asian “tiger” economies also emerged, with Korean brands such as LG and Samsung succeeding in consumer electronics and Kia and Hyundai making inroads in the automobile industry, and Taiwanese brands such as Acer and Asus making waves in the technology industry. These companies have managed to sustain and grow sales overseas while maintaining their competitive advantages — lower costs, efficient management practices, superior product quality and innovative R&D.

While Chinese companies have exhibited one or more of these qualities, a significant number have failed to overcome the disdain with which many people regard products that are “Made in China.” A few companies, such as Haier, have made significant progress. The Qingdao-based company has become the world’s leading white-goods brand in terms of revenue. Yet, despite encouraging progress on the part of these pioneers, negative consumer perceptions and other challenges, such as domestic and foreign legal barriers, remain. How will globally ambitious Chinese companies tackle these challenges to develop reputable and desirable brands abroad?

Perceptions of a Brand

As global competition intensifies, Chinese companies have had to increase their focus on brand development. Previously, the concept of a brand was equivalent to that of a trademark or logo. The modern idea encompasses much more than simply a design and is inherently more valuable. According to Interbrand, a leading global brand consultancy, brands now must “drive market demand for their products on the one hand, and help their company charge a premium price for better profits on the other.” Jez Frampton, Interbrand’s Global CEO, notes that “brands are playing an increasingly important role in pushing forward the development of Chinese enterprises.” Today, they often represent a promise to the customer, and Chinese firms are realizing that the future success of a company depends on fulfilling customer needs and developing reliable reputations. These two factors are paramount to gaining customer loyalty, driving price premiums and increasing market share. This is especially true for higher-priced goods such as household appliances and consumer electronics.

Interbrand defines a brand as a “mixture of attributes, tangible and intangible, symbolized by a trademark, which if managed properly, creates value and influence.” In essence, a recognizable brand generates considerable value. However, although quantitative analyses can evaluate a brand’s monetary value objectively, its worth is determined ultimately by consumers’ perceptions and loyalty. Companies that successfully develop a recognizable brand at home can promote the brand’s attributes more easily in a new market by using its established reputation. No Chinese brand appears in Interbrand's 2010 rankings of the 100 most valuable global brands.

Since China is the second-largest economy after the U.S., many foreign companies with developed brands have entered the Chinese market in search of growth opportunities. China continues to grow at an impressive rate, with its gross domestic product increasing 9.5% year-over-year in the second quarter of 2011. A growing Chinese middle class, armed with impressive purchasing power, has emerged, ready and willing to buy brand-name goods at a premium.

In China, surveys show that foreign brands are associated with better quality, innovative design and reliability. A July 2011 survey of Beijing graduate students (ages 21-28) asked respondents about their perceptions of Chinese and non-Chinese brands. One student responded: "In reality, foreign brands seem more reliable"; another responded that foreign brands are "better in quality, though [I] don't know why." The presence of foreign brands in the Chinese market has shaped local consumers' perceptions of which brands are successful and why. The same survey revealed that respondents defined a brand as one that is consumer-focused and reliable; 100% of the respondents considered quality first when evaluating a brand.

As Chinese consumers continue to evolve from cost- to brand-conscious, increasingly they will hold domestic brands to the same standards as foreign ones with regard to quality, design and service. However, Chinese companies have struggled to make headway in these areas from the consumer's point of view, as "Made in China" is still disfavored by both Chinese and foreign consumers. In the Beijing student survey, the majority of respondents believed that quality, innovation and design were the top three barriers for Chinese companies in developing a strong international presence. Similarly, in a parallel survey conducted in August 2011 among U.S. graduate students (ages 25-32), when asked to compare a Chinese product with a non-Chinese product, 65% of respondents indicated they would be less likely to buy an equivalent Chinese product simply because it was "Made in China." These results are representative of a broader problematic trend: Products manufactured in China have a stigma attached to them, and several issues must be resolved before Chinese brands can win the affections of a global audience.

Confronting Basic Challenges

To succeed abroad, one of the most important challenges Chinese companies must address is actual and perceived product quality. Globally aspiring Chinese companies have often found that consumers assume their products are of inferior quality compared to those of their competitors. Notorious incidents, such as the 2007 recall of Chinese-manufactured toys coated with lead paint or poisonous toothpaste, have worsened the reputation of "Made in China." As a result, Chinese companies entering global markets bear the burden of proof when it comes to delivering products that match the quality of their Western and Japanese counterparts.

Chinese companies have tackled this problem in two ways. The first approach is that of acquiring foreign companies, benefiting from their manufacturing and R&D knowledge, and associating with the reputation of an already-established brand. Lenovo chose this approach when it acquired IBM's PC unit, which made Lenovo a global player overnight and boosted its global market share from almost zero to 9% within six years.

The other approach is to create a corporate culture that stresses quality from within. Haier was committed to quality from the beginning, recognizing that any oversight or flaw could saddle the company with a reputation for poor-quality products. To emphasize this commitment, Haier CEO Zhang Ruimin pulled 76 flawed refrigerators off the production line and ordered the staff to smash them to bits. "I wasn't going to sell just anything, like my [Chinese] competitors would. It had to be the best." Haier's efforts have paid off. In 2009, the company overtook Whirlpool to become the world's largest white-goods manufacturer in terms of revenue, owning approximately 5% of the world market. Its market share increased to 6.1% percent in 2010, with profits of US$1 billion on revenues of more than US$21 billion.

It is evident that an investment in quality allows Chinese companies to reap rewards, as Haier has demonstrated.

Other companies have not made as many strides and continue to struggle with product quality as perceived by consumers. For example, the August 2011 survey conducted in the U.S. found that 12% of respondents refused to consider buying any type of Chinese product. Most respondents were unwilling to purchase higher-priced products, such as electronics and household goods, and only 4% were willing to consider buying a Chinese automobile.

Overcoming Legal Obstacles

Although Chinese companies such as Haier and Lenovo have made significant progress in becoming successful global brands, Chinese brands in general face several legal issues in the international market.

Intellectual property (IP) is likely the greatest, or at least most notorious, legal obstacle. Moreover, according to the U.S. International Trade Commission, "foreign businesses have reportedly been pressured to transfer know-how and technology to Chinese firms in order to gain access to the Chinese market." Chinese manufacturers have chosen to grow businesses by copying foreign IP and selling copycat products at a cheaper price point. However, as China has opened up to the world, this strategy has become less successful. Although these products are still available, the Chinese government has been increasingly vigilant about policing sales of counterfeit goods, a policy that is likely to only strengthen over time. In addition, Chinese manufacturers themselves are becoming more sophisticated and are beginning to acknowledge the importance of having their own IP.

Haier was one of China's pioneers in this respect, recognizing that to compete abroad successfully, it needed to create its own IP. However, since the company did not have the foundation in place to grow its IP at home, it decided to "purchase" it from Germany. According to Haier's top lawyer, Su Xiaoxi, "When we introduced the technologies from the German company, we had to pay it royalties. At the time, most Chinese companies couldn't imagine paying money for something you could not see, that was invisible. But even then, we had this awareness of the value of intellectual property rights." Since Haier wanted to target the American market first, this strategy allowed the company to avoid copyright lawsuits over IP patents. While Haier has been successful both abroad and at home, few other Chinese manufacturers have chosen to create their own IP. Thus, these companies will have difficulty exporting their products. For example, the original owners of the IP can use Chinese customs to prevent the export of infringing products under Chinese law.

Second, the poor quality of many Chinese products has led to increased product-liability lawsuits and regulations, which then make it more difficult for Chinese manufacturers to export their products and succeed internationally. Since China has different safety standards for what is produced abroad and at home, local products face the prospect of failing to meet safety standards abroad. The U.S. is monitored by the Consumer Product Safety Commission (CPSC), which regulates imports from China and elsewhere and educates these foreign manufacturers on safety strategies to increase compliance with American standards.

Finally, Chinese manufacturers must address how differences in the Chinese and American legal standards affect their success abroad. American manufacturers file many complaints about Chinese price-fixing schemes to inflate prices for the U.S. market. In addition, Chinese manufacturers face an increasing number of antitrust claims. The more dominant the Chinese firms are at home, the more likely they are to be sued under antitrust laws abroad. This is problematic for many Chinese manufacturers, which aim to dominate the Chinese market first before making the move to go global.

Nevertheless, these legal issues are likely to be temporary setbacks and not permanent obstacles. Chinese companies are becoming more sophisticated, in terms of both IP and meeting the requirements of the American legal system, which will allow them to navigate more easily and enter global markets. Their success will then depend on their ability to grow and manage their brand's reputation.

A Strategic Brand Identity

"U.S. consumers are very savvy," notes James Liess, Haier America's senior manager of corporate communications. "They know what they want, and they know what they want to pay for it. As a company, no matter where you are located, you have to [continually] understand consumer needs and differentiate yourself with better and targeted products." While a lack of quality and innovation are the primary challenges to global development, Chinese companies also struggle with sustaining and managing their brands.

Today's successful Chinese brands have tackled the "Made in China" stigma not only by investing significantly in R&D and IP, but also by relying on a foreign relationship or identity. For example, Haier achieved success in the U.S. through the strategic creation of a local subsidiary, Haier America. In the U.S., the company did not emphasize its Chinese origin, but focused instead on creating unique IP and consistently superior quality to compete with other global brands. In addition, Haier's exclusive partnership with the National Basketball Association (NBA) reflects its commitment to "thinking big" and partnering with established local entities — in this case, an organization perceived as thoroughly American — to validate its reputation outside China.

Thanks to Haier's partnership with the NBA and its other strategic moves to localize in the U.S., American consumers have not realized that the company is actually Chinese. The perception that it is American has helped it succeed in a market that is generally hostile toward products "Made in China." As a result, companies like Haier that have global aspirations must find ways to dissolve the harmful effects of their Chinese label, which can otherwise outweigh the product's quality or innovativeness. Most successful Chinese companies have decided, at least for now, to deemphasize their Chinese origins in favor of promoting themselves as a local or Western brand. Lenovo, for example, still uses IBM's "ThinkPad" logo to ensure that customers continue to link its products with the IBM brand.

The message for other aspiring Chinese brands is loud and clear: To reign both domestically and abroad, superior quality and unique products are necessary, but not nearly sufficient. Companies should also distinguish themselves as international or Western brands. As more Chinese companies adopt strict quality control standards, their products will become more reliable, and consumers' perceptions will start to change. At some point, "Made in China" will become a neutral or positive association. For now, it remains a liability — one that leading firms must surmount creatively.

This article was written by Maggie Chao, Elaine Chow, Gil Kerbs and Kate Long, members of the Lauder Class of 2013.

Business vs. Ethics: The India Tradeoff?

As Ratan Tata, chairman of the Tata Group, observed, "If you choose not to participate in [corruption], you leave behind a fair amount of business." Much has been written about the benefits of doing business in India — low input costs, easy access to labor and a massive consumer base. Less has been said about the ability of companies in India to thrive by bending rules, greasing palms and broadening ethical boundaries. At a time when the issue of corruption threatens the stability of the Indian government and scandals unearthed in sectors from sports to telecommunications total tens of billions of dollars, it is becoming increasingly critical for multinational managers to ask whether business success in India comes at an ethical cost.

Following the 1991 fiscal reforms, India's growth story is entering its third decade in dramatic fashion. Annual growth bordering on double digits, a middle class set to grow eightfold in the coming two decades and 800 million mobile subscribers are but a few highlights of the narrative that has reshaped the global business landscape. The sheer magnitude of the opportunity has brought multinational businesses racing to the subcontinent from all over the world for a slice of the burgeoning pie: In a recent survey conducted by the United Nations Conference on Trade and Development (UNCTAD), India replaced the U.S. as the second-most important foreign direct investment (FDI) destination for transnational corporations.

Swimming against the Current

Yet even a small slice of that pie has been elusive for many transnationals. Goldman Sachs India admitted that growth to date has been slow, as the company's priority has been to protect its reputation by dealing only with clients with the highest ethical standards. The German firm Enercon, the world's fifth-largest wind turbine manufacturer, was forced to walk away from its US$566 million joint venture after being intimidated by authorities and failing to find legal recourse to what it termed "government-abetted theft." Even Ratan Tata admitted that officials' expectations of bribes were the reason he did not establish a domestic airline.

Understandably, frustration abounds for foreign entrants. An extensive 2010 survey by the Federation of Indian Chambers of Commerce and Industry (FICCI) found that only 12% of foreign companies rated the overall legal framework and regulatory mechanism as "good." Furthermore, when asked about ground-level hassles, only 14% reported the situation as comfortable while 93% found procedural delays to be a serious concern.

In discussions with executives of multibillion-dollar companies, from Jet Airways to McKinsey & Company, it became clear that success in India requires a unique approach. Managers across industries agree that the heart of the Indian competitive advantage lies in the concept of *jugaad*, or, as defined by the former CEO of a leading Indian real estate group, "finding a way to your cheese." Eighty-one percent of Indian businessmen surveyed by the Legatum Institute said that *jugaad* was the key reason for their success. It is this innovation through whatever means necessary, like water flowing through the paths of least resistance, that has formed the backbone of India's growth story.

Slicing through bureaucracy, inadequate infrastructure and chaotic environments demands a unique genius

— one that sometimes neglects Western ethical norms. Ethically questionable scenarios in the Indian market range from the mundane to the spectacular. Certainly, at the civic level, day-to-day business will often find one across the table from bureaucratic gatekeepers selling their signatures at monopoly prices. However, cultivating "mutually beneficial" political relationships is perhaps even more important as the deal value rises. Earlier in 2011, taped conversations released by the Indian Supreme Court detailed the role of Member of Parliament and well-known power broker Amar Singh in helping a leading commodities player, Bajaj Hindusthan Sugar, fix policy, obtain clearance and resolve legal irregularities. On the recordings, Singh assured his clients that "no one can do things for you like I do. Whatever you wish will happen, as long as I remain in power."

The pervasiveness of *jugaad* in modern Indian business — and its relatively lower profile in developed Western economies — speaks volumes. To the casual observer, this juxtaposition brings to mind Kipling's famous words, "Oh, East is East and West is West, and never the twain shall meet." This evokes stereotypes of the unethical emerging East and the ethical emerged West, of the delta between developing and developed markets, of a necessary barrier that emerging markets will have to breach before they count themselves among the financial elite.

However, this may be far from reality.

Of Cultural Contexts and Ethical Equilibriums

Many multinational managers may wonder whether India is moving toward more "Western" business ethics or whether it has already reached a static state. While most have assumed the former, it is important to recognize the unique features of Indian culture that provide additional context.

Historically, Indian society has placed great emphasis on loyalty to the collective, be it one's caste, village or family. This drives a culture of favors, friendship and clanship that clashes with the Western concepts of conflict of interest and pure meritocracy. The Indian ethos emerges in a survey of Indian government officials who explicitly value loyalty over competence when making hiring decisions.

Furthermore, Indian literary history fully embraces the concept of noble ends justifying dubious means. Three texts intrinsic to Indian culture and philosophy help to explain the current business landscape: the epics *Ramayana* and *Mahabarata* and the economic treatise *Arthshastra*.

In both the *Ramayana* and the *Mahabharata*, even gods resort to deceit and trickery to accomplish their ends. In the latter, Lord Krishna repeatedly devises "underhanded" methods to defeat the opposing army — going so far as to encourage the protagonist, Arjuna, to attack and kill an unarmed adversary.

In addition, the *Arthshastra* is often cited publicly by prominent politicians and businessmen as the foundation of their strategic thought. Written to advise a king on statecraft, economic policy and military strategy, the work advocates the use of deception and sometimes brutal measures for the common good. Max Weber described Machiavelli's draconian *Prince* as harmless when compared to the *Arthshastra*, whose topics range from "when a nation should violate a treaty and invade" to "when killing domestic opponents is wise."

It may be presumptuous to view Indian culture, one that has thrived for three thousand years, through a Western ethical lens. Both civilizations have different origins and, therefore, are likely to have different ethical equilibriums.

The Millstone around India's Neck…

India's lax ethical standards, coupled with a rigid bureaucracy and weak enforcement mechanisms, have certainly hurt the country in many ways. The causes of this fiscal pain can be seen at the government, corporate and individual levels.

Scandals in the political and business spheres seem to have become endemic in India. The infamous "2G" scandal of 2008, in which the government granted telecommunication licenses on a first-come-first-served basis instead of through an auction, is estimated to have cost taxpayers US$40 billion. This resulted in bargain-basement prices for valuable assets and precluded many eligible parties from procuring licenses. Lax corporate governance has also hurt investor confidence, as illustrated by the revelation of questionable accounting practices at Satyam Computer Services. This 2009 scandal saw US$70 million in real assets transformed into US$1 billion in imaginary assets and sent the Bombay Stock Exchange tumbling 5% in a single day.

Indicative of the ubiquity of the problem, it is estimated that US$1.5 trillion in black money — an amount far exceeding India's GDP — is hidden in foreign banks. Individual cases help ground this issue in reality. Madhu Koda, the son of a tribal farmer, who rose to become chief minister of the State of Jharkhand, was discovered to have undisclosed assets of US$1 billion, including a hotel in Thailand and a coal mine in Liberia. Businessman Hasan Ali, accused of money-laundering and arms-dealing, owes the government US$16 billion in taxes.

As a result, the total fiscal loss is staggering. According to Global Financial Integrity, US$314 billion has flown out of India since 1991 in the form of evaded taxes, crime and corruption. Furthermore, Transparency International has ranked India 87th out of 178 countries on its Corruption Perceptions Index, and the World Bank has ranked India 134th out of 183 countries in "ease of doing business." It is widely believed that these factors have contributed to shaky investor confidence in India, as foreign direct investment fell 31% in 2010.

… Or the Fire beneath India's Feet?

Another perspective is to view these challenging factors — India's lax ethical standards, rigid bureaucracy and weak enforcement mechanisms — as the fire beneath India's feet, a crucible for Indian businesses and entrepreneurs. This crucible tempers and hones the innovative spirit and bold nature of Indian businessmen.

This crucible prompted the chairman and founder of one of India's leading retail groups to say that in India corruption is *necessary* for growth. He went on to cite the example of the "2G" scandal: Without it, had the licenses been granted by auction, mobile calls would never have fallen so quickly to two cents per minute.

This crucible also allows Indian businessmen to innovate boldly when presented with opportunities created from these challenging factors. Dhirubai Ambani embodied the spirit of using creative solutions — legal and otherwise — to create economic value. Rising from being a petrol-pump attendant to head one of the largest conglomerates in the world, Ambani exported junk in exchange for import entitlements, built internal capacities far beyond license quotas, imported massive machinery as "spare parts" and influenced favorable changes in textile and telecom laws. At the same time, he short-circuited the socialist bureaucracy to build the world's cheapest refineries, realized his dream of making telephone calls cheaper than a postcard and helped privatize the Indian energy market. Today, the successors of his Reliance Group have a combined market capitalization of more than US$160 billion.

Opportunities created by these challenging factors have also been seized through ethical means. The microfinance industry came into being as a result of the inefficiency of government-funded financial programs designed to provide loans to lower-income households. Ujjivan Financial Services, a microfinance institution set up in Bangalore in 2004, caters to the urban poor. According to Kavitha Nehemiah, product manager at Ujjivan, "government programs are badly run, corrupt and do not reach the target audience. Additionally, banks shy away from this demographic given documentation requirements and high costs with low returns." Ujjivan lends at a 24% rate, which is much higher than banks but lower than private money lenders that charge between 50% and 300%. As of March 31, 2011, the institution had disbursed more than US$450 million to more than 991,000 customers.

Just as notably, Indian businessmen are able to extrapolate these lessons to situations relatively unscathed by lax ethical standards, rigid bureaucracy and weak enforcement mechanisms. The characteristics forged in the Indian crucible — innovation and boldness — can swiftly become firm competitive advantages in innovation and creativity. The "one-lakh car," the Tata Nano, made waves in the mature automotive industry and was heralded by a major news publication as "a triumph of homegrown engineering." Although its price tag has ballooned by 40% since its introduction, it remains half the price of its closest competitor.

The Way Forward

Today's Indian media outlets are dominated by Anna Hazare, a crusader attempting to strengthen India's checks and balances against corruption. He headlines a national movement that has brought ethics to the forefront of India's national consciousness and has forced the country to confront its ethical standards and explicitly choose a way forward. "This movement has convinced the youth of this country that they are active agents of change," noted Varun Gandhi, Member of Parliament, following the end of Hazare's 12-day hunger strike in August 2011. "A churning is taking place," he added. "We could say it is a silent revolution, except it is not so silent anymore."

Currently, it is incumbent on the multinational managers to realize that business in India is held to a different set of ethical rules than those found in the West. Today, success in India comes from playing by these rules. In the future, it will be up to the multinational managers to recognize that India is moving ponderously toward a new ethical equilibrium. The nation's intersection of business and ethics is shifting, and the India trade-off likely will never look the same again.

And it will be up to the multinational managers to realize that, while the direction of this shift is inevitable, its magnitude is certainly more complicated to ascertain. Will it be a seismic shift or a minor tremor? Will it reshape boundaries or modify the status quo only slightly?

At the end of the day, the answer lies within the Indian businessman. So much of what has held him back has propelled him forward: He has been both burned and forged at the same crucible. What new equilibrium will benefit him, and his nation, the most? And will the policymakers be able to understand and be willing to execute whatever is necessary to reach this target?

Only with time will we be able to observe this dilemma's resolution. The multinational managers would do well to pay heed, lest they leave behind a fair amount of business.

This article was written by Ajay Anand, Kavitha Cherian, Arpan Gautam, Roopak Majmudar and Arzan Raimawala, members of the Lauder class of 2013.

Born in the USA, Made in France: How McDonald's Succeeds in the Land of Michelin Stars

France — the land of haute cuisine, fine wine and cheese — would be the last place you would expect to find a thriving fast-food market. In a country known for its strong national identity and anti-globalization movement, it seems improbable that McDonald's could have survived the onslaught of French social and political activism. In 1999, José Bové, an agricultural unionist, became a hero to anti-globalization supporters when he and his political group, Confédération Paysanne, bulldozed a McDonald's in Milau, France, to protest against U.S. trade restrictions on French dairy products. With bullhorn in hand, he declared to the television news cameras: "We attacked this McDonald's because it is a symbol of multinationals that want to stuff us with junk food and ruin our farmers." In 2004, amid the nutritional controversy sparked by Morgan Spurlock's documentary Supersize Me, McDonald's was declared in French media to be the epitome of malbouffe, *or "junk food," and deemed partly to blame for the nation's rising obesity rate.*

And yet McDonald's, the world's largest fast-food corporation, with a global presence in 123 countries across all six inhabited continents, has turned the home of Le Cordon Bleu cooking academies and the Michelin Guide of world-renowned restaurants into its second-most profitable market in the world. The chain has more than 1,200 restaurants in France — all locally owned franchises — and a growth rate of 30 restaurants per year in the past five years alone. What is at the heart of this impressive growth that has stunned French observers and surprised business analysts? The three main reasons for McDonald's success are local responsiveness, rebranding and a robust corporate ecosystem.

Local Responsiveness

Burger King — arguably McDonald's largest competitor in the world — entered the French market in 1981 but closed its 39 stores in 1997. Its strategy of directly transplanting the American restaurants, with no local adaptation, resulted in weak sales. A French hotel and restaurant journal remarked at the time of the brand's closing that "Burger King faced no significant handicap against its rivals McDonald's and Quick. Despite the three companies entering the French market around the same time, McDonald's has grown to 542 restaurants and Quick [to] 258." To put Burger King's failure into context, from 1983 to 1996, the French fast-food market grew by nearly 1,450 restaurants, and total market value increased fivefold. The different growth trajectory of McDonald's France is largely attributed to the age-old American adage, slightly refined: The customer — the French customer, to be exact — is king. At every turn, the management of McDonald's France has been sensitive to the preferences of French consumers, both inside the restaurants and in their daily lives.

Since opening its first French restaurant in Strasbourg in 1979, McDonald's has sought to leverage the strength of the global conglomerate while tailoring its menu to the French palate. Although some elements of an international strategy were apparent in McDonald's French entry, overall the chain was not responding to local market needs and opportunities. Strasbourg was chosen as the initial location in order to leverage the brand recognition that already existed in Germany, while keeping the same restaurant décor and recipes for France. According to Nawfal Trabelsi, senior VP for McDonald's France and Southern Europe, "For the first 15 years, from 1980, what we did above all was offer people a slice of America." However, in 1995, McDonald's started using French cheeses such as chevre, cantal and blue, as well as whole-grain French mustard sauce. By changing the recipes in France, McDonald's started executing a multidomestic strategy and winning the hearts of French consumers.

McDonald's also demonstrated the power of understanding the cultural particularities of consumers across national boundaries. In France, barely 10% of meals are eaten outside the home, compared to nearly 40% in the U.S. and the U.K. Unlike their Anglo-Saxon counterparts, French consumers rarely snack between breakfast, lunch and dinner. As a result, French meal times also last longer, and more food is consumed through multiple courses, creating unique opportunities and challenges for fast-food dining. McDonald's decided to capitalize on the opportunity. Rather than run promotions that encourage snacking, the company freed up valuable labor by installing electronic ordering kiosks, which are used by one out of every three customers in more than 800 of its restaurants. McDonald's has capitalized on the French cultural preference for longer meals by using surplus labor to provide table-side service, particularly in taking orders from lingering diners inclined to order an additional coffee or dessert item. Thanks to such initiatives, the average French consumer spends about US$15 per visit to McDonald's — four times what their American counterparts spend.

Moreover, to solve the issue of empty tables during non-meal times, McDonald's introduced McCafé in France — a range of high-end coffees and pastries available from a separate counter. McCafé pastries come from the Holder Group, a baking conglomerate that operates the popular Paul and luxury Ladurée brand stores in France. According to McDonald's France chief of staff Alexis Lemoine, "I set up taste tests for my friends between McDonald's macaroons and those of Ladurée, and almost no one can tell the difference." This unorthodox move from the most traditional purveyor of burgers and fries not only increased revenues by 5% — by adding products with over 80% profit margins — but also contributed to the *embourgeoisement* (gentrification) of the chain's image.

In August 2011, McDonald's announced that the McCafé would be taking on another ubiquitous French food icon: the baguette bread roll (which will also be supplied by the Holder group). By baking the baguettes in-house and offering them both as a breakfast item and in the form of baguette sandwiches, McDonald's is clearly making a play for the non-franchised "fast-food" segment currently occupied by the tens of thousands of bakeries across France. According to a 2009 study by French restaurant industry consulting firm Gira Conseil, the French consume nine times more traditional sandwiches than hamburgers, and more than 70% of all sandwiches consumed in France are made on baguettes. As McDonald's Trabelsi notes, "Today, we are part of French daily life. Our priority is to integrate locally while offering our traditional products…. The French are passionate about bread and crazy about baguettes. We're gradually responding to a natural demand."

As a response to the growing trend for healthy eating in France, McDonald's introduced the McSalad. The new concept store, designed and implemented by McDonald's France as an all-salad restaurant, is the first of the company's 32,000+ global restaurants where customers will not find any of the traditional burgers, fries or shakes. Situated in the heart of La Défense, Paris' massive corporate office park, the McSalad is targeted at the upscale clientele of the area's 200,000 daily business workers who can place their orders online from their desks to maximize their short lunch breaks. According to Elizabeth Rosenthal, a *New York Times* contributor and researcher on food trends, the French spent an average of 38 minutes per meal in 2005, down from an average of 82 minutes in 1978.

Fireplaces and Flatscreen TVs

The second major success factor could be headlined "progressive marketing." Perhaps the most striking aspect about McDonald's restaurants in France is not found on the menu — it is the restaurants themselves. McDonald's franchisees have invested heavily in their ambiance and spent approximately US$5 billion in renovations in less than a decade. The most noticeable innovation has been the refinement of the restaurant interiors to create a welcoming environment where customers linger — a stark departure from the American restaurants' strategy to minimize customer visiting time and maximize purchasing turnover. Sleek, modern tables with plush, comfortable chairs and high-impact wall graphics are more reminiscent of Starbucks than a traditional fast-food chain. Outside, the store's visual profile and signage are so subdued as to be practically invisible to passers-by until customers are directly in front of the restaurant itself. This contrasts strongly with the chain's style of buildings in the U.S., where the lighted golden arches logo is hoisted high in the air in order to be seen from a distance.

Far from the homogenous design layouts throughout the U.S., French franchise owners have opted for tasteful, diverse and regionally appropriate restaurants. McDonald's Alexis Lemoine notes that, even within Paris, restaurants varied tremendously according to target demographics. In 2005, free wifi was implemented in all McDonald's restaurants in France — a move not followed by their U.S. compatriots until 2010.

This strategic shift in the fast-food business model has not gone unnoticed by other global subsidiaries. In September 2011, McDonald's Canada appeared to follow the French lead and announced its own $1 billion, 1,400-store overhaul. In explaining the decision to transform the traditional restaurant layout into sleek stone-and-wood interiors — complete with free wifi, fireplaces and flatscreen TVs — McDonald's Canada CEO John Betts notes, "People tend to linger a little bit more in restaurants today. They want to enjoy their meals and take a break from the busy lifestyle that they lead. We think our restaurants today are certainly doing that a lot better than in the past."

In trying to appeal to the modern French restaurant goer, McDonald's has also pushed to publicize the "greening" of its image. In France, the golden arches are not surrounded by the familiar red background, but by a forest green color. Although initially controversial with the head U.S. office, this branding has already been followed by several of its European subsidiaries. Furthermore, McDonald's advertises that it aims to reduce gas emissions by more than 50% over the next 10 years and already recycles 7,000 tons of frying oil to be used as bio-diesel fuel. Steps have yet to be taken to recycle the many tons of paper and plastic produced in-store. Lemoine claims it has proven "too difficult," but it clearly seems a logical next step for the "green" company to take.

In line with the strategy of redefining its image, McDonald's reviewed its reputation for unhealthy food. Jean-Pierre Petit, the CEO of McDonald's France, put his decades of marketing skills to good use. Although not required, nutritional and caloric information were added to all food packaging. Other health-friendly features of McDonald's France include reducing salt on french fries, fresh fruit packets (introduced in 2007), and "le Big Mac" with a whole-wheat-bun option. Although the lion's share of McDonald's revenue will continue to be burgers and fries, the company has taken steps to show that it is committed to healthy eating and using French fare.

Suppliers as Partners

Perhaps the greatest strength of McDonald's France, in addition to its uncanny ability to predict French consumer preferences, is its ability to redefine the American model that has worked so well in the U.S. McDonald's France has created an entire ecosystem that has been critical to its current success. After the José Bové bulldozer incident, McDonald's France introduced ad campaigns to tell customers more about itself, where it came from, what ingredients it used, and who it employed — just how French it had actually become. It then strengthened ties to French agribusiness, advertising widely that 95% of the company's ingredients come from France, with the rest coming from the European Union.

McDonald's is today the number-one purchaser of beef in France. "We know where every hamburger and chicken nugget came from," notes Lemoine. "We can trace them to the farm within one day." This also allowed for some advantages during the mid-1990s' "mad cow disease" panic (bovine spongiform encephalopathy). "Our competitors had to cut out all beef production. We were so confident we knew our farms that we continued producing and gained market share."

Moreover, although McDonald's sources 95% of its produce in France, very few of its suppliers have formal contracts with the chain. Instead, they are seen as partners whose success is symbiotic to McDonald's. "McDonald's cannot afford to have supply issues preventing it from selling Big Macs," Lemoine says, "but the large capital investment that suppliers make to provide products makes them equally dependent on Big Mac sales — creating a sort of interdependence between supplier and the restaurant."

Employees are supported through programs to give them particular qualifications, such as nationally recognized diplomas and certifications, and in turn, employees regularly have been found supporting McDonald's and protecting its brand on Internet forums and blogs. McDonald's leverages its franchises and their proximity to customers by ensuring that 20 elected franchisee representatives vote on every marketing campaign and product launch before they are implemented. French doctors were consulted when discussing how to improve McDonald's nutritional content, and Greenpeace was engaged to discuss its environmental strategy.

In their book, *The Soul of the Corporation,* Hamid Bouchikhi, a professor at ESSEC business school in France, and John Kimberly, a professor at Wharton, examine the challenge of both corporate and national identity in multinational corporations. Ask any French person the "nationality" of McDonald's, and he or she will most certainly say it is an American brand. However, 95% of all McDonald's France products are sourced from French farms. The company's management, employees and franchisees are 100% French and operate nearly autonomously from the U.S. parent organization. Its menu items, designed by French chefs and featuring regional specialties, such as Roquefort cheese sandwiches and Parisian macaroons, are found nowhere else in its global network of restaurants.

Can McDonald's France still be considered an "American" company? Can its unique French characteristics explain its success there? Although McDonald's France leverages the power of the global network — contributing to, and benefiting from, the brand and innovation — it has redefined itself as a French company that is constantly looking to adapt to the needs and preferences of the French culture.

This article was written by Lucy Fancourt, Bredesen Lewis and Nicholas Majka, members of the Lauder Class of 2013.

In Germany, the Oxymoron of Mr. Du

In the world of business, there is no worse mistake than addressing your boss, client or counterpart in a negotiation in a way that might be perceived as disrespectful or simply out of place. While all countries have rules when it comes to language etiquette, using the correct terminology in Germany can be a somewhat daunting task. It is well-known that people's titles in Germany can fill up several lines on their business cards — your German colleague, while known as Klaus in Philadelphia, is really Herr Professor Doktor Graf Mueller in Frankfurt. To make matters worse, the German language is but one of several in which there are two forms for the simple American you: the familiar du and the formal Sie. The complications surrounding the proper form of the address for others in Germany do not end here. They are historical, social and evocative.

Frederick the Great, the infamous king of Prussia during the country's height of influence in 18th century Europe, was an extremely private man. It was said that one could have been a guest in his summer palace for months and never noticed that he had a wife. This is ironic, given that he deliberately built his palace with little space for guests to begin with. Rather than socializing with humans, he chose to surround himself with his beloved dogs. In fact, he addressed his dogs with the formal *Sie.* Arguably, his mere use of this pronoun signaled Frederick's deep affection for his dogs, more so than the fact that he insisted on being buried next to them.

Mr. Du in Theory

Simply said, the informal *du* is used only between family members and close friends. In addition, it is used in prayers when addressing God and other holy figures. Obviously, it is also used in relation to animals. The formal *Sie* is used in all other cases and signals politeness, respect and distance. In terms of other commonly applied rules, in the celebratory transition from the formal to the informal pronoun, the *du* can be "offered" to the conversational partner to acknowledge established closeness and trust. With older, more traditional Germans, this success would even be commemorated through "drinking to brotherhood." Two could also meet in the middle — continuing to use the *Sie*, but switching to first names. Once Germans agree to use the *du,* reversing it would symbolize the demise of their relationship.

In addition, the rules of etiquette apply differently depending on the context. Thus, a customer at a high-end store in a posh Berlin district must be addressed with the *Sie*, while not even the most distinguished Herr Doktor is guaranteed the same treatment at the convenience store around the corner. The differences also extend to Germany's leading political parties. The Social Democrats rarely, if ever, address each other with the *Sie*, while doing so among the ruling Christian Democrats or their coalition partners is standard practice.

Understanding the differences in use between the *du* and the *Sie* is a complicated process, as the rules have changed noticeably over the years. The significance in the use of salutations can be traced through various points in German literature and history. These salutations have frequently become a way of making political or religious statements. For example, as early as the beginning of the 16th century, Martin Luther blasphemously used the *du* in addressing the Pope in his writings. Implicit in this communication was criticism of the Pope as well as a suggestion of equality between man and church. Later, in Friedrich Schiller's *Intrigue and Love,* published in 1784, Secretary Wurm used the *Sie* to address a working-class couple — an unprecedented gesture in relation to the "lower social ranks." The reader, initially baffled by this formal behavior, subsequently learns of a relationship between the couple's daughter and the President's son, a connection that conveys social and political importance. Thus, the mere use of one of these pronouns carries an intricate and deep social and political meaning with regard to respect.

In recent history, 1968 saw the restructuring of German society. Young German students, now known as the "Generation of '68," stormed the streets to protest against German conservatism, which led to lasting changes. In particular, the students protested against the Vietnam War, set in motion the founding of the environmentally progressive Green Party and sparked the feminist movement. But most importantly in the current context, they revolutionized German linguistics. Until then the *Sie* was used even among family members. Naturally, students addressed fellow students with the formal *Sie* as well. Marking a turning point, members of the student movement purposefully began addressing each other with the *du* to signal group solidarity and equality — mimicking a concurrent movement exhibited by the workers' party. At the same time, and due in part to the split of Germany, the transition to the *du* signaled equality between the people of the German Democratic Republic — one of the socialist principles easily enforced through language.

And today? There is an ongoing struggle between the move to liberal modernity and the traditional rules of the strict class system that call for social formalities and politeness. Thus, an unclear, subjective system is in place. Generally, Germans assess two main criteria to determine which pronoun to use: how well they know someone and whether this person is a member of the same social group. A quick test of the rules in present-day Germany reveals that they tend to be a little less complicated and definitely more liberal than in past decades.

Mr. Du on a Conference Call

German academic settings have clearly defined the rules for using the *Sie* and the *du,* even though not everyone chooses to conform to them. Consider the dynamics in German classrooms. When speaking to their teachers and professors, students use the formal address as well as the title of *Frau* (Mrs.) or *Herr* (Mr.) and the last name. During the first 10 years of schooling, teachers use the *du* when addressing students. However, in secondary schools, starting in the eleventh grade, it is common for teachers to start addressing their students with the *Sie* while also continuing to use the first name — a form of address known as the "Hamburger *Sie*."

At universities, students will almost always use the *Sie* with their professors and vice versa, but even here we encounter exceptions to the rule. For example, Annette Mintgen, a student at the Technical University in Munich, had a more progressive professor who tried to implement a mutual *du* usage policy. The students were not accustomed to this unusual proposition and quickly rejected the professor's efforts in order to protect the familiar status quo.

In the business world — an intrinsically hierarchical environment — the question of proper etiquette in forms of address arises with regularity. How do you address a junior member of the team? Do you always use the *Sie* with your boss, even if he or she is younger? What do you say to the people with whom you have a personal relationship outside of work? Ask Germans how to answer these questions, and they will invariably hesitate before they respond. Matthias Keckl, investment manager at Frauenhofer Venture Group, and Johannes Elsner, associate principal at McKinsey, both observed that "it is a very complex issue."

In Germany, tradition dictates that one must maintain formality in the workplace and address all coworkers — from recent college graduates to the CEO of the company — with the formal *Sie*. This norm is believed to create a necessary distance between management and subordinates, foster a culture of mutual respect in the workplace and clearly delineate personal and professional relationships. After all, how could one fire a subordinate or give a co-worker a bad performance review if the conversational style were to imply that the two parties are friends? The formal *Sie* provides the necessary distance. Formal rules aside, Germans recognize that their traditionally conservative culture has become more liberal in recent decades. In fact, most will admit that the rules of the *du* and the *Sie* are changing in the workplace.

"Creative" companies — such as technology start-ups, publishing houses and advertising agencies — have completely abandoned the formal *Sie* and not only allow, but insist on the use of the informal *du* throughout the organizational hierarchy. Managers at these companies firmly believe it is more important to establish good team dynamics than to maintain authority and distance through linguistics. For example, the founders of Ray Sono, a hip Internet advertising agency, have set an explicit goal to promote friendship among their employees. They believe the required use of the informal *du* in the workplace goes a long way toward achieving this harmony.

At the same time, the widespread belief in the German business world states that employees in traditionally conservative industries — such as banking, management consulting and insurance — must continue to address each other with the *Sie*. But is the reality really so strict? Conversations with bankers, consultants and employees in the insurance business reveal that they all address each other with the informal *du* — from the junior analyst to the managing director — and usually extend the invitation to use the informal address to their clients at the very start of their professional relationships.

A recent informational meeting with consulting firm Bain & Company opened with, "Let's just address each other with the *du* for simplicity's sake." Similarly, a visit to investment management giant PIMCO revealed that co-workers refuse to consider the formal *Sie* when interacting among themselves. In contrast, a minority of ultra-conservative and traditional German companies, such as Siemens and BMW, continue to insist on maintaining the traditional *Sie* in all professional interactions. However, with the strong trend toward a more informal workplace, even these companies are beginning to experience changes in their employees' linguistic behavior.

Today, many German companies have global operations and hire non-German-speaking employees in their German offices. In these situations, meetings and workplace conversations are often conducted in English, where the appropriate form of address in German is no longer relevant. For example, at PIMCO Germany, where most conversations tend to be conducted in German, as soon as an American manager walks into the conference room, the language of communication immediately switches to English and the *du* and *Sie* dilemma disappears.

As with any rule, there are notable exceptions, especially if convenience is in question. Therefore, Germans continue to use the *Sie* in potentially conflicting or heated business situations as well as in regular day-to-day interactions between colleagues to create distance between the parties. It is somehow easier to take a strong stance on a contract or situation when the formality created by the *Sie* exists. Therefore, efforts are made to maintain this distance to minimize future surprises or clashes. As Katy Herrick, a manager at BMW, notes, she was addressed repeatedly with the *du* by a junior colleague without having offered it to him. Because she viewed his behavior as informal and unprofessional for the work setting, she emphasized the use of the *Sie* in communication with him to indirectly reinstate the distance he had disrupted.

Mr. Du at the Beer Garden

At first glance, the line between the *Sie* and the *du* is much less clear in social situations than in the formal world. Maresa Winkler, a teacher of German as a foreign language, provides an example to illustrate this ambiguity. When she met her new neighbor for the first time, she was not sure how she should address him. On one hand, he appeared to be her age. On the other hand, he was wearing business formal attire — obviously on his way to work. When he introduced himself with his first name, Maresa knew she should use the informal *du* with him. Had he introduced himself with his last name as well, she would have addressed him with the formal *Sie*. Speaking from experience, Maresa provides advice for similar ambiguous situations and suggests avoiding the use of personal pronouns altogether.

As another example, fitness trainer Telat Salcan uses the *du* form most of the time. With people who are his age, he uses the informal address exclusively. With older people, such as his friend's parents, for example, he will use the *Sie* until offered the *du*. An important factor in such situations is whether the friend's parents are conservative or not. Similarly, Annette Mintgen notes that her boyfriend's parents always use the formal *Sie* when addressing her. Annette's father also used the *Sie* with her sister's husband for more than 10 years, until the son-in-law finally decided to take the first step and started using the *du*. At first, the father-in-law was surprised, but he quickly began to address his son-in-law similarly. Although the father-in-law was generally not opposed to this informality, the thought of offering the *du* had just never crossed his mind.

Naturally, social rules pertaining to the *du* versus the *Sie* distinction may also include regional variations. Born and raised in the southern federal state of Bavaria, college student Christine Riederer pointed out that, while Bavarians in Munich are more likely to be more formal in addressing other people, Bavarians in the countryside use the *du* most of the time. This peculiarity has led to many bizarre situations, including a lawsuit filed against a 55-year-old Bavarian woman who once addressed a police officer with the *du*. Fortunately, the judge ruled that her behavior was not offensive, but rather a customary form of address in her rural hometown.

What can we conclude from this quagmire? Germany's linguistic culture is liberalizing. It is more common than ever to hear the *du* in the office, regardless of whether the company is considered young and hip or mature and conservative. In leisure activities and family relations, the *du* is also used more often. In fact, it is not surprising for colleagues to address each other with the *du* in both professional and personal realms. Traditionally, "Dienst [war] Dienst und Schnaps [war] Schnaps," that is, "duty was duty and liquor was liquor." This saying, which once summarized Germans' approach to the *du* versus the *Sie* dilemma, has become obsolete. While formal literature still recommends the conservative, polite and overly respectful German, society is moving in the opposite direction and calling for a friendlier and more informal German. For the American onlooker, whose own language does not have this clear distinction, it is important to understand that the use of the *du* and the *Sie* is not a simple change in pronouns, but rather a significant and telling change in modality and mood. Moreover, a mere pronoun wrapped in context can signal deep appreciation and adoration. King Frederick and his dogs would definitely agree.

This article was written by Mila Adamova, Tanja Magas and Inna Morgounova, members of the Lauder Class of 2013.

Small Businesses in Russia: Drowning in a Sea of Giants

"It helps that I have such a small company," said entrepreneur Yury Sinodov, who has managed to keep government bureaucracy from consuming his online venture. Sinodov is the sole owner of roem.ru, an online blog journal similar to techcrunch.com. Unlike many other small- and medium-sized enterprises (SMEs), roem.ru has not faced pervasive corruption and government red tape, yet Sinodov has had to deal with stringent and inefficient administrative requirements that have adversely affected his business.

Small businesses operating in Russia may appear to face fewer administrative obstacles. In reality, however, they face increasingly difficult odds of survival when expanding their operations. At a 2011 rally in Moscow, private business owners said they were crippled by a lack of funding, corrupt courts and greedy officials. They gave Prime Minister Vladimir Putin a model of a sinking ship with the words "small business" etched on the side. These challenges stifle growth and the development of small business activities. Routinely, businesses face corrupt officials who have the power to deny licenses, permits, office space and access to supplies unless substantial "gifts" or bribes are offered.

Another small business owner, "Nikolai," the entrepreneur of a baking company who asked to remain anonymous, has had "no choice but to raise prices to stay in business" due to legalized corruption practices. He has transitioned his Moscow regional-based baked goods company from the Soviet-centralized economy to the liberalized but unpredictable market economy that exists in Russia today. Armed with little more than smart intuition, he has balanced pressures from the market, creditors and corrupt government officials to keep his business afloat.

The Big Picture

SMEs are vital to the future of the Russian economy, even more so than in other countries. They are growing in Russia and are key to GDP and employment growth. According to data collected by Opora, a nonprofit devoted to SME development in Russia, there are currently about 1.6 million small and micro enterprises in Russia, a substantial increase since 2006. The number of SMEs grew by 7% between 2000 and 2005. In contrast, the number grew by 40% between 2005 and 2009. SMEs employ 17 million people, representing about 22.5% of the working-age population, and account for about 21% of GDP.

Although the number of SMEs in Russia is increasing, they face challenges, including an inaccessible credit environment and inefficient short-term government efforts to improve the business environment. The greatest threat to small businesses is the underdeveloped legal and administrative infrastructure, which is highly susceptible to corruption.

Even though the government passed new laws restricting the number of annual inspections for businesses and required that regulatory officials obtain prior approval from the prosecutor's office to conduct said inspections, small businesses see the entire legislative apparatus as corrupt. Nikolai argues that "it is an attempt to ease things up; however, until the legislation in Russia changes from a system that authorizes government officials to manipulate the market to one that lets the market dictate the laws of supply and demand, the system remains flawed and highly inefficient."

Nikolai views the government officials performing the inspections as extremely hostile, "regarding themselves as kings — we are nobody in their eyes, and they are the ones who do not produce anything for this society. On the contrary, they actually impede the people who want to contribute." In one instance, Nikolai needed an advertisement for one of his stores, which would normally cost around 10,000 rubles (roughly US$300) to construct and install. However, a special permit from the auto-regulatory police station was required, including a signature that cost approximately US$500.

"The consumers are the ones who are hit the most, as they end up paying the artificially inflated prices," Nikolai argues. "No wonder Moscow has become one of the most expensive cities in the world. Corruption in Russia is practiced through official channels where bribes are legalized through a system of unfair practices that reduce producers' profitability and completely destroy consumers' surplus. Little can be done to impede this vicious cycle of corruption."

Some outside observers note that Russia's impending WTO accession has brought the legal and regulatory regime more in line with international standards. On the other hand, many see very little progress in the legal and regulatory environments. The World Bank's 2011 *Ease of Doing Business* report places Russia behind other BRIC (Brazil, Russia, India and China) countries in several categories that rely heavily on legal and regulatory infrastructure, including dealing with building permits, trading across borders and protecting investors. In the report's overall ease-of-doing-business measurement, Russia ranked 123 out of 183 countries.

In the case of Sinodov's roem.ru, even though no corruption is involved, government inefficiencies and questionable services seriously impact the bottom line. As the sole full-time employee of his company, Sinodov is still required to pay all social security and benefit costs for his contracted (freelance) writers. He has spent nearly 10% of his time since he started the company in 2008 dealing with the tax matters and various reporting requirements.

The government has the right to freeze company bank accounts instantaneously, and without warning, if payment is not made on time. In one such instance, Sinodov's company bank account was frozen for nearly a month. In a country where mail delivery is unreliable, an entrepreneur like Sinodov has only two options for dealing with the tax department: through postal couriers or in person. Because mail consistently arrives late or gets misplaced, entrepreneurs are forced to waste days dealing with administrative matters in person.

A Historical Perspective

Russia is fortunate to be one of the most resource-rich countries in the world. These resources, combined with an economically strategic position linking the Asian and European markets, ensure the country's position in the global economy. Yet the country remains plagued by its massive land mass and crumbling physical infrastructure, its young bureaucracies carrying the vestiges of their Soviet predecessors, and the small groups of elites who hold economic power. Despite this, the SMEs have survived two economic crises and pervasive corruption, presenting Russia with an important growth opportunity. Furthermore, these businesses have the potential to be the key to innovation and diversification in an economy that neither fosters nor rewards innovations, among economic elites who are not incentivized to invest in new start-ups.

Nikolai started his company in the late 1980s as a cooperative that distributed a variety of baked goods to centrally controlled Soviet chain stores. Many newly minted entrepreneurs at that time had no professional business knowledge or training. This was their first experience with any type of market economy and their first chance to earn an actual profit. Most of Nikolai's early decisions were based on intuition. He also faced several challenges along the way — e.g., finding rental space and acquiring capital to invest in refurbishing the cooperative's production line. The only capital he had was some savings set aside from prior jobs, a used computer, energy and good health. Soon after the collapse of the Soviet Union, all of his partners decided to quit. They doubted that Russia's environment would ever improve and sought stability by emigrating abroad. Nikolai decided to stay.

Prices for consumer goods were liberalized at the beginning of the 1990s. This step toward a market economy affected the survival of many small business ventures in Russia for whom that decade was an extremely challenging time. Inflation was rampant. It was unclear how much the cost of raw materials would escalate from day to day.

Nikolai was forced to become creative when the centrally controlled Soviet chain stores — the only retail chain in the country — collapsed along with the Soviet Union, making it difficult for entrepreneurs to sell their products. "My driver stormed into my office and told me that the stores would not take the bread or any of the baked goods we produced that day. I told him to take all the bread, put it in the back of his van and drive to one of the most crowded metro stops in Moscow. Imagine the middle of January, freezing outside…. When he came back, his face was bright red from the stringent cold but he was so exhilarated with joy; they had sold everything they had in the van."

There was a constant rotation of labor: On Mondays the employees could work as bakers, Tuesdays as drivers and Wednesdays as vendors near the metro. A majority of the revenue was reinvested immediately into the daily operations of the business, and a small portion was distributed among the employees as wages. Nikolai's business was able to survive in a country that was on the brink of social and economic collapse; other businesses would not be as fortunate.

Nikolai learned the hard way that "private ownership is an illusion in Russia. At any time, the assets of any businessman could be seized without any explanation. Russia is still far from being a free country; there are always entrepreneurs who disappear … and there is no one who is held accountable for it." The spirit of free enterprise was weak for many centuries in Russia, where a strong and merciless state restrained any action of disobedience or free will. "Currently, the risk in Russia is similar to, if not even worse than, what it used to be before," Nikolai adds. "In the early 1990s, the gangs of bandits that controlled most of the markets during the period of organized crime seemed to be more humane than the current government officials; they had a certain threshold that they abided by; now these corrupt clerks can take even the last piece from our mouths."

The Future for SMEs

Prospects for small business development in Russia depend greatly on passing and implementing laws that improve the regulatory environment for SMEs. The country faces a self-imposed drought of talented individuals; with an aging population, too many bright and young individuals seek opportunities abroad. If and when changes do occur to ease the bureaucracy and minimize opportunities for corruption, things could improve. Currently, poor credit conditions make it difficult for all but the largest businesses to succeed.

The loss in motivation to pursue entrepreneurship has been one of the biggest problems affecting the state of small businesses in Russia. According to Ovanes Oganesyan, a Renaissance Capital analyst, potential entrepreneurs prefer working for large government organizations due to the relative stability and safety this provides. The risks associated with dealing with the government through private small business ventures set the tone for the future of SMEs.

Nikolai shares the sentiment that "there is a brighter outlook for larger corporations and big firms in Russia. During the Soviet Union, everything large was considered good. Now I see a similar mentality; small business entrepreneurs were always regarded with contempt and distrust in this society." Oganesyan suggests that the government might dislike small owners because they are more independent, while larger state-owned firms need little convincing to support government policies. But many government-friendly big businesses have not turned out to be nearly as productive, profitable or innovative as the small businesses struggling to survive.

Until the day when corruption and credit obstacles are removed, Sinodov remains cautiously skeptical while reflecting on the future outlook of roem.ru. Due to an unstable income stream from ads, no access to capital and an even-more-unreliable government legal structure where "laws can be enacted at any moment and are constantly changing," the future is bleak. In the meantime, Sinodov has learned to take matters into his own hands, to be pro-active and to live in the present as far as his business activities are concerned.

This article was written by Florentina Furtuna and Anna Ruvinskaya, members of the Lauder Class of 2013.

Globalization and the French Horse Racing Industry

On a serene Tuesday evening, as the sun begins to set and the clouds reflect an ethereal glow from city lights, crowds congregate at the Vincennes racetrack just outside Paris. Proud horse owners, the bourgeoisie families gather on the indoor balconies of the hippodrome for dinner as they follow the races with binoculars. Parisian locals, mostly aging lower-to-middle-income laborers and salary men, congregate on the outdoor stands and pore over the plethora of statistics available for each race. They ardently debate each horse's genealogical lineage, the performance of the jockeys, the quality of the trainers, the condition of the turf, and whether horseshoes should be worn on the front hoofs, the hind hoofs or not at all. No detail is too trivial to be factored into a bettor's secret recipe for selecting the winning horse.

A scene much like this took place in exactly the same location in the nineteenth century, a testament to the fact that horse racing today is one of the least modernized and most perennially popular sports in France and around the world. The Tour de France takes place once a year and the World Cup is played once every four years, but each year more than 10,000 horse races are followed closely by 6.5 million bettors, wagering more than €9.5 billion (US$12.7 billion). At the heart of French horse racing is Pari Mutuel Urbain (PMU), the state-supervised horse racing authority, the second largest betting organization worldwide and the single largest supporter of the French equine industry. PMU acquired its name after revolutionizing horse-race betting 80 years ago by bringing pari-mutuel betting from racetracks to urban centers, thus popularizing the sport in villages, towns and cities all over France with a network of more than 11,000 points-of-sale.

The rituals and traditions of French horse racing have endured, but today the industry faces very modern threats: an aging bettor profile, a growing contingent of potentially untapped online gamers and gamblers, and competition from new horse race betting operators who contest PMU's support from the French government.

These challenges, hastened along by the loss of monopoly status for online betting in France in 2010, became a catalyst for PMU to modernize its commercial approach strategically and promote the globalization of the French horse-racing industry. As the largest pari-mutuel betting operator in Europe and the second largest in the world, PMU responded proactively and turned these challenges into opportunities to become better prepared for the globalized economy.

Curtailed from Expanding Abroad and Restrained at Home

With the development of European Union free trade agreements, PMU saw its monopoly status to operate horse-race betting become a barrier to both international expansion and competitiveness at home. In 1989, PMU's attempt to expand by offering French racing content exclusively through a Belgian partner competed directly against U.K. gaming company Ladbroke's Belgian subsidiary. Ladbroke lodged a complaint with the Court of the European Communities, which levied a fine against PMU for receiving French government support. In 1997, Ladbroke filed a second complaint when the French government reduced the state betting levy by approximately 1.1% to help develop PMU's social scheme, implement a computerized betting system and restructure PMU's majority shareholders. Ladbroke and PMU finally settled the issue in 2001, when it was decided that PMU's expansion into horse-race betting in Belgium would be limited to a standard business-to-business exportation model.

At home, PMU's future competitiveness was potentially at risk when, in 2007, the French Supreme Court reversed a 2005 court decision blocking Maltese ZETurf.com from accepting bets from French bettors online, declaring it a violation of Article 49 of the founding treaty of the European Economic Community. ZETurf.com took advantage of differing tax structures within the EU countries and paid only 0.5% tax to the Maltese government, allowing the company to retain 4.5% in profits while still distributing 95% of bets back to players. In comparison, PMU paid 12% in French taxes and 8% to the French equine industry. After deducting operating costs, it could redistribute only 74% of bets back to players. Due to its monopoly status at home, PMU could not protect the French horse-racing industry from an offshore competitor that offered a 28.4% greater average return to its players.

The online French horse-race betting industry was finally opened with the passing of the Law of May 12, 2010, which, among other measures, created the French Regulating Authority of Online Gaming (ARJEL). The mission of this independent administrative authority is to protect the consumer, recognize approved gaming operators, fight fraud and money-laundering, and control tax revenue on stakes from the three approved sectors of online gaming: horse racing, sports betting and poker. PMU lost its rights to a French monopoly for online betting but maintained exclusive rights to non-Internet betting through its physical network of betting terminals.

PMU has not only survived the loss of its online gaming monopoly, but also has thrived by leveraging its core competencies to modernize itself for the online market and globalize French horse-race betting operations. In the words of PMU CEO Philippe Germond, "the loss of monopoly status presents a company with the ideal opportunity to reinvent itself."

First, ARJEL's impartial regulation of online gambling leveled the playing field for all betting operators and eliminated the advantages of operators located in tax havens, such as ZEturf.com in Malta. Foreign gaming websites were free to request a license to operate in France, but were required to pay the same taxes and contribute the same percentage of their stakes toward supporting the French equine industry as PMU had always done. Higher taxes eroded profit margins and reduced the competitiveness of foreign operators who did not benefit from PMU's long history, brand recognition or economy of scale.

Second, rather than choosing to simply defend its position in horse-race betting, PMU moved into the previously unexplored markets of online sports betting and poker to become a one-stop-shop for French gamers. This key strategic decision was designed not only to cater to the rapidly increasing popularity of sports betting and poker in France, but was also an attempt to rejuvenate an aging consumer base by attracting a new generation of younger players. A redesigned PMU.fr website that offered sports betting and poker alongside traditional horse-race betting coincided with the launch of a radical marketing campaign that was far from PMU's traditional image. Humorous television advertisements featuring star jockeys in fish-out-of-water sports situations (for example, performing the All Blacks Haka dance before a rugby match or sitting on each other's shoulders to compete against a basketball team) were voted France's second-favorite advertising campaign in 2010.

Third, the ability to offer a large betting pool is a critical point of competitiveness in pari-mutuel betting. According to Gilles Bourron, PMU's head of treasury and insurance, "one of PMU's core strengths has always been our large player community. In pari-mutuel betting, where the amount of the winning pay-out is a percentage of the total amount wagered, PMU benefits from having a large number of bettors and a large total wagered amount, which allows us to offer more exotic and profitable betting products." In 2010, 6.5 million players made five billion bets, and PMU is still the only betting operator that can offer eight ways to bet on each race with a daily €1 million (US$1.34 million) "Tirelire" (jackpot).

The Globalization of French Horse-race Betting

The successful navigation of international and online regulations has not only allowed PMU to enter the sports-betting and poker markets, but has also potentially put PMU on pace to saturate the horse-race-betting market in France. After more than a century of perfecting the pari-mutuel betting business model at home, PMU and horse-racing associations have leveraged their core competencies to aggressively globalize a traditionally local product by exporting French races and importing foreign races for French bettors.

PMU's enormous common betting pool and the array of simple and exotic betting products make partnerships with PMU particularly attractive to foreign horse-race-betting operators looking to offer more profitable betting products to their betting community on PMU's IT platform. This platform is a result of significant PMU investment in order to keep up with the volume of betting, allowing bettors to place bets almost up to the start time of a race and distributing winnings merely five minutes after the official results are announced.

With France as the home to the most active horse-racing industry in Europe, PMU developed a business-to-business media and information network and created a dedicated television channel, *Equidia*, devoted to high quality live coverage of races. Bourron explains the critical relationship between information and propensity for betting: "It is well known that real-time race images significantly increase the volume of bets placed. *Equidia* has won numerous awards for excellent coverage. With multiple cameras covering all areas of the hippodrome — race track and stable areas, *Equidia*'s live commentary is engaging and provides complete information on races." Images, videos and statistics are transmitted in real time to bettors in France and abroad via television, Internet and physical betting terminals.

PMU has been licensing and exporting images of French races through these networks since 1987 and has been offering French bettors foreign races since 1997. According to Aymeric Verlet, PMU's international development director, "international expansion is extremely important for the future on both fronts: offering more foreign races for French bettors and offering more French races to bettors abroad. We are continuously looking to broaden our partnership base and deepen our relationship with these partners." Starting with countries with the least amount of cultural and physical distance, such as those in Western Europe or Francophone Africa, PMU has moved further from its geographic comfort zone to partner with betting operators in countries like the U.S., Hong Kong and Argentina.

Local Malians, similar to their counterparts in many other francophone African countries, were already following French races and placing bets through local operators, so PMU was able to benefit from the vestiges of a colonial pastime to organize a previously unstructured market by offering an official agreement to provide French horse-race betting. South American and Asian races present an interesting alternative to French racing for European bettors due to time differences and opposing seasons. Argentinean races, for example, could be offered during the late evening and in the winter in France, when local races may not be available.

As a consequence of developing business-to-business partnerships for the last 10 years, as of June 2011, PMU was involved in 57 international partnerships, nine of which benefit from sharing PMU's immense betting pool. These business-to-business partnerships represented €384 million (US$516.9 million) in 2010 revenues. To continue growing, might PMU now be free to consider more than just business-to-business partnerships through the acquisition of a foreign operator and provide direct business-to-consumer betting services? Before the aggravation of the European crisis, Odie, PMU's Greek homologue and current partner, was a noteworthy candidate with which to examine a new business model of expanded control in a foreign market.

The broadcast in Athens of the October 14, 2010, Prix de l'Arc de Triomphe marked the debut of PMU's partnership with Odie and was the first step in a chain of events that might ultimately result in PMU acquiring its first-ever international subsidiary. On December 2, 2010, George Kyriakos, special secretary of state-owned enterprises at the Greek Ministry of Finance, presented Odie as an example of one of numerous privatizations planned to raise a portion of the €54 billion (US$72.5

billion) required from Greece as part of the €118 billion (US$159 billion) bail-out orchestrated by the IMF. The partnership between Odie and PMU and French horse-racing associations could double revenues by increasing the number of races, introduce a 50/50 mix of Greek and French products, increase Odie's physical network to 1,000 points-of-sale, and leverage PMU's marketing expertise to broadcast races on a new, dedicated national television channel. Greece also planned changes to its Internet gaming laws in hopes of tapping into the estimated €4.3 billion (US$5.8 billion) Internet-gaming black market.

If it were to follow this strategy, PMU could drastically reverse the Greek racing industry's downward momentum. Although Greece, like France, has a history of horse-race betting, the state of racing in Greece is in a downward spiral in which an insufficient number of races results in meager betting revenue, which further reduces the number of racing events. However, in order for PMU to export its proven business model of pari-mutuel betting, Odie would need to have full control and supervision of the races in Greece, as PMU and horse-racing associations do in France. Currently, that authority rests with the Jockey Club of Greece, which, unlike PMU and the French horse-racing associations, has no stake in Odie. A change so fundamental to the structure of the Greek horse-racing industry might take years of legal wrangling within parliament.

Although there is positive long-term potential for an acquisition in Greece, prospects are clouded by the short-term uncertainty in Greece's and Odie's finances, liberalization of Greek Internet gaming regulations and Odie's ability to obtain greater control over the horse-race organization from the Jockey Club of Greece.

New Demographics, New Games, New Markets

No matter how the Greek partnership evolves, however, the opening of the French online gaming market and PMU's diversification into sports betting and poker present the company with several strategic opportunities and challenges.

One such opportunity is the potential for PMU's rebranding to offer a younger demographic a unified betting platform that places sports betting and poker alongside PMU's core horse-racing product. Sports gamers might also be drawn to a new PMU television channel that targets horse aficionados and racing fans rather than the gambling audience of *Equidia.*

A second opportunity is to grow a strong PMU presence in the online sports-betting and poker markets themselves. Between the opening of the online market in 2010 and August 2011, €12.4 billion (US$16.7 billion) of total online stakes were collected for the entire French market. After the tax payments and distribution of winnings, the net gambling product was €200 million (US$270 million). Of this amount, online sports and online horse-race betting accounted for 12% and 26%, respectively, and poker accounted for the remaining 53%. In terms of market share, PMU maintained 84% of the online market share for horse-race betting and gained 18% market share for online sports betting and 6% for poker: These advances placed PMU as the first global operator in the French online market.

However, the online market of horse-race betting, sports betting and poker combined represents only 10% of PMU's stakes. The remaining 90% of stakes are collected from off-line horse-race betting points-of-sale. Should PMU push into sports betting and poker to continue to expand its presence in the French online gaming market? And would such a move be in line with its priority of supporting the French equine industry?

Finally, a third opportunity is for PMU to realize its mission to improve the equine industry in France by actively boosting the global horse-racing market through direct foreign partnerships. Perhaps the success of a direct investment into a foreign network, such as Greece or another European country, would suggest the viability of similar business-to-consumer expansion into other horse-racing markets such as Asia, South America, Africa or beyond.

This article was written by Elsie Iwase, James Tanabe and Annie Wang, members of the Lauder Class of 2013.

Spain No Longer Battling the Windmills

Comparing Spain's current market grasp on wind energy with the quintessential Spanish literary symbol — Don Quixote battling the windmill in La Mancha — offers a certain irony. If Don Quixote is the representation par excellence *of Spanish culture, today he would no longer be battling windmills, but rather trying to figure out how to manufacture them most efficiently and then exporting his business model all over the world.*

Were this newly imagined persona to drive around in his car and explore the expansion of Spanish multinationals that specialize in wind energy, he would find one company's logo etched on some of the most sophisticated turbines on every continent. Gamesa Corporación Tecnológica's rapid and ambitious expansion story has been anything but a quixotic dream. The Zamudio-based multinational has risen to international prominence thanks, in large part, to certain strategic initiatives.

Spain became a global hub for wind energy innovation due primarily to government subsidies and the use of feed-in tariffs (FITs). According to Cynthia Graber, a journalist who has covered Spanish renewable energy, the growth of wind energy in Spain arose out of local needs to reduce dependence on foreign oil and to lower carbon dioxide emissions. As a result of the oil crises of the 1970s and 1980s, Spain passed a series of laws, beginning with Royal Decree 82/1980, mandating the development of local energy sources. In 1994, Spain joined many other European countries in instituting the use of FITs as a mechanism to advance renewable energy development.

FITs provide market certainty for energy companies through government-set prices for certain sources of energy, allowing producers to sell directly to producers at a highly subsidized rate. For example, Royal Decree 661/2007 set a price of €7.32 (US$9.74) per kWh for the first 20 years. As a result of this government intervention, Spanish wind-energy companies such as Iberdrola, Gamesa and former wind-giant Ecotecnia could confidently invest in technologies that at the time would not have been profitable.

Today, Spain produces 20,676 MW of solar power annually, with a goal of reaching 35,000 MW by 2020. At first glance, this goal may appear to be insurmountable. However, in 2000, the country produced a mere 2,358 MW from wind energy. Spain is the fourth-largest producer of installed wind energy power, behind China, the U.S. and Germany, but its multinational wind-energy companies compete all over the world, including these top three markets. In the Spanish context, Iberdrola is the major operator of wind farms, Acciona is the leading developer of wind farms and Gamesa is the main manufacturer of wind technologies.

Gamesa exemplifies the market prominence of Spanish wind-energy multinationals. Not only is the company a leader in wind-turbine manufacturing, but it also develops and operates wind farms around the world, differing from competitors such as Siemens that only manufacture turbines. According to BTM Consult, Gamesa is the eighth-largest wind-turbine producer in the world (all market shares henceforth refer to MW installed base capacity). The company has remained a key global player over the past 35 years for three reasons: a willingness to go global, an ability to refocus the company and adapt to market needs, and, most recently, an emphasis on developing innovative new technologies through a wide variety of sources. If Gamesa is to remain competitive in today's grim hypercompetitive market, it will need to continue to build on these traits.

Going Global

Going global has played, and no doubt will continue to play, a fundamental role in Gamesa's history and future expansion. According to CEO Jorge Calvet, who spoke at the Forum Europa Tribuna Euskadi conference held in February 2011 in Bilbao, "the economic model is changing at a global level, and Gamesa must play its hand on an international stage. Gamesa has had no choice but to be a global corporation."

Going global has allowed companies like Gamesa to hedge their risks and compensate for slow growth in certain regions while achieving fast growth in others. Much of this was spurred by a management change in the aftermath of the 2008 financial meltdown, when Gamesa suffered from mass order cancellations. In 2009, the company appointed Calvet as CEO. "At the end of 2009, 35% of [the company's] sales were in Spain," he said. "Today … sales in Spain are exactly zero. [We] do not sell anything there." This strategy has proven to be very fruitful. During the first half of 2011, the company increased sales of wind-turbine generators by 26%, despite no domestic sales. Recognizing that its home market was tepid at best, Gamesa was able to increase profits by focusing on other markets.

Beginning in 1999, the company began moving outward, first in nearby countries such as Portugal (1999), Italy (2001), Greece (2001) and France (2002). Not only were these countries geographically close, but they were also all in the eurozone and, therefore, shared a currency and common cultural and historical traits. Gamesa simultaneously expanded to the Americas, setting up operations in the Dominican Republic (2000), Mexico (2001) and Brazil (2001). This expansion was logical because of the shared colonial ties stemming from Gamesa being a Spanish company already installed in Portugal. In 2002, the company entered the U.S. market through acquisition of the Minneapolis-based Navitas Energy. Gamesa then moved to more distant markets such as Australia (2003), the U.K. (2003), Germany (2003), China (2005) and India (2009).

Today, Gamesa has 32 production facilities all over the world and supplies generators to every habitable continent. During the first half of 2011, Latin America accounted for 19% of sales, China for 20% and Europe for 27% (mostly in Eastern Europe). The U.S. accounted for 15% of sales with about 1,000 employees in the country and manufacturing facilities based just outside Philadelphia. On a visit to one of the U.S. plants, President Barack Obama noted: "I think that what you do here is a glimpse of the future…." Gamesa is a multinational today, spreading its risks and profits all over the globe.

Developing a Competitive Edge

In looking at a timeline of the company, it would be difficult to identify a single core competency. Instead, Gamesa's core competitive advantage is its ability to redefine itself and develop new market niches.

Gamesa began in 1976 as a metallurgical producer of industrial equipment in the automotive sector during a boom in Spanish automobile manufacturing. Recognizing that it was attracting top engineers and gaining market position, the company diversified into fields such as robotics, microelectronics, composite materials and environmental protection. However, as many of these industries were lost to more competitive markets overseas, Gamesa needed to find a new focus. In 1993, the company entered the aeronautics market through a government-subsidized program and began supplying airplane and helicopter body components, entering into valuable contracts with Brazilian company Embraer, among others. However, this focus was short-lived and was phased out 10 years later.

Such prior industrial acumen helped Gamesa develop a competitive edge. For instance, the company gained know-how from navigating through the Spanish government and learning how to take advantage of subsidized industries, as it did with the aeronautical industry. Yet it is Gamesa's ongoing experience of being a leading innovator in all the fields that it enters that unifies its diverse and often unpredictable trajectory.

For example, Gamesa has weathered global competition in the wind-energy sector through an ideal innovation strategy. Recognizing the need to become a major player in the development of wind turbines, in 1994 the company established a joint venture, Gamesa Eólica, with Denmark's Vestas and the government of Navarra. This partnership allowed the company to enter the wind turbine market with lower risks and to gain industrial know-how through access to Vestas' technology. By 1997, Gamesa Eólica controlled 70% of Spain's wind-turbine market. In 2001, reaping the benefits of a market advantage, Gamesa purchased Vestas' 40% stake in the venture. Perhaps most importantly, Gamesa was able to retain intellectual property rights and to leverage the knowledge it had already gained from Vestas.

Between 2003 and 2008, Gamesa began to develop its own technology, blazing a path distinct from Vestas'. Today, the company is a global leader in wind turbine innovation. According to Antonio José de la Torre Quiralte, product development director of the technology division, his company's recent innovations will allow Gamesa to continue to prosper globally. He cited Gamesa's dedication to product development, noting that the company had logged 1.5 million hours of engineering and testing to ensure that it was producing the best turbines possible.

An aeronautics engineer by training, de la Torre described the G10X generator system, referring to the impressive size of the rotor blades, doubled from the previous model and, therefore, allowing for a large increase in power generation per unit. The project required the work of about 150 engineers worldwide for six years. According to a Gamesa press release, each turbine is capable of supplying power for 3,169 households per year. To underscore the importance of these turbines, one turbine would be able to replace approximately 1,000 tons of petroleum and eliminate 6,750 tons of carbon dioxide emissions annually.

De la Torre explained that Gamesa's G10X generator is centered on the company's six new technologies: the Innoblade, the MultiSmart set of control strategies, the CompactTrain, the GridMate, the ConcreTower and the Flexifit. The advent of the Innoblade solved one of Gamesa's major problems with developing products that required export to countries all over the world: the transportation of massive structures. With increasingly high oil prices and country-specific regulations concerning the transport of heavy 62-meter-long metallic blades, Gamesa developed a segmented blade divided into 30- and 32-meter parts. This unique technology allows the company to export blades for 5MW and larger generators with transportation costs equivalent to those associated with blades used for 2MW generators, giving Gamesa a strong competitive advantage.

At the same time, the MultiSmart set of control strategies involves software that constantly monitors and minimizes the vibrations of each blade, reducing resistance and improving efficiency by 30%. The CompactTrain technology addresses the problem of complex gear technology with too many parts by creating a medium-speed two-stage system that involves fewer parts and is more compact. The GridMate facilitates optimum connection to grids and allows for higher voltage dips, responding to increased global energy demand and the complexity of modern grid systems. The ConcreTower ensures stability, lowers costs associated with transport of the tower parts through the use of new concrete-and-steel-based technology, and is simple to assemble on site. Finally, the Flexifit is a self-assembly and lifting apparatus that eliminates the need for large external cranes, thereby reducing maintenance and installation costs. In combination, these technologies have produced a highly efficient, low-cost turbine.

To maintain its position as a leading innovator in wind technologies, in 2010 Gamesa invested approximately 2% of its revenue in R&D. In addition, in May 2011, the company announced it will diversify into new renewable technologies by starting a corporate venture capital fund that will invest up to €50 million (US$66.75 million) over the next five years to become a minority shareholder in a large number of renewable-energy-related start-ups. It will focus primarily on wave and tidal, next-generation photovoltaic energy, energy storage, electric vehicles, energy efficiency and off-grid technologies. Gamesa's goal is to be at the forefront of renewable-energy technologies and to develop innovative strategies to match these technologies.

Uncertain Winds

Today, Gamesa faces challenges both in its home country and abroad to maintain its position as a global leader in the design, manufacture, installation and maintenance of wind turbines and the construction of wind farms.

One of the primary challenges to the company's success is on its home front. According to a business manager at one of the largest renewable-energy companies in Spain, who works closely with lobbying groups in the country's wind-energy sector, government subsidies may no longer be available to the extent they have been in the past. In February 2010, the Spanish government announced it would cut spending to reduce its budget deficit to 3% of its gross domestic product by 2013. Prior to that announcement, in May 2009, Spain had already cut subsidies, reportedly because the government had predicted it was already on track to meet long-term goals.

Coupled with the current uncertainty of Spain's national debt, these announcements indicate the business manager's fears may come true. According to him and to a strategy specialist at the same company, government subsidies are still essential for maintaining profitability in Spain. Gamesa may encounter challenges within this context, facing possible drastic reductions in local revenues. Moreover, any market uncertainty in Spain and the possibility of a nationwide collapse of the economy would undoubtedly create risks for the company due to the fact that its main office and R&D facilities are located in Spain.

The second major challenge is the rise of multinationals in the wind energy sector from emerging economies such as China and India. According to BTM Consult, China currently dominates the global market of wind turbine suppliers with seven companies among the top 15 worldwide suppliers in 2010, controlling nearly half the US$45 billion global market. In addition, China currently leads the world in wind energy supply at home, recently surpassing the U.S., and has adopted protectionist regulations to disadvantage foreign players.

For example, in China, Gamesa is obligated to buy components for its generators from local suppliers, forcing the company to invest in understanding unfamiliar distribution channels and detracting from some of the competitive advantages it has developed in turbine production. Moreover, these same local suppliers sell parts to Chinese competitors, which enjoy low-interest loans and low-cost land from the government. Regulations such as these have changed Gamesa's status in the Chinese market. Six years ago, the company had a third of this market; today, Chinese companies control 85% of the market, leaving Gamesa with a mere 3% market share. To make matters worse, these Chinese companies are starting to expand abroad.

Given this situation, Gamesa will need to leverage even more of its resources and intangibles to succeed and sustain its revenues to maintain its competitiveness. While there is room to grow — wind energy is expected to triple its worldwide energy share to 9.1% in 2020 — the company will have to make even more difficult strategic decisions.

Gamesa's most recent developments have been a series of ups and downs. The downs have been due mostly to a widespread economic collapse in Spain, with the blue-chip IBEX-35 nose-diving since early August 2011 due to concerns about the Spanish debt. The ups, on the other hand, seem to be promising and suggest that Gamesa will be a global competitor for a long time, despite the rise of Chinese multinational wind-energy companies. With its 29% growth in the first half of 2011 and 26% sales growth, Gamesa noted in a press release that "the internationalization of our sales and seasonality in Asian markets allowed us to cover 77% of our 2011 sales target at the end of June."

Gamesa's entrance into the Indian market has been highly successful, gaining about 10% market share in just 18 months. Harking back to the Chinese threat, Gamesa has adopted an "if you can't beat them, join them" mindset, entering into strategic cooperation pacts and dealing with various Chinese renewable energy groups in April 2011. Gamesa was one of a few Spanish multinationals that spearheaded a recent Spanish push for a corporate presence abroad, spurring Spanish Prime Minister José Luis Rodríguez Zapatero to proclaim, "China should be the priority of our economic diplomacy, which is a more and more important element."

Meanwhile, on the innovation front, Gamesa has unveiled ambitious plans to build an offshore wind technology facility in Glasgow, Scotland, where it hopes to implement the technology it develops. The €50 million (US$66.75 million) investment is a good strategic move, according to de la Torre, who sees offshore wind technology as the future of the company.

With its successful expansion across the globe, increased revenues to invest in R&D and innovation, and its managerial ability to redefine itself, Gamesa is poised to remain a key global player. However, unless it continues to leverage what has kept it afloat over the decades, Don Quixote may be battling the windmills once again.

This article was written by Felipe Correia, Kevin Hess, Eduardo Küpper, Leonardo Oliveira and Hugo Yoshinaga, members of the Lauder Class of 2013.

Microcultures: Cultural Sustainable Development in France

In early 2011, Louis-Jean Teitelbaum and Jean-Charles Dufeu embarked on an innovative project. Combining their interests in technology, the arts and e-commerce, they created Microcultures, an online company that provides strategic, operational and financial support to independent music artists. Teitelbaum and Dufeu, the company's founding partners, are among the first entrepreneurs to promote an important and recent trend in France: the sustainable development of culture.

Ordinarily, the concept of sustainable development covers three areas: the environment, the economy and social impact. In France, the private and public sectors have initiatives dedicated to sustainable development in all of these areas. This background, combined with the presence and importance of culture to French society, creates room for the insertion of a fourth area in France's sustainable development framework: culture. Microcultures is new company giving credence to this phenomenon.

Microcultures is an artisanal and participative art production house that links consumers and music artists. Consumers, or microcultivators, have the opportunity to donate funds to up-and-coming artists listed on the company's website. Acting as an intermediary, Microcultures manages these funds for the artists, while the consumers, through their funding, feel they are part of the creative process for their favorite artists. "We want to make the link between the artist and its public the most direct possible," says Dufeu. "Following the same model as that of agricultural cooperatives in which producers sell products of higher quality and freshness directly to consumers, we want the cultural transaction to happen with the least intermediation possible, with a transparent financial relation between artist and public."

Microcultures' approach is to promote new music creation and to allow microcultivators to play an integral part in this process. To make all of this possible, the company adheres to the two main pillars that make up its business model: It provides support to selected artists, and it facilitates public involvement with, and investments in, these artists.

For the first pillar, Teiltelbaum, who studied philosophy and freelances in web design and development, and Dufeu, who has experience as a web editorialist and in the music industry's production and distribution areas, have chosen to work with a select number of music bands in a qualitative and quantitative way. Qualitatively, the company works as the band's strategic agent and operational manager, whether launching an album or staging a concert. Quantitatively, Microcultures helps artists gain access to a public willing to invest in their creative ideas. The company accomplishes this by offering the public a pre-sale of each band's music and other products, thereby generating a cash flow that is used to support the artists financially. Here, Microcultures' goal is to guarantee the development of independent art that otherwise may not have had the means to grow.

Microcultures also seeks to facilitate public involvement and investment in the arts. "Although we had an

American website called Kickstarter as an inspirational model, we wanted Microcultures to go further," notes Dufeu. "Rather than just raising funds, we wanted our customers to join us in the creation of art itself." Microcultures' second pillar reflects this idea. By offering the public constant updates on each band's development and by providing each band with real-time feedback from the public, the company seeks to keep the microcultivators and the artists as connected as possible during the creation process. This set-up allows the artists to remain cognizant of their pre-sale success while seeking to respond promptly to the preferences of the public and maintaining their creative integrity.

The idea of allowing consumers to contribute to the company's sustainable efforts already exists in other sectors — for example, buy one pair of shoes and give another in the apparel industry, or purchase organic, environmentally friendly products in the food industry. In the same way, Microcultures satisfies its role as a promoter of the sustainable development of culture by establishing a relationship between artists and the public, based on the process of creating the art and not only the end-product of the art, such as an album or a concert.

Microcultivators have even begun to recognize their role as participants in the sustainable development of culture. In a recent survey, they voted that Microcultures' mission (90%) and its direct support to artists (97%) were "important" or "very important" in their decision to invest in the company's artists. "Actual products offered" on the website were voted as "important" or "very important" by 76% of the respondents. In addition, 95% of the respondents voted that their need to be culturally responsible was "important" or "central" to their participation in the projects. "We play under the idea of 'sustainable commerce' because we promote the same values as the traditional sustainable commerce: valued remuneration to artists, purchase act transformed into responsible act, proximity between artist and consumer, lack of intermediaries, and quality products," says Dufeu.

Cultural Sustainable Development in France

One major reason for Microcultures' success is the existence of a unique phenomenon: French society ascribes significant value to sustainable development and to culture. The distinct combination of these two values allows for a crossover whereby different stakeholders in the society are willing to take responsibility for culture development and culture sustainability. Microcultures presents itself as an alternative vehicle for this conscientious consumption and sustainable development of culture.

In addition to valuing sustainable development, French society fundamentally values culture in the day-to-day activities. Along with the U.S., France places eighth in total spending on recreation and culture. The French government plays an active role in supporting cultural activities, financing or managing 1,212 "Musées de France." Support from citizens is also outstanding, given that more than 30% of the French population visit at least four cultural venues a year — e.g., movie theaters, museums, historical monument sites and street performances. Finally, the French spend from 8% to 15% of their household budget on cultural activities.

Apart from culture and regarding sustainable development on its own, the French government, through the public sector, has shown a commitment to environmental sustainability. For example, as a result of government incentives and campaigns, France has already reduced 7% of greenhouse gas emissions, exceeding the Kyoto protocol's agreement for 2012. In addition, the government plans to increase the renewable share of the country's total energy consumption from 7% in 2004 to 20% by 2020.

France's governmental policies are known for their supportive approach to social issues. The country spends a higher percentage of its GDP in this area compared to other members of the European Union. Finally, the government's efforts to include sustainability as an integral part of its strategy can be seen through the creation of the "National Strategy of Sustainability" for the period between 2010 and 2013. An interministerial committee monitors the development of this strategic plan within each ministry's program and assures the integration of a sustainability action plan.

In the private sector, successful examples of French companies' participation in sustainable development are found in various industries. French automobile manufacturers produce cars with the lowest gas emission rates in Europe. Solidarity funds are also very popular in France and account for the country's fourth-place position in the European socially responsible investment rankings.

In addition, over the last few years, both the public and private sectors have interpreted French culture as an important dimension of sustainability in France and have envisioned ways in which the arts can contribute vastly to the country's sustainable development. According to Frederic Mitterrand, the French minister of culture and communication, "sustainable development requires a profound transformation of the relationship between men and their environment, to make the world livable while respecting its natural and cultural diversity."

Mitterrand's comment raises concerns about culture diversity and relates to the increasingly spreading idea of "culture exception," discussed in depth by the World Trade Organization during the General Agreement on Trade in Services in 1993. According to this idea, because culture products embody so much of a country's civilization and identity, the arts industry should receive support from the private and public sectors, as do other spheres of sustainability (e.g., the environment). Integrating culture into the concept of sustainability actually stabilizes development, as culture can boost environment and social initiatives and vice-versa.

While this transformation can be pursued in various ways, some are already being deployed. For example, the dance event "Le Défilé," which takes place in Lyon, integrates the cultural and social spheres of sustainability through its main objective — the social inclusion of professionally disadvantaged people. This event offers less-favored citizens a professional path into the arts by enabling them to participate in performing dance groups. At the same time, it assures that new artists' productions are disseminated across all the social classes. This event creates awareness for, and interest from, a vast public to new cultural productions, promoting opportunities for new artists to succeed. Also, the ministry of culture and communication itself has been allocating 26% of its budget to broadening the access to, and the democratization of, culture. In addition to contributing to social welfare, this initiative also helps create market conditions by increasing the demand for culture.

In summary, the integration of culture in sustainability in France depends on two drivers: assuring market conditions for arts creation and providing the means for the public, government and other stakeholders to contribute to it.

Microcultures positions itself as an agent of change for sustainable culture, as it participates in both drivers. On the first point, as noted above, the company supports independent artists' creations financially and managerially. On the second point, the company identifies a common sustainably responsible profile among its stakeholders and creates innovative ways for them to contribute to cultural sustainability.

Based on a survey of its stakeholders, Microcultures states that consumers of art products are conscious of the sustainable development of culture and are willing to participate. When asked what prevented them from being more participative, only 20% of the microcultivators mentioned a lack of interest. However, the survey results indicate that the 80% who are interested do not participate more actively because they still do not have the means to do so. Among the reasons they mentioned are the lack of more affordable ways to participate, the lack of time and limited access to the artists' creations.

Microcultures is, therefore, positioning itself to provide the tools consumers need to act as stakeholders in the phenomenon of cultural sustainability by offering a range of products in terms of price, content and format. Connected to this relationship with consumers, the company closes the circle among other stakeholders: the independent artists searching for support and the government willing to ensure culture production.

Three Avenues to Growth

Even though it is advancing at a rapid pace, Microcultures is still a start-up that needs to solidify its position and grow its presence. The company's growth is a benefit both to its owners and to the French society, since its success boosts the promotion of cultural sustainable development in France.

In what ways can Microcultures strengthen and grow? Conversations with the owners and analyses of the client base and the market have shown three main avenues: first, to increase the participation of the already culturally responsible public; second, to make culturally responsible the public that already acts in a sustainable way in the three traditional spheres of sustainability; and third, to transform into a culturally responsible group the public that is not yet responsible in any of the other spheres.

To increase the participation of the already culturally conscious public, including the microcultivators, Microcultures can increase its offerings by adding projects in different domains of art, such as writing, and by adding different offerings to the arts with which it works already. This last activity would not only increase the revenues for bands, but would also increase the connection between the artists and the public. Products such as meetings with the artists, private chats or participation in rehearsals and tours would enable consumers to remain connected.

To attract environmentally or socially responsible consumers to act in concert in terms of culture, Microcultures can leverage the means used by the other spheres to present new ideas and products to the public. One example would be investing in marketing partnerships with companies closely related to sustainability, such as Whole Foods, a retailer that attracts already-responsible customers who may not yet know about the possibility of participating in cultural sustainability as well. Through these partnerships, the company would be able to offer its products in a gift-card model, for example, that would spread the cultural sustainability concept.

Finally, to attract those who are not concerned about sustainable development, Microcultures may seek to attract consumers based on pure product features and content, to then increase their awareness of sustainable development and to then promote their active participation.

Expectations of a First Mover

Microcultures positions itself as a first mover within an innovative business model of art production and cultural development through funding and support. The company promotes itself as a promise of success for its proximity to, and positive response from, the target market.

The company's current client base is already formed mainly by conscious sustainably responsible customers. Their interest in participating in arts development is a crucial element in the phenomenon of integrating culture into sustainability. By expanding its horizons to environmentally and socially responsible markets, the company's goal is to not only solidify its operations, but also to set itself as an example of a successful cultural sustainability supporter to other private companies.

More than focusing on business performance, Microcultures takes this unique opportunity to lead by example and influence other stakeholders in the private sector to develop solid support for the integration of culture as a main pillar of sustainability in France.

This article was written by Lindsey Laveaux, Paula Martinelli and Camila Penazzo, members of the Lauder Class of 2013.

The Unexpected Early Winners of the Arab Spring

After toppling long-standing regimes, destabilizing others and grabbing the world's attention, the Arab Spring's protestors most likely remain amazed at the far-reaching effects of their actions in early 2011. Although their demands in Tunisia and Egypt were focused squarely on long-term economic and political betterment, they also had an immediate impact on investment prospects in two countries that are geographic bookends of the Middle East — Morocco and Iraq.

Indeed, the near-term beneficiaries of the Arab Spring may be those farthest from the intense protests. Both Morocco and Iraq are attracting fresh foreign investment as countries such as Egypt and Tunisia — the current champions for long-term economic opportunity — see investors flee to countries that formerly took a back seat to their relative dominance.

Already positioned with established, aggressive programs to attract investors, Morocco and Iraq are among the early winners of the Arab Spring. Morocco, whose popular king has reigned for the last 12 years with a record of dramatic reforms targeted at modernizing the economy, seized the opportunity of turmoil elsewhere by embracing a new, stability-inducing constitution that is already paying dividends. In the case of Iraq, which continues to find its political footing and secure rising oil revenues, foreign investors are giving the country a fresh look since the unrest began in January 2011.

While each country's long-term economic appeal remains to be seen as the region's political battles are fought, Morocco and Iraq — each distinctly affected by its pre-Arab Spring circumstances — have emerged as early economic winners.

Morocco: A Long Wait in the Corridors

Morocco's ability to seize the changing tides of the investment landscape in the wake of the Arab Spring is not surprising in light of its track record over the past 10 to 15 years. Under the leadership of the current king, Mohammed VI, the country has aggressively pursued economic liberalization with clear positive outcomes, including a competitive telecom market with three licensed operators following the privatization of the industry in the 1990s, and a thriving Tangier Free Zone that has brought 475 international companies to the country's main Mediterranean port.

In 2008, automobile manufacturer Renault-Nissan inked a deal to begin construction of a vast industrial complex in the Tangier Free Zone at an estimated cost of nearly €700 million (US$1 billion), one of its largest investments in the African continent. According to Jacques Chauvet, Renault's head of Europe, Middle East and Africa operations, Morocco's growing domestic consumer market, its strategic proximity to various European and African countries and its reliable infrastructure with strong labor-cost advantages are what tipped the investment case in its favor. Thus, even prior to the events of the Arab Spring, Morocco was emerging as an attractive destination for foreign direct investment (FDI).

Some observers suggest that revolutionary sentiment in Tunisia and Egypt caused Morocco to redouble its focus on attracting investment. As the early months of the Arab Spring unfolded and despots around the region responded to protests with underwhelming concessions, Morocco stayed ahead of the curve by quickly initiating constitutional reforms and other efforts aimed at quelling revolutionary sentiments. These reforms clearly aided the investment atmosphere by reducing the perception of political instability and attracting new FDI projects during the first quarter of 2011 — a time when countries such as Egypt, Tunisia, Libya and Syria suffered significant investment outflows.

Perhaps anticipating the opportunity to affirm his country as a beacon of stability in the region, King Mohammed VI pushed constitutional reforms that further strengthened Morocco's attractiveness for investing. On the heels of the peaceful protests of February 20, 2011, the king announced the beginning of a dialogue that would change the country's constitution. His speech, unprecedented in the region for its clear and significant concessions, had messages for protesting Moroccans and others. Investors received a strong signal from his statement that "we shall continue to press ahead with thorough reforms ... in development-related sectors. We shall see to it all institutions and agencies fulfill their mission in an optimal manner, [and] observe good governance standards...." Investors observed the fulfillment of other concessions and were confident that this was definitely not an empty promise.

This and subsequent speeches were well-received by investors monitoring the shifting sands of the Arab Spring. A July 2011 survey by the Economist Intelligence Unit found that an astounding 46% of respondents cited political instability as a top obstacle to doing business in Egypt, compared to just 14% in Morocco. Moreover, the International Monetary Fund, in its July 2011 mission to Morocco, praised the ongoing governmental reforms, saying they "will enhance efforts to strengthen structural reforms and foster medium-term growth." Indeed, it seems that Morocco has been successful in using political reform as a catalyst for improving investors' perceptions of the country's political stability.

These political calculations and years of work positioning Morocco as an appealing investment destination have paid off in terms of economic prospects during the Arab Spring. In one example of a win for the country, Guy Hachey, president and CEO of Bombardier Aerospace, the world's third-largest airplane manufacturer, announced in May 2011 that Morocco was very likely to win a major industrial investment in competition with other regional players. His pronouncement praised the Moroccan government's stability and efforts at reform, noting that they allowed Bombardier to invest "with confidence."

The international law firm Allen & Overy had a similar assessment. After several months of evaluating the best expansion route into Africa, the firm decided to establish an office in Morocco in July 2011. Wim Dejonghe, the managing partner, cited the country's "exemplary stability" relative to others in the region as a motivator for the decision. Bombardier and Allen & Overy are part of a trend as investors view Morocco with renewed interest compared to its protesting neighbors. The 2011 Global Venture Capital and Private Equity Country Attractiveness Index saw Morocco's overall attractiveness ranking rise over the first and second quarters of 2011, whereas Egypt's fell over the same time period.

Most importantly, this upward trend in attractiveness is reflected in the amount of FDI projects entering Morocco, compared to its Middle Eastern and North African counterparts. According to the 2011 first quarter report by the Mediterranean Investment and Partnership Observatory, Morocco was the only country in the Middle East and North Africa regions (excluding Iraq and the Gulf nations) to record a substantial year-over-year increase (61%) in FDI project announcements during the first half of 2011. This compares with devastating decreases of 35% and 43% in Egypt and Tunisia, respectively.

Overall, Morocco has deployed a careful strategy to attract investment over the past decade and has affirmed its ability to capture opportunity during the Arab Spring. Well-designed political reforms have established the country as a center of political stability. Initial reports on FDI note that the country has recorded substantial investment growth in the first quarter of 2011. Of course, the challenge for Morocco will be maintaining this momentum as larger economies, such as Egypt's, come back refreshed.

Iraq: A Well-timed Re-entrance

Morocco is not alone in its potential for attracting new investors, thanks to shifting political instabilities and years of work liberalizing its economy. While the people of Tunisia and Egypt were revolting in early 2011, Iraq was indicating that it had, after years of struggle, turned the page toward stability and progress. Indeed, increased oil production and high oil prices are projected to result in a 76% yearly growth in oil receipts in 2011, providing significant resources to invest in the country. Even against the backdrop of an uptick in violence and concerns over endemic corruption, the Arab Spring's repainting of political risk presents an opportunity for international investors to participate in the Iraqi reconstruction project.

Iraq is hardly a new player in the region's investment scene, although the country is now likely to attract renewed attention. Iraq's fundamentals are unbeatable, with oil reserves believed to be larger than Saudi Arabia's, an educated and enterprising populace accustomed to a leadership position in its region, and high economic growth coupled with low inflation. However, despite these advantages, investors typically have been unable to commit fully to Iraq because of corruption, political risks and obstacles to FDI.

The country's governance is keenly aware of these disadvantages relative to its neighbors, even those that were formerly beacons of political stability. Iraq now employs the international accounting firm PricewaterhouseCoopers to support its transparency initiatives. More substantially, investment laws were recently changed to allow foreign investors to own land for housing projects and to exempt foreign companies from tax levies for up to 10 years. Sami al-Araji, chairman of the National Investment Commission, describes these measures as "help(ing) foreign companies and investors become involved in this massive reconstruction opportunity."

As countries such as Tunisia and Egypt go back to the drawing board to move their economies forward, Iraq is leveraging established businesses — namely those initially created to serve coalition forces — as a driver of growth. Such companies are already deeply familiar with Iraq and are poised to use their presence to sell similar services to the emerging oil and gas industry and to Iraqi consumers. The Almco Group of Companies in Iraq, for example, has shifted successfully from providing wide-ranging services to the U.S. military to providing catering and construction to the oil and gas industry. Similarly, Al Morrell Development is marketing its Oasis bottled water brand to Iraqi consumers after years of being the primary bottled water vendor for the U.S. military.

Independent of protests throughout the Arab world, the changing landscape of Iraq has already reaped benefits. Growing foreign investment and years of spending by the U.S. government have created a new wave of Iraqi wealth. These factors and surging demand from Iraqi consumers for imported products are leading international companies, aware of such shifts, to invest in brand-building and distribution in the country. Ghassan Obaid, manager of the Iraqi media company Sadaa Media, has observed this directly: "We've seen a pronounced shift in our business breakdown in the past year. International brands like Nokia, Peugeot and Pepsi now make up the majority of our advertising clients."

Iraq also has demand for housing. While housing projects are being halted in Egypt and Tunisia, international investors and construction firms are flocking to Iraq. According to Dunia Frontier Consultants, foreign commercial activity doubled in the first half of 2011, compared to 2010, with real estate being the single largest sector.

Despite this notable drive, the energy sector is still the most substantial benefactor of Iraq's relatively appealing and improving investment prospects. Forty-five international oil companies participated in Iraq's third oil-licensing auction round in the first half of 2011, and 41 have been approved to participate in the fourth round. This substantial increase over the first two rounds in 2009 is driven by the dramatic improvement in the security and political situations, and the competition should help Iraq sign favorable contracts.

These contracts promise to be major drivers of growth in the country, with the first round alone committing the winning bidders to more than US$200 billion in investment. The burgeoning oil and gas industry is also beginning to attract the interest of financial players.

Northern Gulf Partners (NGP), an Iraq-focused financial advisory firm, recently helped raise private equity capital for an Iraqi-owned oil-field services firm. Zaab Sethna, co-founder of NGP, points to this and other deals in the pipeline as not only a vote of confidence for the oil sector, but also an indication that investors believe the country is "emerging as an enthusiastic democracy with liberal investment laws."

As investment risk increases in Egypt and simultaneously decreases in Iraq, the latter is still not without substantial obstacles. The World Bank ranks Iraq 166 out of 183 for ease of doing business (compared to rankings of 114, 94 and 55 for Morocco, Egypt and Tunisia, respectively) and 175 out of 178 for levels of corruption (compared to rankings of 85, 98 and 59 for Morocco, Egypt and Tunisia, respectively). Moreover, an early 2011 effort to attract foreign investors to privatize state-owned factories failed to attract any takers. Although Iraq's stock market fared impressively through the Arab Spring — recording a 40% increase year-to-date in August 2011, compared to a 34% drop in Egypt's main index over the same period — it is clear that more challenges await Iraq to attract foreign investment.

Despite these obstacles, investors such as Sethna remain optimistic about Iraq. While new leaders in Egypt and Tunisia will struggle to meet the people's demands for economic growth, Sethna predicts that per capita GDP in Iraq will probably double in the next four years. Fast-rising incomes, coupled with increasing political stability and FDI, will allow Iraq to "regain its place as a regional leader and economic engine."

A Long Road Ahead

Even though the Arab Spring has created fresh investment opportunities for Morocco and Iraq, both countries face growing challenges to consolidate the relative advantage they earned in the first half of 2011. As stability emerges in neighboring countries, it will become even more critical for each country to confront its challenges head-on.

In the case of Morocco, public equity investors remain wary of the country's stock exchange, given the thinly traded float and significant concentration of the king's investment holding company, which until recently indirectly controlled nearly 50% of the Casablanca stock exchange. Furthermore, restrictions on the free flow of funds make it difficult for multinationals to operate freely and to transfer funds outside the country. Finally, Morocco, like many of its peers across the Arab world, is hobbled by persistently high unemployment and underdeveloped human capital.

Meanwhile, Iraq faces far more acute challenges. Despite signs of renewed investor interest and stability, the country continues to be a shadow of its former self. Most multinational corporations and international investors remain fixated on headline risks of insecurity and political instability, preferring to sit on the sidelines until the dust fully settles. Moreover, even institutional investors who recognize the country's enormous potential are holding back because of the reputational risks of entering prematurely.

Although both Morocco and Iraq have gained relative credibility in light of the region's spreading tumult, they continue to suffer from the associative bias against investing in the Middle East and North Africa. International investors often assess risk in broad strokes and fall short in understanding the unique economic drivers of a region's constituent countries. For instance, on the heels of the protests in Tunisia, the Casablanca stock exchange declined nearly 10% from its mid-January 2011 highs. Moreover, Iraq — often the driver of blunt perceptions of instability in the Middle East — for many years has been marching to the beat of its own economic drum and refurbishing its investment environment, with only limited notice from international investors.

While both Morocco and Iraq certainly face significant challenges in the future, they are the unexpected short-term beneficiaries of the Arab Spring, a movement that turned from the one act of self-immolation by a single Tunisian into regime-challenging protests by millions across the Arab world. Indeed, these brave protestors have made a significant down payment on brighter prospects for economic opportunity in their countries. Even so, the biggest short-term winners of the Arab Spring are found at the bookends of the Middle East and North Africa.

As unrest in the region evolves, investors who recognize the changing pockets of opportunity stand to benefit the most. According to Mustafa Abdel-Wadood, of Abraj Capital, a Dubai-based private equity house, “You start to differentiate in a post-Arab Spring world, and you look at the different markets that were affected.”

It is this level of nuance that countries like Morocco and Iraq are counting on. Whatever the future holds for the region’s shifting opportunities, however, investors are wisely taking the long view. As Abdel-Wadood notes, “I think the main theme when considering whether to enter these markets is the potential for long-term growth that will ultimately lead to a more positive outcome.”

This article was written by Christopher Hogg, Amir Memon and Taylor Valore, members of the Lauder Class of 2013.

Saving Vocational Education in a New Arab World

In the days leading up to Hosni Mubarak's resignation in February 2011, Tarek was in the heart of Cairo's Tahrir Square. For the first time, he felt a sense of power over his and his country's future. Since then, however, even with a bachelor's degree in business, he has been unable to find a job. He now remains in Tahrir Square, not as a revolutionary, but as a street vendor.

Tarek is only one of millions of young Egyptians and Tunisians struggling to earn a living wage. The Egyptian and Tunisian revolutions brought hope and optimism to young adults frustrated with political and economic paralysis. While rampant unemployment was one of the primary catalysts of the Arab Spring, the unstable state of sweeping political reform has actually decreased their chances for employment in the near future.

Many see *taaleem fanee* — Vocational Education and Training (VET) — as the most realistic path toward employment for the region's young adults. Though a member of what some see as the "old guard" of governance in the region, Queen Rania Al Abdullah of Jordan remains a leading advocate of education reform in the region. Referring to VET, she stated: "If we can provide quality education that leads to lasting employment, we will have done our part in shaping the future of the Arab World." VET prepares trainees for mid-level jobs based on manual or practical activities, such as carpentry or hospitality. While VET has been present through public and private initiatives in both Egypt and Tunisia for more than two decades, neither country has established a viable or sustainable model. Following the revolutions in the early part of 2011, the economic and political challenges only became more formidable, making it increasingly difficult to establish VET centers.

While these new obstacles continue to exacerbate unemployment in Egypt and Tunisia, the revolutions also created an historic opportunity for the new regimes to prioritize the reform and facilitation of VET through public-private partnerships (PPPs). Now, more than ever, is the time for Arab governments to play a leading role in facilitating the provision of marketable skills to a jobless generation.

If implemented effectively, VET could become a key component for solving the prevailing quandary of human capital development in the Middle East.

The Unemployment Crisis

According to the International Labour Organization, since the 1990s the unemployment rate in the Arab world has been among the highest in the world, with an overall rate of 10.3% and a staggering 23.7% for those under age 25.

While the unemployment rate is alarming, it masks an even harsher phenomenon: A smaller percentage of people in the Arab world even seek employment. The region's young-adult participation rate in the labor force stands at around 35% compared to the global average of 52%, according to McKinsey & Co. This reflects both a low participation rate among young women and extreme frustration with job prospects, but does not take into account ambiguities associated with employment in the informal sector. In Egypt, the World Bank estimates that the informal sector employs 37% of the workforce, although official unemployment numbers do not factor this in.

Vocational institutions provide trainees with the specific skills and knowledge needed to succeed in the labor market. These six-month to two-year programs fall both within and outside the traditional post-secondary education system. Because VET improves individual employability through a focus on specific skills aligned with market needs, it leads to higher worker productivity and is, therefore, vital to modernizing and increasing the competitiveness of developing economies. An upgraded workforce, for example, in manufacturing and construction would not only empower these high-potential sectors in Egyptian local markets, but also strengthen global competitiveness.

Similarly, a greater number of skilled workers will allow Tunisia to diversify its economy beyond low-skilled sectors. "We can no longer focus on providing 'cheap labor' [for developed markets]. We need other competitive advantages," stated Mongi Amemmi, director of research at the Tunisian General Labor Union (UGTT). "Vocational training [is] one of the tools that makes the risk of forced mobility [and instability] of work in the current market environment into an opportunity."

Currently, training for vocational professions — such as plumbing or automotive maintenance in the region — is limited to apprenticeships in the informal sector, work-readiness programs through employers and military-service training. According to a McKinsey report financed by the International Finance Corporation (IFC) and the Islamic Development Bank, titled "Education for Employment: Realizing Arab Youth Potential," only 20% of post-secondary students in the region's public education system attend VET schools.

Historical Challenges to VET Implementation

Long seen only as a limited component of education policy and, therefore, an exclusive prerogative of the government, the rampant corruption and political inertia of Egypt's and Tunisia's former regimes have infected VET initiatives for more than two decades. Considered a last-chance educational opportunity for under-performing students, hopeful students have also faced the social stigma attached to it.

A 2008 UNESCO report estimated that the Egyptian government directed a mere 3.76% of GDP to education, compared to 8% in Malaysia, for example. The vocational training programs that were created displayed the hallmarks of an underfunded system: poor facilities, a lack of qualified instructors, and, most importantly, insufficient strategic planning by 14 loosely coordinated government entities. Students graduated without marketable skills and without a sense of how to market those skills they did possess, forcing employers to either bear the cost of retraining or under-employing university graduates. Marie-Therese Nagy, head of commercial training at Mobinil, one of Egypt's largest telecom providers, concurs. "Of course it is preferable to hire people with a vocational training background; it saves a lot of investment and time [rather] than developing [employees] who may be lacking these skills."

In Tunisia, the same mismatch between market demand and the skills of VET graduates stemmed, not from a lack of funding, but from a mismanagement of educational policy. Faced with an overflow of young, unemployed university graduates, VET became a priority for Tunisia's recently ousted regime as early as the 1990s. Referred to as *takween mahani* in local parlance, the government set up a centralized system, established the Ministry of Employment and Vocational Training in 1990, and later created four separate agencies under the Ministry's control to administer training, funnel graduates into appropriate positions, and provide funding for those hoping to use these new skills in micro-enterprise. In 1999, a presidential decree established the Funds 21-21 program, which allocated significant resources to microfinance and SMEs, provided means for the "reconversion" of unemployed workers into new industries, and offered access to professional training programs to integrate unskilled or poverty-stricken workers into public-sector employment.

Nonetheless, according to Amemmi, "corruption and the revolving door of leadership [a result of appointments at the whim of a fickle dictator] meant that continuity in policy was impossible." His colleague, Lamjed Jemli, current coordinator of private sector activities at the UGTT union — a former political prisoner and, after being fired from a government post, an unemployed graduate himself — agreed. Obligatory background checks by the Interior Ministry "eliminated any and all candidates who did not have connections to power or maintain 'correct' relations with the government."

Post-revolution political and economic instability threatens the successful implementation of VET. The founder and CEO of one of Egypt's largest professional training firms called the six months following the revolution the most difficult of his company's history. In addition to a sharp decrease in revenue due to customer attrition, the company had to function without crucial government subsidies from the Industrial Training Council (ITC), a subsidiary of the Ministry of Trade and Industry. According to this CEO, "The entire system for financing training has been put on hold until the government has been stabilized. The reality is that the new regime is focused on larger, more public issues, and doesn't view the subsidization of professional training as a priority at the moment."

The timing of the revolution could not have been worse for his company, which was viewed as one of Egypt's premier firms. Two large European buyers were at the table ready to write a check. Following news of a burgeoning revolution, however, one pulled its offer and the other opted to lessen its exposure through a strategic partnership. "We were also quite far along with a Saudi investor interested in funding a new vocational training program … focused on a few specific occupations," the CEO added. "However, the instability of the revolution created too much additional risk to move forward."

In addition to the lack of available public and private financing, the absence of government-approved standards for offering training certificates and accreditations presents a significant obstacle for VET providers. As the CEO noted, "Our company competes based upon the high quality of our services as certified by government administrators. Universal standards for accreditation are crucial for both the companies and trainees relying upon our services. We may be unable to launch new programs if there is no infrastructure for creating new standards."

Relaunching VET: Conditions for Success

While political turmoil will likely burden the region in the coming years, it is crucial for governments to quickly establish proper infrastructure to support the development of VET. In McKinsey's recent study, experts found four key pillars needed for a successful system: (1) close involvement with the industry in areas such as curriculum content, training provision and internship opportunities to ensure that courses are kept up-to-date and in line with industry requirements; (2) wide recognition of VET qualifications (e.g., diplomas) by businesses within the industry or industries at the national (or international) level; (3) assurance of employment with attractive wage levels; and (4) a business model with robust and diversified revenue streams. Of course, there is also the perpetual challenge of funding such initiatives.

Fortunately, the new Egyptian government has taken some initial steps toward reinvesting in VET. However, large-scale plans are on hold until some level of political stability has been attained. In May 2011, Planning and International Cooperation Minister Faiza Abu El-Naga announced a post-revolution development plan worth 230 billion pounds (about US$38.6 billion), of which 55% would come from the private sector and 45% from the public sector. "The hope is that the private sector — local, Arab and international investors — will contribute to this plan after security returns to the country," she noted. The plan envisages adding 1.7 billion pounds (about US$285 billion) for extra spending on healthcare and education, including VET in particular.

Nagui Elyas, an Egyptian-American and co-founder of B&H Education, which operates more than 50 beauty training schools on the west coast of the U.S., is cautiously optimistic, but fears the mistakes of the past might be repeated. Convinced that Egypt was in dire need of VET to develop sustainable industries, particularly in the healthcare sector, Elyas financed and launched a pilot VET center focused on dental assistant and nurse training in Alexandria in the mid-1990s. All 30 of the first group of students completed the six-month course, and 29 found full-time positions immediately.

Despite the center's success, funding was unavailable from public and private investors to launch a full-time comprehensive VET facility. "The government claimed it didn't have any room in its budget, and private investors thought the opportunity was too risky," said Elyas. "Without some sort of large initial investment, even the right VET managers and administrators are unable to move forward on exciting developments."

Executives at Tunisia's only privately run microfinance institution, Enda Inter-arabe, echoed Elyas' concerns. With funding from European governmental sources and in partnership with the Ministry of Vocational Training and Employment and the Tunisian Agency for Professional Training, almost immediately after the revolution this microfinance institution began work on a vocational training program to equip young entrepreneurs with the financial and leadership skills needed to create successful start-ups. In recognition of Tunisia's history with an ineffective VET, the program will not only educate but also provide follow-up coaching and mentoring and an introduction into Enda's already substantial network of micro-entrepreneurs to create market linkages and facilitate the continuing development of professional skills for its graduates.

Despite the conviction of Enda's leadership that "vocational training aimed at the creation of youth-run micro-enterprises" is the "only real short-term solution" as the new government struggles to create a long-term development policy channeling young unemployed university graduates into salaried employment, the initiative is impossible without ample and diversified funding. According to Mourad Hentati, director of research and marketing at Enda, "the additional risk of providing both capital and maintenance loans to inexperienced young graduates" is a departure from established principles of microfinance. "We cannot push these types of initiatives through without considerable financial support."

"The government certainly shouldn't expect the trainees to be able to pay for training by themselves, as most of them were unemployed adults and students in the first place," Elyas noted. "Nor should they expect private investors to lead the way, as the risk is too high without more substantive financial and administrative support already in place." Whether through subsidies, nonprofit trusts, grants, scholarships or the creation of dedicated international funds, the government is the key to creating greater private interest. "With the … government committed, along with the financial and rhetorical support of international allies and organizations, private investors will jump in," Elyas added. "Herein lies the essence of the public-private partnership needed to sustain VET development."

Ending the Vicious Cycle

A Catch-22 has historically characterized the relationship between education and economic development in the Middle East. In order to develop a sustainable and diversified economy, a country must have a skilled workforce, which requires an effective educational system. However, to develop an effective education system, a country requires a strong economy to provide adequate funding. Without prioritizing and investing in practical education, the Arab world will continue to find itself in perpetual economic decline.

Egypt and Tunisia should look, perhaps, to its successful global peers as models. Professional education in Brazil, for example, is now firmly on the national agenda. Since 2003, the annual budget for vocational institutes has increased from US$385 million to US$3.8 billion, with some 401,000 students now studying at federally financed technical institutes, up from 102,000 in 2002.

Mona Mourshed, Middle East office partner and co-leader of McKinsey's global education practice, believes some Latin American countries have shown the rest of the emerging world how to create a viable model. However, private collaboration is also crucial. "Those VET programs that are large-scale and successful — i.e., large segments of students pursue VET tracks and find employment thereafter — around the world have similar attributes, [mainly] heavy employer involvement, [and] at least half of [the] curriculum is practicum-based." In Brazil, for example, the availability of publicly funded VET centers has allowed private companies such as Vale SA, a multibillion dollar Brazilian mining company, to partner with companies in the region to create training programs in industry-specific disciplines. Such PPPs are exactly what Mobinil would love to participate in, according to Nagy, should the educational infrastructure exist.

Post-revolutionary fervor remains alive, but it is still unclear for how long. Reshaping and enhancing the provision of VET will help transform life in the Arab world, halting a Catch-22 that threatens to haunt the region for decades to come. Youth revolutions opened the door for transformation, but political and business leaders must provide them with the opportunity to help rebuild their countries.

This article was written by Kareem El Sawy, Christen Farr and Sarah Newera, members of the Lauder Class of 2013.

Are Colombian Flowers Experiencing a U.S. Drought?

Most Americans purchase roses only once or twice a year. But do they ever think about where these roses come from? Do they ever consider what it takes to get them to their local market just in time for their purchase?

The flower industry is dominated by only a few major countries: 83% of the world's cut flowers come from Holland (40% of production value), Colombia, Ecuador and Kenya; and 73% of the cut-flower production is imported by Germany, the U.K., the U.S., Holland and France.

Chances are that the roses purchased for Valentine's Day or Mother's Day came from Colombia. According to Asocolflores, the Colombian Association of Flower Exporters, three out of every four flowers sold in the U.S. are grown in Colombia, making it the number one exporter of flowers to the U.S. Flowers are also Colombia's second leading agriculture export, distributed to 89 countries, making the country the number two exporter worldwide. Together, the industry accounts for the second-leading agriculture export in Colombia. Similar to the coffee industry, Colombian flower producers are part of growers associations. Currently, the firms are split between two organizations. Asocolflores represents the large exporters, while Fedeflores represents the medium- to small-sized Colombian-owned farms.

Colombian flower farms have leveraged the country's natural climate, favorable economic conditions (including exchange-rate advantages) and proximity to the U.S. to develop the American consumer market into its largest importer. What is not well-known, however, is that this relationship between Colombia and the U.S. in the production and sale of flowers began more than 40 years ago. It has facilitated both the growth of the Colombian flower industry and the broader development of the Colombian economy. Have the Colombian flower farms outgrown their exclusive and dependent relationship with the U.S. consumer market or does the industry still have room to grow and expand the flower demands there?

An Interdependent Relationship

Since the flower industry's inception, Colombia and the U.S. have had a robust and almost symbiotic bond. David Cheever, an American university student, wrote an academic research paper that identified the key local characteristics necessary for industry development: ideal climate and land, low-cost labor, suitable transportation and proximity to the U.S. market. His analysis sparked the initiation of the Colombian floriculture industry. In 1969, he and three others put his ideas into practice by launching Colombia's first multinational flower company, Floramerica. Other entrepreneurs followed their lead and entered the new market, investing significant amounts of money into the capital-intensive industry.

Many years later, in the early 1990s, the Colombian flower industry became a primary focus in the trade negotiations between the U.S. and Colombia. The ATPA (Andean Trade Preference Act), first passed in 1991, used economic and trade incentives as a key tool to help four Andean countries (Bolivia, Ecuador, Peru and Colombia) combat drug production within their borders. To encourage exports and increase production, the pact eliminated tariff duties on key products, including cut flowers. In 2002, the trade agreement, now called ATPDEA (Andean Trade Promotion and Drug Eradication Act), was renewed and expanded further so that, today, cut flowers are Colombia's second-largest category of U.S. imports under the act.

The U.S. has also given direct aid to Colombia, leveraging the flower industry to promote and distribute social aid. In the past, Colombia has received funding from sources such as the U.S. Agency for International Development (USAID). As a result, today this sector is responsible for an estimated 172,000 jobs, of which 92,000 are associated directly with floriculture. This sector is also the largest employer of women in rural areas, with women comprising 65%. The "corporate responsibility" the industry has been able to implement includes childcare centers, subsidized meals and continuing education. According to Mónica Morena, an operations manager at C.I. Flores Ipanema Ltda., outside of Bogotá, all the employees are provided with a daily breakfast of *agua de panela* (sugar water) and bread, a subsidized lunch of 4,000 pesos (~US$2.20), and free transportation to and from the farm. For an additional cost, they also have access to child care and continuing education (elementary and secondary).

The U.S.-Colombia relationship within the flower industry is not one-sided, however. Both countries have benefited economically through this arrangement. For example, about 150 flower importer-distributor companies alone have been founded within the U.S., mostly in and around the Miami area. Cut flowers have also become Miami International Airport's most important cargo item, while Bogotá's international airport handles 200,000 tons of flower-related air freight annually. Freight costs paid to U.S.- and Colombian-based airlines represent approximately US$200 million per year. From the U.S.-based importers to the brokers, truckers, wholesalers and floral retailers, the industry is the source of US$7 billion of added value for the U.S.

Current Challenges for the Industry

The flower industry faces several challenges within the sector. First is an oversupply of flowers with an unmatched sales demand. In recent years, flower production has expanded as a result of the increase in the amount of lands being cultivated and the more advanced technologies used in the different types of production. These factors allow for growth in production efficiency, which, consequently, increases the supply. However, flower demand does not follow this same trend. The industry is highly dependent on the U.S. consumer market, which receives 80% of Colombia's flower exports. This high level of sales exclusivity and key characteristics of the U.S. market itself contribute to the issues related to excess supply. The U.S. has a relatively low per capita annual consumption of flowers (US$29).

In addition, the seasonality of sales within the U.S. presents challenges in supplying for the two peak days of the year: Mother's Day and Valentine's Day. As Morena notes, "In order to meet Mother's Day and Valentine's Day demand levels, we have to significantly increase flower production, time the cultivation of the roses perfectly and bring on about 1,000 additional seasonal employees." In Colombia, flowers may be produced year-round, making the supply constant. However, the demand for flowers in the U.S. is extremely seasonal. This creates an awkward mismatch between the traditional microeconomic factors.

Another market factor that affects Colombia's flower business is the distribution channel. More than 50% of the flower market in the U.S., for example, is concentrated in supermarkets. This figure has been increasing year after year, forcing producers to conform to supermarket standards and pricing. As a result of preferences for high-quality flowers at lower prices, producer margins have been reduced. Adding additional pressure, the value of the Colombian peso has risen against the U.S. dollar, reducing profit margins even further. With an economic recession, decreased margins and an appreciation of the peso, does it still make sense for Colombia to concentrate almost entirely on one market?

Given these concerns, the floriculture industry in Colombia must consider several alternatives in order to maintain and ideally increase its global market share. One option is to grow U.S. sales through a focus on expanding demand — in other words, "expanding the pie." This strategy would utilize a marketing campaign promoting flower purchases throughout the year rather than only for specific holidays. The campaign would strive to increase Americans' per capita consumption to a level similar to that of Europeans. Asocolflores has already identified this option as a key strategic objective for its group. This approach, however, still leaves Colombia susceptible to the risks of single-market dependency and exchange-rate fluctuations.

A second alternative for Colombian businesses to explore would be expansion outside the U.S. With its growing middle class and obvious proximity, the broader Latin American market could provide additional consumers to absorb the excess supply. Currently, Colombian producers export US$2.9 million to Mercosur (Argentina, Brazil, Uruguay and Paraguay) and another US$2.9 million to Central America and the Caribbean. However, countries such as Mexico and Brazil produce enough flowers to meet their own domestic demands, and Ecuador itself is a global exporter of flowers and in direct competition with Colombia. It is, thus, unclear whether this market could, indeed, provide sufficient growth potential.

Farther away, Europe presents another potential market in which to expand since, currently, only 3% of flowers purchased there have Colombian origins. In addition, Europeans' per capita consumption of flowers is much higher than that of Americans — on average, the Swiss spend €77 (US$112) on cut flowers per year versus the €20 (US$29) spent by Americans. Colombian producers have two primary options when entering the European market. They can ship the flowers directly from Colombia, or consider the multinational route and establish a production presence in Kenya. The former would help alleviate excess supply issues but add additional challenges related to distance and the perishability of the cut flowers. The latter would improve the physical proximity but present new challenges related to cultural differences, political instability and language barriers. Neither option addresses the challenge of distribution channels moving from primarily florist-based sales to supermarket-based sales. The bottom line is that, with Holland already dominating the European market with 67% of the market share, it is uncertain whether Colombia would be able to become a dominant player there.

In addition to expanding consumer demand, Colombian flower producers also have the potential option of reducing production costs and increasing process automation in order to improve profit margins with or without an increase in revenue. The floriculture industry, regardless of the production country, is highly dependent on manual labor. Automation and technological advances would obviously reduce expenses. In addition, improving transportation infrastructure and production technology would provide producers with increased control over their supply production and delivery and help to improve efficiency within each of these processes.

Reducing costs through automation, however, opens producers up to new issues related primarily to the risk of operational losses. As explained by one of the *trolistas* (the men who transport the flowers between the greenhouse and postharvest operations) at the Colombian rose farm, C.I. Flores Ipanema Ltda., "the moment a rose touches the ground, it is no longer suitable for sale, destroying the entire value of that flower." Unlike an automated trolley, which Ipanema did try to implement at one time, a human being has the ability to not only control the flow of transported flowers, but also use additional care and judgment to ensure that the flowers arrive safely at their predefined destinations. Thus, given the fragile nature of their product, flower producers must find a delicate balance between automation and manual labor so that both operational expenses and operational losses are minimized.

As the global floriculture industry becomes more and more competitive, Colombia's producers must find ways to adapt. Relying on an intimate knowledge of the industry, high-quality flower production and future technological advances to help them navigate through the current challenges that threaten their survival are just some of the tools to be engaged. Each firm will have to explore its strengths, weaknesses and specific cultures to determine which path forward provides the most growth potential. All the possible alternatives present clear advantages and disadvantages. The only option currently not on the table for the Colombian floriculture industry is to simply stand still.

This article was written by Alicia Figueroa, Adriana Lima and Elizabeth McCracken, members of the Lauder Class of 2013.

Will a Shortage of Qualified Labor Derail the Brazilian Economy?

Brazil is booming. In contrast to the economies of the U.S. and the Eurozone — where a mix of debt woes, dysfunctional politics and consumer weakness has conspired to dampen economic growth — Brazil is on track for yet another year of above-average GDP performance. Driven by a number of factors — including Chinese demand for raw materials, a fast-growing and highly acquisitive middle class, large inflows of foreign investment and the ongoing development of its vast pre-salt oil deposits — the country is experiencing a multiyear growth spurt unlike any in its recent past.

However, while outsized economic growth brings the promise of greater national prosperity, it also poses a host of new challenges, some of which the country may not be fully prepared to address. "One of Brazil's biggest problems," says Masao Ukon, a partner in the São Paulo office of the Boston Consulting Group, "is a shortage of qualified labor." Indeed, as one of the key inputs to Brazil's burgeoning economy, qualified labor is a precious resource whose inadequate supply could pose significant risks to the country's growth trajectory.

Demand Outstrips Supply

At its most basic level, Brazil's shortage of qualified labor is little more than a supply-demand imbalance. With the Brazilian economy firing on all cylinders — and in the context of a legacy of dramatic government underinvestment in education — firms operating across a number of industries and sectors are demanding more skilled workers than the labor market currently offers, leading to unmet hiring quotas, increased pressure on existing employees and slower firm growth. The shortage is especially pronounced for firms in need of technicians and engineers. Given their demand for large numbers of these specialist employees, the oil and gas, real estate and aerospace industries have been hit particularly hard by the shortfall.

In particular, while many developing countries are suffering from a similar phenomenon, the labor problem is especially severe in Brazil, which recently placed third in a global ranking of countries coping with labor shortages. Indeed, according to the study, in which human resources firm Manpower interviewed more than 40,000 employers across 39 different countries, 57% of employers in Brazil are unable to find the skilled workers they need to operate their businesses. Claudio Lampert, chief legal officer of Brazilian logistics firm Grupo LLX, is one these employers. "Lack of qualified labor isn't a problem for the future; it's a problem we're facing today," he states. "At this very moment, we're in need of an additional 3,000 employees." This acute labor shortage has dramatic implications for Brazilian citizens, Brazilian firms, foreign job seekers and the future of the Brazilian economy in general.

What explains Brazil's lack of qualified labor, and what are the historical underpinnings of this modern-day problem? While the answers to these questions are highly nuanced, many observers begin by pointing to Brazil's historical underinvestment in education as the primary culprit behind today's labor shortage. For example, Roberto Civita, chairman and editorial director of Grupo Abril, Brazil's largest media conglomerate, states that the country lacks qualified labor because "Brazil basically ignored education during a large portion of its history." In support of this thesis, many academic specialists on the subject state that, beginning in the colonial era, the Brazilian elite deliberately neglected education because their productive assets (which, until the latter half of the 20th century, were focused primarily on the production and export of primary goods) did not require the use of skilled labor. This historical legacy contributed to the formation of an educational system ill-equipped to meet the needs of a fast-growing and diversified economy.

Most experts agree that the solution to Brazil's labor shortage is a long-term one that involves broadening access to education, building more schools and improving the quality of existing educational institutions. But what can be done to address the issue in the short term? How are Brazilian companies coping with the shortfall? Can and should highly skilled foreigners be used to fill the gap? And what are the long-term implications of a prolonged labor shortage?

Corporates Enter the Stage

Facing an ever-widening gap between healthy growth projections and qualified talent supply shortages, Brazilian companies — such as mining giant Vale (fomerly Companhia Vale do Rio Doce or CVRD), Petrobras and Schincariol — have taken on the talent gap proactively by establishing their own corporate universities. While not intended to replace conventional education systems, corporate universities increasingly resemble them. They seek to accelerate the acquisition of academic knowledge and immediately facilitate practical, on-the-job application through short-term immersion courses such as those found in academic settings.

Vale's Valer University spent US$34.7 million in 2010 on its educational programs across the value chain — from operational and specialist technicians to management leaders — even reaching suppliers that have difficulty providing high-quality service due to poor management skills.

Valer University trains employees in mining, port operations and railways, among other fields. In 2010 alone, it produced 60 railway engineers who would not otherwise have had the skills necessary for Vale's operations. It is also considered the unparalleled leader in producing talent specialized in extracting ore from the Amazon rainforest. Although focused on particular technical skills for the mining company, Valer also finds itself picking up the slack for Brazil's underdeveloped education system. "Teaching math and Portuguese is not part of our core business," notes Desiê Ribeiro, education manager at Vale. "But because of flaws in the educational system, we frequently find ourselves in that role."

Petrobras University in Rio de Janeiro confronts another challenge — developing engineers with the brainpower to discover and produce new deepwater techniques for pumping oil from beneath 7,000 meters of ocean, rock, salt and sand. With offshore oil training becoming part of Petrobras University's core curriculum, the school aims to educate a significant portion of the estimated 8,000 to 9,000 employees who will be required for deepwater operations by 2015, far more than the country's formal education system is slated to produce. The company is world-renowned for its leading deep-water expertise.

But what about those companies that do not have their own corporate universities to provide a controllable, if undersupplied, pipeline of qualified talent ready to be employed in positions critical for meeting growth expectations? Even Petrobras is facing a talent challenge given that 45% of its workforce is set to retire in the near term, taking with them a significant amount of the company's experience and know-how. Logistics company LLX, part of Eike Batista's Grupo EBX, is already experiencing the lack of a qualified labor force. With construction of the Açu Superport Industrial Complex — eventually one of the three largest port complexes in the world — already underway, "the lack of manpower is not going to be a problem; it already is," according to Claudio Lampert, the company's general counsel. LLX is struggling to find more than 3,000 workers to construct and operate the port.

Similar demands for skilled laborers and technically trained employees in the financial services, consulting, beer and industrial sectors, among others, have many Brazilian companies worried. "We've run out of Brazilians," says Luiz Mendonça, CEO of Braskem's international business unit, a chemical company that is a global leader in bioplastics.

Toward an Open-door Policy

Considering the educational challenges and dramatic economic growth underway, it may seem desirable for Brazil to admit skilled labor selectively into the domestic economy. However, since the first presidency of Getúlio Vargas from 1930 to 1945, Brazil's federal bureaucracy has included a powerful Ministry of Labor and a hierarchy of specialized courts focusing on extensive labor laws, all of which seek to protect the domestic labor market. Successive governments mostly have supported the status quo, especially with respect to limits on foreign workers. On July 7, 2011, Carlos Lupi, Brazil's current Minister of Labor, summarized the government's reluctance to issue work permits, observing that "in Brazil, we are in a growth process, and we must ensure that the labor market continues strongly for Brazilians."

The volume of recent work authorizations conceded by the Ministry of Labor, a prerequisite before a work visa can be issued by a Brazilian embassy or consulate, reveals the magnitude of the problem facing Brazilian companies. During the first six months of 2011, work authorizations increased by nearly 18% over previous years, to 28,556. However, only 44% were valid for one to two years, the maximum duration granted for a temporary work permit, while 39% were valid for less than 90 days. Even though the state of São Paulo had a GDP of US$548 billion in 2008, representing 33% of the national economy, only 1,461 work permits were issued to business professionals and executives within the state, further demonstrating the extent of protectionist policies. Furthermore, 17% of Brazilian work visas were issued for technical-support visits of less than 90 days, without a Brazilian work contract, in line with government policy goals of transferring know-how while maximizing job vacancies available to locals.

A review of the work authorization data also identifies areas where the foreign labor market is addressing domestic labor shortages. During the first six months of 2011, fully 25% of work visas were issued to crews of offshore oil platforms or ships in the state of Rio de Janeiro, representing by far the largest bloc of recipients and a key area for foreign direct investment. After the U.S., the second largest national origin of successful work visa applicants is the Philippines, at 2,294 (9%), with many hired under short-term contracts for fully staffed ships. The largest category of recipients in the state of São Paulo is "artists and athletes," followed by short-term technical support and tourism-related flight or ship crews Thus, the top three categories of São Paulo visa recipients do not displace local employees.

Senator Cristovam Buarque sums up the predicament of the Brazilian economy by saying that "o Brasil está bem, mas não vai bem," meaning that Brazil is doing well now, but it is not headed in the right direction. As a leader in the fight to improve the quality of education in Brazil, Buarque faces the daily challenge of convincing stakeholders in the Brazilian economy that education is an issue deserving immediate attention. With at least US$30 billion headed to infrastructure projects in preparation for the 2014 World Cup and 2016 Olympic Games, Buarque's voice seems to be taking a back seat. Most politicians do not want to talk about the long-term implications of a failing education system. The more popular response to the current economic moment is to take advantage of the boom while it lasts.

For nearly a year, a proposed National Education Plan (*Plano Nacional de Educação*) has been held up in Congress and has already been through more than 3,000 amendments. The education plan seeks to establish quantifiable goals to measure the improvement of the country's education system over a period of 10 years. The fact that many Brazilian politicians are holding up the legislation may be simply a reflection of culture. According to Julio Sampaio, president of Associação Alumni, a Brazilian nonprofit dedicated to English language instruction, traditionally the powerful elite have lacked interest in guaranteeing a quality education for all Brazilians.

Where will Brazil be in 20 years without a government-driven effort to improve the quality of education? What will the impact of doing nothing be on GDP and foreign investment? While no one can answer these questions directly with figures, there is a general consensus that Brazil's education problem is not going away anytime soon and that executives from the outside looking in ought to keep this major issue in mind.

Despite being home to a culture that is only just beginning to value education and professional preparedness, Brazil is also host to a wide variety of opportunities that it will display proudly on the world stage for the first time in 2014 at the World Cup. While Brazilian business leaders recognize the labor challenges facing them in the short- and mid-terms, they continue to be optimistic about their growth scenarios. Whether some companies plan to establish or bolster current corporate university programs or to increase the number of foreign workers as the visa process becomes ever-more lenient, executives are hopeful that their growth projections are on track. As the demand for a qualified labor force becomes more significant, so, too, will the efforts to find and create it. As Civita says, "If I could be anywhere in the world at age 27, I would be in Brazil."

This article was written by Marcus Anderson, Thomas Baldwin, Lisa Lovallo and Gabriel Pumariega, members of the Lauder Class of 2013.

Open for Business: The Pacification of Brazil's *Favelas*

Dawn on November 28, 2010. The Brazilian Special Forces, Military Police, BOPE (Police Special Operations Unit), Forestry Police, Civil Police, Federal Police and Army Parachute Brigade surrounded the Complexo do Alemão, one of Brazil's largest shanty-town communities, with an estimated population of 150,000 and site of the country's most vicious drug wars. This coordinated military effort succeeded in securing the premises within two hours, as police arrested 30 warranted criminals and seized more than 10 tons of narcotics and weapons. Residents raised the national and state flags to claim victory in the "War of Rio de Janeiro." The Complexo do Alemão, which had been responsible for receiving and distributing 90% of the drugs in Rio de Janeiro, was now in the hands of government security forces.

These days, just a few miles north of the multimillion-dollar apartments of Leblon, not far from Ipanema beach, the former "microwaves" of the Complexo do Alemão are still visible. These are intersections where, only a year before, gangs "cooked" their victims in stacks of rubber tires. The average family in this once war-torn *favela* earns 257 reais (US$140) a month (more than three times less than the rest of Rio de Janeiro). Twenty-nine percent of its residents bring home less than the minimum wage, and the average resident of this community expects to live nine years less than his "Carioca" counterpart. Part of this stems from an infant mortality rate five times higher than that of the city's wealthy Southern Zone. The other part comes from the *favela's* long history of violence and poverty.

The Origins of the Complexo do Alemão

Soon after World War I, Leonard Kaczarkiewicz migrated to Brazil from Poland in search of a new beginning. He purchased land just north of central Rio de Janeiro to build a plantation. The local workers thought he was German, and the entire area soon became known as the Complexo do Alemão — the German's compound.

The construction of Avenida Brasil in 1946, in the midst of President Getulio Vargas' campaign of nationalization and ISI (import substitution and industrialization), led to the opening of many factories around the Complexo, including the Cortume Carioca, which grew to be the nation's largest leather producer. Thousands of workers migrated to the area in search of work, mostly from the rural northeastern part of Brazil. Seeing an opportunity in his real estate, Kaczarkiewicz divided his land into smaller plots, selling them to workers from the nearby plants. Brazil, like most countries in Latin America, suffered slow and uneven economic growth through the 1970s and 1980s, and many of the factories in the area were shut down. Drug trafficking became the area's largest business, which led to a further deindustrialization of the complex as companies searched for safer work sites. The deindustrialization of the 1990s alone led to the loss of nearly 20,000 jobs in the area as the complex fell into a state of decadence.

Many attribute the Complexo's population explosion and the proliferation of drug gangs in the region to Governor Leonel Brizola. His mid-1980s' reforms provided public services to, and recognized, housing property in *favelas* — thereby legitimizing them — and forbade police entry into *favelas*, which allowed the gangs to flourish. According to Walmir dos Santos, "The new immigrant wave was made up of poor migrants from northeastern Brazil who came in search of work. The problem was that there were no jobs, and there was nowhere else to go. With no education or opportunities for work, many residents saw drugs and gang life as their only alternative."

On June 2, 2002, Tim Lopes, a *Rede Globo* journalist who had been investigating the drug and sex trade within the Complexo, was tortured and killed by Complexo gang members. President Fernando Henrique Cardoso condemned the killing, and Rio's head of police vowed an appropriate response. Brazilians could no longer look away from the atrocities in their back yard. During the next eight years, until the successful action of 2010, the police conducted various raids and operations that yielded minor successes but did not completely quash the violence and crime in the Complexo.

One of the low points in the government's battle against crime took place in June 2007. In advance of the Pan-American games, the police launched a mega action in the Complexo. Nineteen people were killed by the police in an operation that was condemned by Amnesty International and the Order of Attorneys of Brazil. "About 1,300 men came with so many weapons, with armored trucks and bullet-proof vests," remembers dos Santos, a community leader in the Complexo. "They killed 19 people, some of whom were drug traffickers and others who were just residents, workers."

This was a huge blow for the police, an already mistrusted group, and public pressure increased significantly. The residents of the Complexo were greatly affected by this attack. According to the testimony of Ashley Henderson, a former director at Community in Action, a local NGO, "When they have these operations to go after a couple of drug dealers, all the rest of the people who live right in the middle of this have to stop their lives completely.… Economies totally stagnate … and schools close down."

This preemptive attack was a complete failure, but it was also the catalyst that sparked a change in police strategy and tactics, ultimately leading to the successful 2010 raid.

With all eyes on Brazil's economy and its ongoing plans to host the 2014 World Cup and 2016 Summer Olympics, the government is paving the way for a new economy. Many Brazilians see the pacification as a symbol of the end of drug-based societies and the opportunity for new economic beginnings in the *favelas*.

Entrepreneurial Initiatives

The government's main economic initiative is channeled through PAC, the government's Growth Acceleration Program. Through PAC, launched in 2007, the federal, state and municipal governments have invested more than 700 million reais (approximately US$400 million) in infrastructure, healthcare, education, public housing, transportation and social services in the Complexo. In particular, the PAC investments include paved streets and steps going up the hills; drainage and sewage systems; a *teleférico*, or gondola, connecting the various hills of the Complexo with each other; an intra-city train, the metro; schools; an integrated health services center; apartments for more than 7,000 families; a library; and various social service centers.

Caixa is another tool used by the government to stimulate entrepreneurship. Primarily through its *emprendedor individual* program, Caixa has extended financial support, including small revolving credit lines, such as *crédito Caixa fácil* and low-limit credit cards. Beyond direct credit and financial support, Caixa offers a wide range of benefits and incentives designed to help small entrepreneurs, including simplified accounting requirements and consolidated purchasing. In addition, Caixa offers direct benefits, such as reduced health-care costs, tax breaks for hiring additional employees and technical support from other government agencies. However, as Filipe Vinicius da Silvera, a manager at Caixa's complex branch noted, "entrepreneurship in an open Complexo still faces a number of challenges, including outside competition, resistance to formalization and lack of professional training. Caixa is offering a number of programs and financing options in order to expedite its advancement."

The government is not alone in this. SEBRAE, a nonprofit organization that aims to promote the competitiveness and sustainable development of small and micro businesses, shares this view. According to SEBRAE's José Luiz de Souza Lima, "the pacification of *favelas* opens the possibility of constructing an atmosphere of peace and developing productive activities, attracting public and private investment." SEBRAE created a division for the Development of Entrepreneurship in Pacified Communities with this aim in mind. Within the Complexo, it is working with the government, financial institutions, local entrepreneurs, local organizations, research institutions and companies to promote entrepreneurship and to improve the local business environment.

In addition, SEBRAE, in collaboration with community leaders and businesses, is developing a promising tourism project in the Complexo that seeks to take advantage of the *teleférico* installation. SEBRAE sees the Complexo as a potential model for other pacified communities, a testing ground for experimentation. "The Alemão will be a great laboratory for SEBRAE," says de Souza Lima. "We are going to be able to test various methodologies of SEBRAE there."

NGOs are not the only groups entering the Complexo. Various other corporate heavyweights are also moving into this new unchartered market. The bank Santander Brasil led the way by opening a branch in Grota, a main section of the Complexo, in May 2010, even before pacification. This was an unprecedented move: No international bank had ever had such a direct presence in a *favela*.

Natura, a socially conscious Brazilian cosmetics company with a small presence in the Complexo for several years, is now partnering with Santander Brasil, the third largest retail bank in Brazil, with a 10% market share, to expand in the community. Natura is the biggest door-to-door cosmetic company in Brazil and has a well-earned reputation for being environmentally friendly and socially focused. "We have been working in the Complexo do Alemão for three years, but the *pacificação* made it easier and safer for us to access the area and expand our work," stated Luis Bueno, a regional director for Natura, in an interview for *The Guardian*. "It also provided us an opportunity to help the community at a time when they need it most, because after the drug gangs leave, the local economy dips as the money spent by dealers on services dries up." The recent changes in the Complexo do Alemão have opened an avenue of entry for Natura.

Natura is known throughout Brazil through its consultants, or salespeople, who buy and sell the company's products. The policy at the company is to not hire as a salesperson anyone who has incurred debt. However, after close analysis of the Complexo, Natura decided to offer a program for this indebted population and established *Projeto Comunidade.* This microfinance program finances the Complexo salespeople, who receive products from Natura with an obligation to repay the loan within 21 days. This option is available only to women who have debts of less than 500 reais (US$312).

For women with debts of more than 500 reais, Natura offers two options: either pay for the products up front or form a "solidarity group" microfinance loan. This latter option is distributed in partnership with Santander Brasil. The loan is taken out by several people, but the payment is collective. If one member of the group cannot pay, then the others must cover the shortage, thus ensuring a lower rate of delinquency.

Natura's goal in providing these increased options is to include as many women as possible, thereby increasing the community's chances of developing.

As a way to expand, Natura has partnered with AfroReggae, a music- and culture-focused NGO with a strong presence in the community. Through this partnership, Natura sponsors AfroReggae and, reciprocally, AfroReggae offers its infrastructure within the Complexo for Natura to sell its products. This method increases the safety of the distribution process and avoids some of the robberies, such as those experienced during the initial stages of Natura's entry.

Oi (Telemar Norte Leste S.A.) is representative of the complete shift in position toward investment in the Complexo. Before the pacification, Oi was forced to interrupt the fixed telephone services to inhabitants of the Complexo due to violence in the area, which hindered maintenance and service. Another company, Light, an electric energy concessionary, faced similar problems. Due to illegal connections of its distribution lines and alterations in its electric meters, the company faced losses equivalent to 30% of the energy it supplied.

However, after the pacification process began in different *favelas* in Rio de Janeiro, more than 600,000 people stopped paying for the illegal services provided by the drug gangs that ran the *favelas.* As a result, new subscriptions to companies such as Oi and Light are soaring: "Our goal is to reach 50,000 subscribers in the Complexo do Alemão over the next year," notes George Moraes, a director of Oi and vice president of Oi Futuro Institute.

The presence of these service companies in the Complexo has benefited the community in many ways. Families are now accountable and are eligible to get credit from Caixa. Entrepreneurs now have access to the key services necessary to manage a company effectively, and workers are contracting shop assistants and technicians as these companies open shops in these communities and provide maintenance services.

However, as promising as all this outside investment appears, the onus ultimately lies with the local entrepreneurs themselves to foster development. That is why the government and companies investing in the community hope that success stories such as those of CLD Info and Plantador Fiel are just the start of a developing trend.

CLD Info is an Internet provider company founded by Christiano and Daniel Da Silva. The two previously unemployed brothers benefited from Empresa Bacana, a joint project between SEBRAE and the municipal government of Rio, to open a formally registered business. To expand their business to computer sales, they intend to take advantage of Caixa's financial offering for the communities: the *crédito Caixa fácil.* The Da Silva brothers have managed to create a growing company by leveraging the new economic reality in the Complexo, and they foresee a promising future for business. According to Christiano, "Out of 160,000 people, only five percent have a computer. The market is huge."

A second example of this developing trend is *Plantador Fiel,* a monthly newspaper of the Comunidade led by André Luís Ramos. Empresa Bacana was also the main instigator and supporting force behind this business. Ramos' business plan placed third out of nearly 40 applications, and he wanted to move quickly on this opportunity. Benefiting from Caixa's entrepreneurship program, called *empreendendor individual, Plantandor Fiel* has been achieving a monthly circulation of between 5,000 and 8,000 since December 2010.

The economic progress of what was once the center of the Rio drug trade is an essential component for improving the city's safety and prosperity in the lead-up to the 2016 Olympics. Success will continue to rely on government efforts to maintain security and provide access. Those efforts have been overshadowed by the arrival of formal service offerings by large companies that will undoubtedly contribute to an improved quality of life. However, the role of public entities like Caixa and private entities such as Natura and Santander Brasil are essential for providing a crucial source of peace and stability: economic growth through local entrepreneurship. The Da Silva brothers and Ramos are a small part of a new chapter in the history of the Complexo do Alemão, one made possible by public and private efforts to provide access to capital and opportunities. While decidedly for profit, private enterprise has also managed to work with NGOs such as AfroReggae to guarantee better returns and to assure the continued existence of their operations.

The advances made in the Complexo do Alemão have gone a long way toward transforming the once-notorious community into a vital part of the city. There are already signs of change. On March 26, 2011, Fox Pictures chose to hold the national premier of the movie *Rio* within the Complexo do Alemão. More than a mere publicity stunt, the screening was a sign of the new-found commercial potential within the growing number of communities the government has singled out for pacification. This recent progress has not been without challenges for businesses and the pacification movement. The early September 2011 flair-up between ex-drug runners and the police demonstrates that the government and the community still have a long way to go toward complete pacification. Yet the Complexo is moving in the right direction, and the residents are heartened by the fact that their community is open for business.

This article was written by Donald Canavaggio, W. Malcolm Dorson, Peter Isaacson, Gonzalo Manrique and Pablo Pedrejón-García, members of the Lauder Class of 2013.

From Terrorism to Tourism: Waving the Flag of Development in Colombia

"This country has moved from terrorism to tourism," former Colombian President Alvaro Uribe told delegates at the United Nations World Tourism Organization gathered in Cartagena for their General Assembly in December 2007.

Colombia's history has been plagued by violence, corruption and crime, an image that has been readily apparent to the outside world due to media depictions and worldwide travel warnings. Guerilla fighters and drug kingpins rivaled the government in political and economic power well into the 1990s. However, the death of Pablo Escobar in the mid-1990s and President Uribe's implementation of a comprehensive security strategy in the mid-2000s significantly weakened illegal armed groups.

As a direct result of the increase in safety and stability accomplished by the Uribe administration between 2002 and 2010, Colombia has become a destination accessible to more than just a select group of intrepid business travelers and vacationers. The country is a natural magnet for visitors, boasting richness in both cultural diversity and biodiversity. It is home to eight UNESCO World Heritage sights and is quickly becoming known for its culture and history. Bordered by two oceans, it has three mountain ranges in addition to jungle and plains regions. The country's cultural diversity is reflected in its heterogeneous roots — mainly indigenous, European and African. Diversity is also found in its rich urban centers, which thrive on business, commerce, and cultural activities as well as a vibrant nightlife. The largest of these urban centers, Bogotá, is currently the sixth most-visited city in Latin America and 47th worldwide.

Having only recently been a fledgling industry, tourism in Colombia is now thriving. In 2011, the tourism sector is expected to contribute 28 trillion pesos (US$15.7 billion) to GDP (4.9%), 945,000 jobs (5.4% of total employment), and 7.1 trillion pesos (US$4 billion) in capital investment. Foreign travelers' visits to Colombia rose from 0.6 million in 2000 to nearly 1.4 million in 2009, reflecting an average annual growth rate of more than 10% (almost four times the world's average). These recent years of growth have shaped political decision making and allowed the government to recognize tourism as a promising avenue for future economic development. Tourism has also greatly influenced the political, social and commercial environments in which Colombians live, and will continue to have important implications in these areas.

Positioning for Growth

In 2005, a multidimensional international marketing campaign, "Colombia Is Passion," was launched to foster the expansion of tourism in Colombia. The movement aims to improve the country's image abroad while also rebuilding morale among its citizens. This campaign, a cooperative effort between the Ministry of Commerce, Industry, and Tourism and public and private institutions, invites airline representatives, tourism-agency executives, politicians, celebrities and international media figures to see Colombia's tourist attractions and recent achievements in safety, foreign direct investment and economic development. Funding has also been used to propagate the new official slogan: "Colombia, the only risk is wanting to stay." This is an ongoing project with many successes realized thus far, including the inauguration of the coastal town of Cartagena as host of the World Tourism Organization's 2007 convention. Furthermore, since the campaign's launch, Colombia has hosted a number of other fairs and trade shows of international prestige.

The country's appeal to potential investors is strengthened further by government investment in infrastructure. For many years, commerce in Colombia had been hindered by its out-of-date transportation network (in addition to the previously mentioned security issues). With three mountain ranges dividing the country's most populated regions and a weak network of roads and rail links, the movement of goods had always been time-consuming and costly. The government's renewed focus on infrastructure investment not only benefits tourism, but also improves transportation costs for unrelated sectors.

Plans to upgrade seven airports throughout the country are underway, including the current expansion of the international airport in Bogotá, which will make it one of the largest and most modern in Latin America. Since 2000, international flights to Colombia have increased by 120%, reaching an average of 5,600 flights per month as of 2008. Roberto Jungito, CEO of Copa Colombia, described the surge in tourism as a virtuous cycle: Improvements in Colombia's image and security measures have increased the demand for flights, which has, in turn, increased supply, resulting in more competitive prices and an augmentation of air traffic. In addition, the 2011 Open Skies air-transport agreement between Colombia and the U.S. increases the number of passenger and cargo flights and spurs price competition among airlines.

Recent initiatives aimed at supporting broader infrastructure in the tourism industry have also been announced. For example, in September 2010, President Juan Manuel Santos introduced a 118 billion pesos (US$66 million) plan directed toward projects that benefit the construction and expansion of shipping docks and convention centers throughout the nation.

In hopes of boosting private investments in the hotel sector, the government began a program in 2003 that offers a 30-year income tax break on all construction or remodeling projects through 2018. By 2006, this had led to the addition of more than 7,300 hotel rooms and more than 152 billion pesos (US$85 million) in investment. The government also recently cooperated with the private sector to change legislation and allow the formation of Real Estate Investment Trusts (REITs), investment vehicles that facilitate the flow of foreign capital into real estate development and management. José Robledo, founder of Terranum, Colombia's first REIT, states that "The regulatory process to launch the REIT was quite complex. However, we managed to achieve a very robust structure because government officials understood the advantages that this type of financial vehicle offered for the development of the country's capital markets. Even so, I believe it was still unclear to them how this type of vehicle could bring benefits specifically to the tourism and hotel sector." These benefits can be seen today, as Terranum is currently in the construction phase of several hotel projects that are financed via international parties. By allowing the formation of REITs, the government made it easier for outside institutions to finance and participate in the country's growth.

Ripples Throughout the Economy

Due to sustained political support for the tourism industry and improvements in safety, tourism has become one of the most important sectors of economic activity in Colombia. The country receives billions of dollars in foreign exchange through tourism each year, making it the third most important sector by this measure, behind oil and coal. As President Santos noted in an announcement at the 2010 Celebration of Tourism Day in Bogotá, "tourism's importance in generating hard currency inflows necessitates continuation of the government's policy of growth in tourism."

Tourism has generated strong economic growth in Colombia, which, in turn, is attracting an increasing number of investors in other sectors from around the world. The effect of Colombia's drastically improved international reputation, while all but impossible to quantify, is difficult to refute. Net foreign direct investment has peaked in recent years, during which it has averaged approximately 16 trillion pesos (US$9 billion), or about 4% of GDP. Businesses within the tourism industry and related supporting sectors, such as restaurants and retailers, tend to be labor intensive. As a result, foreign investment in tourism has helped reduce the country's unemployment rate, which fell from nearly 20% in the early 2000s to about 12% in recent years. Even though profits from tourism-related investments are repatriated elsewhere, a great deal of money stays within the country due to requirements that the vast majority of all employees and managers be of Colombian citizenship.

Job creation is partly a result of Colombia's legal stability contracts and free trade zones, mechanisms that the Colombian government created to generate favorable conditions for both domestic and foreign investors. Legal stability contracts are a unique tool used to boost investor protection against political risk by guaranteeing that changes to legislation will not adversely affect the profitability of a particular investment. Furthermore, within Latin America, Colombia has some of the most competitive free trade zones. While companies in these zones reap benefits, such as a 15% corporate income tax rate and no customs tax on imports, companies must also meet both investment and job-creation requirements.

Colombia's recent improvement in its macroeconomic performance, internal security and stability for business means more jobs and opportunities. The creation of employment, in particular, has impacted popular vacation destinations, such as Cartagena, which comprises a large Afro-Colombian population living under the poverty line. Tourism will continue to be a factor in reducing unemployment, as illustrated by President Santos' announcement in 2011 that the national government seeks to create 250,000 jobs in the tourism sector over the next four years.

The growing tourism sector has both created new employment opportunities for locals and influenced migration to tourist-heavy cities, such as Bogotá, Cartagena and Medellín. As has been seen in other developing countries, urbanization results in the creation of new types of employment for individuals previously outside the labor force, such as women. Minister Luis Plata, in an interview with the BBC, stated that "tourism demands a lot of labor and not necessarily the most qualified labor. It has tremendous social impact," given its effectiveness in fighting poverty.

The government, however, has identified the need for social and education programs to support the increased demand for labor — both skilled and unskilled. In 2006, the Ministry of National Education financed the Caribbean Colombian Alliance, which aims to improve education in the coastal region in order to support technical and technological training for employment in tourism and eco-tourism. Colombian higher education institutions have partnered with foundations and trade unions, local communities and the private sector to accomplish specific goals. These goals include increasing matriculation by 30,000 students, redesigning competency-based curricula to ensure alignment with those skills relevant to the tourism sector and improving educational infrastructure. Within three years, 1,500 young adults received technical training in Cartagena and now have the competencies and skills necessary to work in tourism. There are also expected to be an additional 600-plus graduates per year in the technology space. Germán Bula Escobar, former minister of National Education, praises the success of this type of initiative. "The government supports universities and the productive sector," he notes. "It is these successes that will drive [us] to continue to support these types of alliances that benefit both education and business."

Tourism has served as a tool for sustainable social development in Colombia. The training has led Colombia to achieve levels of human capital comparable to those found in other well-developed nations. According to the *2009 IMD World Competitiveness Yearbook,* Colombian labor relations are the best in the region, and the labor force is qualified at levels similar to those of Italy and the United Kingdom. This strength, developed through linkages between the private and public sectors, will serve as a strong foundation for growth as other areas of tourism are developed, and they continue to realize additional positive social impacts.

Positive Feedback

Colombia is now on the world stage, and the stakes have been raised. The ever-increasing importance of tourism to the country's economy places added pressure on the government to continue its multifaceted approach to support this growing sector. This includes not only maintaining a harsh stance against violence, but also continuing the government's policy of identifying and eradicating fraud and corruption. A cautionary note can be taken from recent developments in Mexico, which ranks 10th on the list of most-visited countries worldwide and whose tourism sector comprises approximately one-tenth of its economy. In contrast to the new growth Colombia is experiencing as it emerges from an era of violence, tourism in Mexico is being threatened by a recent surge of drug-related organized crime. Local businesses have resorted to cutting prices in order to prop up demand, which still has not returned to the levels seen in 2008. Colombia's tourism industry is less mature and only a quarter the size of Mexico's, which means it would be even less resilient to government missteps in maintaining security and stability.

Sound economic decision-making will also be critical. To date, the Colombian government has facilitated policies that have led to rapid growth in tourism. However, tax and investment incentives will eventually expire, implying that the industry must become less reliant on such measures to attract investment in the long term.

Although Colombia's progress in combating its global reputation issues is impressive, the country's image is still marred by its history of violence — one of the greatest impediments to its growth. Catalina Crane, advisor to President Santos in public and private investment affairs, recognizes the importance of security for the future of tourism in the country when she states that "we need to promote the tourism sector and, as such, security remains the most important factor."

This article was written by Juliana Berger, Paula Herrera and Kathryn Roberts, members of the Lauder Class of 2013.

Building Blocks: The Bright Future of Colombia's Cement Industry

Colombia is poised to be the next Latin American growth story, ripe with opportunity for foreign investment. Heavy industries, particularly infrastructure, will be the big winners, as Juan Manuel Santos' government looks to enact new reforms that will modernize the economy. Much like a house, the foundation for the new Colombia will be built upon the cement industry. The bulk of infrastructure spending will be directed toward transportation (primarily roads) and housing, whose key input product is cement. Within Colombia, the cement industry is dominated by three key players: Argos, Cemex and Holcim.

For international investors interested in Colombia, three themes seem to dominate their general perceptions of the country: the illicit drug trade, security concerns and tourism. However, these themes, all interrelated and paramount to achieving sustainable growth and political stability, are not the key obstacles to the country's economic development. Colombia's most crucial requirement for success is to promote and execute its new infrastructure development plan — in particular, the development of a robust and effective transportation network as well as affordable housing for its growing population.

Within Colombia's transportation network, the mode most in need of development is land transport — in particular, rail and roads. Unlike most other Latin American countries, Colombia is comprised of four key economic centers: Bogotá (the capital), Medellín, Cali and Barranquilla. (Cartagena, the fifth-largest city, is focused primarily on tourism.) An extremely frail network of roads and highways currently connects these principal cities. With regard to housing, the growing middle class has caused real estate prices to increase steadily. In addition, increased economic prosperity has shifted the spotlight to social welfare and affordable housing, as 45.5% of Colombia's population lives in poverty and 75% of the population lives in cities. As Edgar Ramirez, vice president of planning and market development at Cemex Colombia, noted: "Colombia currently faces an approximate quantitative housing deficit of 1.3 million and a qualitative housing deficit of 2.5 million for a total deficit of 3.8 million. The deficit is expected to grow despite the housing currently under construction." The qualitative housing deficit is a measure that looks to capture the differences in construction quality.

Pioneering a New Mini-plant Design

Often used interchangeably, cement and concrete actually denote different substances. Portland cement, the key element in the manufacture of concrete, is made from a combination of iron, calcium, silicon and aluminum in predetermined, specific proportions. It is so named by its inventor, Joseph Aspdin, for its resemblance to a stone from the quarries on the Isle of Portland near the British Coast. From the original mixture, clinker (an intermediate product) is made from a heating and mixing process that eventually produces cement after further burning and grinding. Cement, when combined with water and aggregates (typically sand, gravel or crushed stone) forms concrete, which is ideal for constructing roads and buildings.

Cement consumption in Colombia is based on market dynamics specific to the country. According to the leading Colombian manufacturers (Argos, Cemex and Holcim), approximately 70% of the cement is consumed in bags and about 30% is consumed in bulk (*a granel*). In comparison, the U.S. consumes about 95% of its cement in bulk (typically sold to concrete and ready-mix manufacturers) and only 5% in bags. In addition, ready-mix concrete in bags, which is quite popular in the U.S., has not yet proven viable in Colombia due to its shorter shelf life vis-à-vis bags of cement. Concrete consumers in Colombia (for up to medium-sized projects) will purchase the aggregates, additional building supplies and cement in bags (usually the last purchase) over a period of time, mixing the concrete only when all the materials have been amassed and construction is ready to begin. This group and low-income consumers are constrained by the relatively short shelf life of pre-mixed dry concrete and its higher retail price.

Small and independent contractors in Colombia are already accustomed to purchasing bags of cement and mixing concrete at construction sites on their own, which leads to quality-control issues during construction. To guarantee quality concrete for smaller projects while still allowing contractors to consume cement in bags, Cemex, for example, is pioneering an innovative new mini-plant (*miniplanta*) design that will allow contractors to continue purchasing bags of cement. The proportions of cement, water and aggregates will be monitored to ensure that the resulting concrete mixture is of the highest quality. As Ramirez noted, "for larger construction projects, cement producers either set up mixing facilities at the construction site or deliver ready-mix concrete in trucks to the construction site as needed."

Breaking Down Colombia's Cement Producers

According to Martha Quintero, manager of Bogotá's marketing and distribution department for Holcim Colombia, cement consumption in 2010 was approximately 9.5 million metric tons, and concrete consumption was approximately 5 million cubic meters. The three largest producers are Cementos Argos (4.3 million tons of cement and 1.9 million cubic meters of concrete), followed by Cemex Colombia (3.4 million tons and 2.0 million cubic meters) and Holcim Colombia (1.5 million tons and 1.0 million cubic meters). Together, the three produce more than 95% of the total output. Cementos Argos, headquartered in Medellín, has a national presence throughout Colombia. It is also the only one of the three largest players that is locally owned through Inversiones Argos, which, in turn, has a complex cross-ownership structure with Grupo de Inversiones Suramericana and other local businesses and pension funds.

Holcim Colombia focuses on the market in and around Bogotá, which represents approximately 40% of the national cement consumption and 60% of Holcim's production. According to Tomas Uribe, head of investor relations at Cementos Argos, "Argos has an installed capacity of approximately 8-9 million metric tons of cement and represents approximately 51% of the total installed capacity in Colombia at nearly 16 million metric tons." Cemex Colombia's installed capacity is approximately 4-5 million metric tons, or 31% of the market. Other, smaller players in the market account for the remaining 5%. Cemex Colombia markets two brands of cement as a result of the acquisitions it made when it entered the market: Sanper, which is available mainly in and around Bogotá, and Diamante, which is available nationally. Lastly, Holcim Colombia represents 13% of the market, with an installed capacity of approximately 2 million metric tons.

However, competition on a national scale is limited primarily because of high transportation costs and the weight of the cement and derivative products. Despite the obstacles to competition on a national scale and the particular consumption dynamics present in Colombia, cement and concrete are expected to experience healthy growth rates in the near and medium terms. According to Ramirez, "cement typically grows at 1.1-1.3x the GDP growth rate and concrete grows at 1.5x the rate of growth of cement." Colombia's expected real GDP growth rate is 5.0% for 2011 and 2012, as indicated by José Darío Uribe, Governor, Banco de la República Colombia, in his June 2011 presentation. Therefore, cement is expected to grow 5.5%-6.5% and concrete is expected to grow 8.25%-9.75% in 2011. Nevertheless, as Ramirez was quick to note, "Cemex Colombia's sale of cement grew 11.1% during the first quarter of 2011 (January 1st to March 31st)," indicating that 2011 will be a good year for the cement and concrete markets.

Roadmap to a Better Transportation Network

Heavy rainstorms at the beginning of 2011 caused major flooding and devastating damage to Colombia's fragile network of roads and highways. As a result, US$14 billion in resources have been allocated this year for repairing and developing infrastructure. The damage literally caused cities to be cut off from each other and isolated, inconveniencing the general population and adversely affecting the competitiveness of Colombian products in the international market due to elevated transportation costs. In addition, even during the dry season (typically between May and September), roads — often with only one lane — are congested with trucks that limit the average speed to 30 kilometers per hour (kph). During holidays, the average speed can fall to 20 kph.

It is no surprise, then, that, according to Colombia's Ministry of Transportation Investment Plan, of the 99.3 trillion Colombian pesos (US$ 56.3 billion) destined for transportation investments over the next 10 years, more than 56%, or 55.9 trillion pesos (US$31.6 billion), will be invested in highways and roads. Furthermore, more than 34%, or 19.2 trillion pesos (US$10.8 billion), will be invested over the next five years in highways and roads. Inevitably, the concentration of infrastructure investments in roads will create a strong demand for rigid (concrete) and flexible (asphalt) paving systems. However, understanding the differences between these two systems is also important to explain why Colombia's current network of roads and highways has deteriorated and remains susceptible to flooding.

As Ramirez noted, currently, 90%-95% of Colombia's roads are constructed with asphalt, which is cheaper than concrete (by a factor of three) and benefits from not being subjected to value-added taxes. Nevertheless, the useful life for asphalt roads is only three-to-four years, whereas roads constructed with concrete can last, on average, 10 years. Quintero, however, pointed out that it is not easy to simply build all new roads with concrete under a rigid paving system. Much of Colombia's geography is marked by mountain ranges, and the underlying tectonic plates continue to shift. According to Quintero, "Building any road with concrete or asphalt requires extensive technical and environmental impact studies that at the end of the day will still indicate using asphalt in certain regions that are highly prone to geological movements."

Corruption continues to create a huge obstacle to the successful development of Colombia's infrastructure. For example, many of the companies that produce asphalt (a petrochemical-based product) are owned by, or have ties to, local or national politicians. Second, winning construction contracts through public auction has long been plagued by bribery, where the lowest bidder does not necessarily win or, even worse, revises costs upward after winning the contract. In addition, the law governing the auction process, "La ley 80 de contratación pública" (Law 80 of public contracting), for construction contracts provides winning bidders with *anticipos* (up-front payments) to start construction. As highlighted in the article, "La caída del Grupo Nule" ("The Fall of Grupo Nule"), which appeared in the September 2010 issue of *Semana*, the Nule brothers and their cousin Guido were finally exposed for their corrupt practices of winning contracts and living off the up-front payments in a pyramid-like scheme while completing, at best, only part of their projects.

Nevertheless, Colombian President Santos has made infrastructure a pillar of his government. To that end, a new revision of the concession and public auction law is expected at the end of 2011, and changes to the law are expected to be retroactive. Furthermore, Santos has made battling corruption another focus of his government. Construction companies have taken note, and projects that were just begun or are about to begin have been delayed as further technical and environmental studies are conducted to ensure that the appropriate standards are met. Although 90% of the current pipeline for road construction will use the flexible paving system, it is expected that the newer projects will use more concrete where appropriate, which will be a further boost to the cement industry.

High Demand for Housing

The 2005 Colombian census revealed a shortage of approximately 1.3 million homes in the country. Since then, the deficit has continued to increase, currently approaching approximately 2.4 million homes, according to estimates by the *Global Property Guide.* This shortage does not mean the housing market in Colombia is struggling. On the contrary, the market continues to perform well, with average housing prices rising 9.25% in 2010. However, similar to other developing countries, Colombia is not producing housing fast enough for its growing population. Each year, approximately 285,000 new households are created, but only around 145,000 new homes are built. In other words, the shortage increases by 140,000 units per year. According to Martha Pinto de Hart, the executive president of the Colombian Chamber of Construction (CAMACOL), "The current government has an ambitious plan to build one million homes over the next four years, which will require an investment of about US$43.5 billion, 70% of which will be housing solutions for low-income families."

Despite a crisis in the real estate market in other parts of the world, housing prices in Colombia continue to rise. A peaceful transition to a new president and a positive economic outlook for the country have contributed to the healthy market. In March 2011, the country's credit rating improved to investment grade, opening the gates for significant foreign direct investment in the housing market.

In developing economies, the housing sector often makes up a significant portion of the cement industry's revenues. With a strong performance from the housing sector anticipated, the Colombian cement industry is expected to thrive. The industry recognizes its dependence on housing for its growth and has taken action to assist low-income families in purchasing homes.

Cemex developed a program called Patrimonio Hoy (Worth Today), that provides support to lower socio-economic classes to encourage and ease the financial constraints of home ownership. Following the initiative's success in Mexico, Cemex brought Patrimonio Hoy to Colombia. The program seeks to reduce the Colombian housing deficit by encouraging low-income populations to save in order to pay for housing. It organizes low-income families into self-financing cells that facilitate and expedite the typical home-building process. Families served by Patrimonio Hoy gain access to credit, enjoy better living conditions and learn improved savings behavior. The primary challenge for social housing policy now is preparing the urban land for the construction of housing in all price ranges. As Ramirez noted, "With 2.5 million people in need of housing, Cemex continues to explore public housing projects that could provide more options to low-income individuals. They are searching for the right mechanism to counter both the housing shortage and the approximately 800,000 low-income individuals who currently reside in shanty towns."

The housing demand in Colombia will remain strong due to the country's solid economic outlook in terms of growth and inflation and the initial elevated deficit. The building sector's growth is predicted to be an average 10% annually for 2011 and 2012. According to BBVA Research, building permits are at high levels and mortgage interest rates are at historic lows, encouraging home ownership. In the coming years, housing prices and costs will continue to increase moderately. In fact, even when the cost of cement decreases, housing prices remain constant — evidence of sufficient demand in the market place. Cement sellers in Colombia predict an increase in their prices toward the end of 2011 due to increases in the costs of production and distribution associated with the strong rainy season. This is yet another reason to expect rising prices in the housing industry.

Colombia has a large low-income population and, since 60%-70% of cement consumption is "do-it-yourself" construction, pricing is the most important factor for consumers. Ramirez pointed out that "there is little-to-no brand loyalty — consumers purchase the most inexpensive brand within a 700 peso margin per bag." Furthermore, the lack of a developed market for more convenient (but also more expensive) premixed bags of cement reflects the importance of price to the average Colombian consumer.

This consumer sensitivity to price has made cement the most popular building material in Colombia because cement structures are relatively inexpensive when compared to those built from other materials. In addition, the Colombian government's commitment to infrastructure development and repairs to existing infrastructure over the next four years will create significant demand for cement. The growth of the housing sector will contribute further to cement industry sales.

Based on the growth of these indicators in Colombia as well as improved credit and economic indicators, all signs point to strong growth in this industry.

This article was written by Jordan Brock and Julian Lautersztain, members of the Lauder Class of 2013.

The Lauder Global Business Insight Report 2012

Transformative Times: New Opportunities for Business in an Era of Upheaval

The Lauder Institute
Wharton · Arts & Sciences
University *of* Pennsylvania

Knowledge@Wharton

Wharton
University *of* Pennsylvania