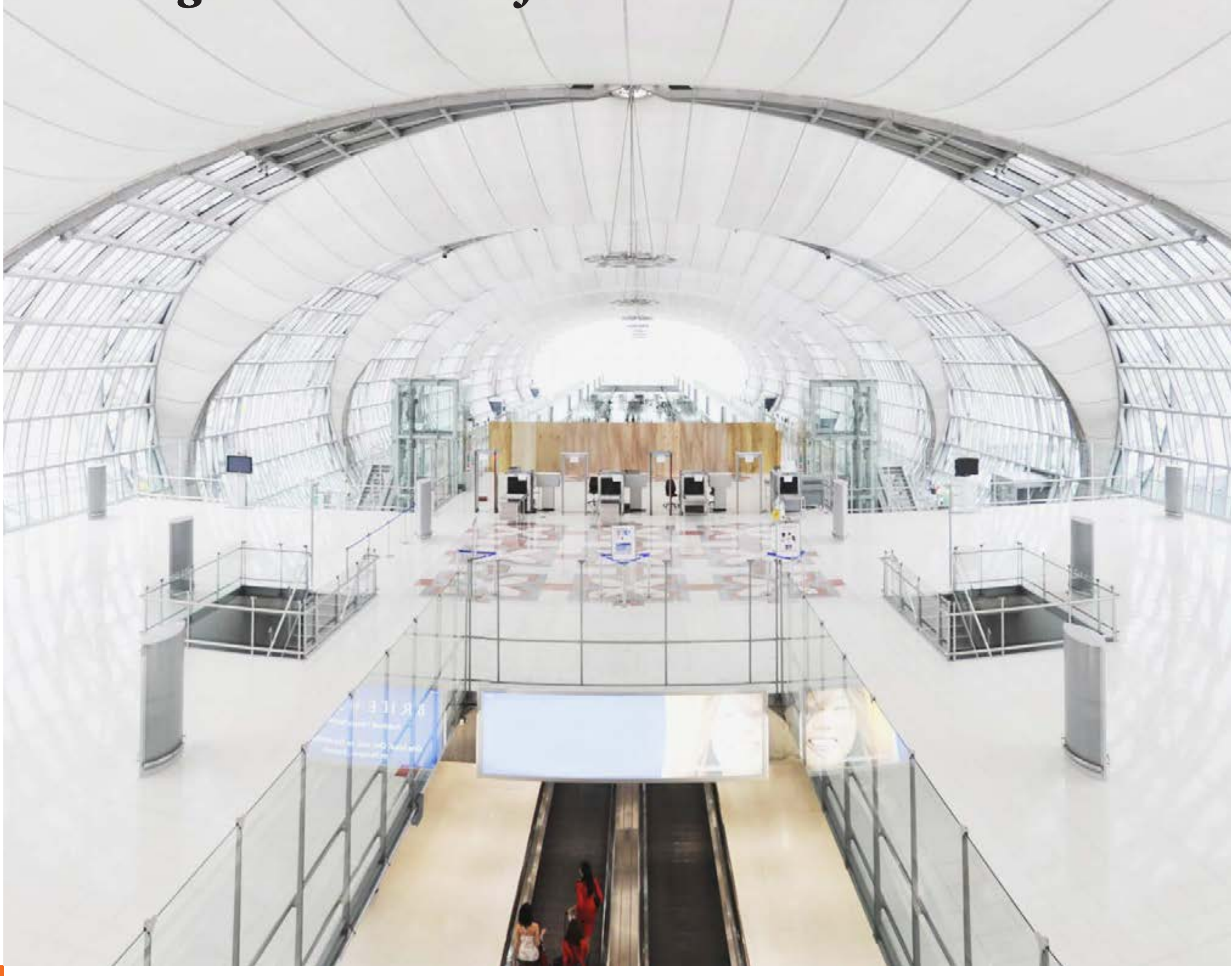
Marketmap

How emerging markets change the global economy

2012
Issue 2

The Southeast Asian tigers roar again: this time for real



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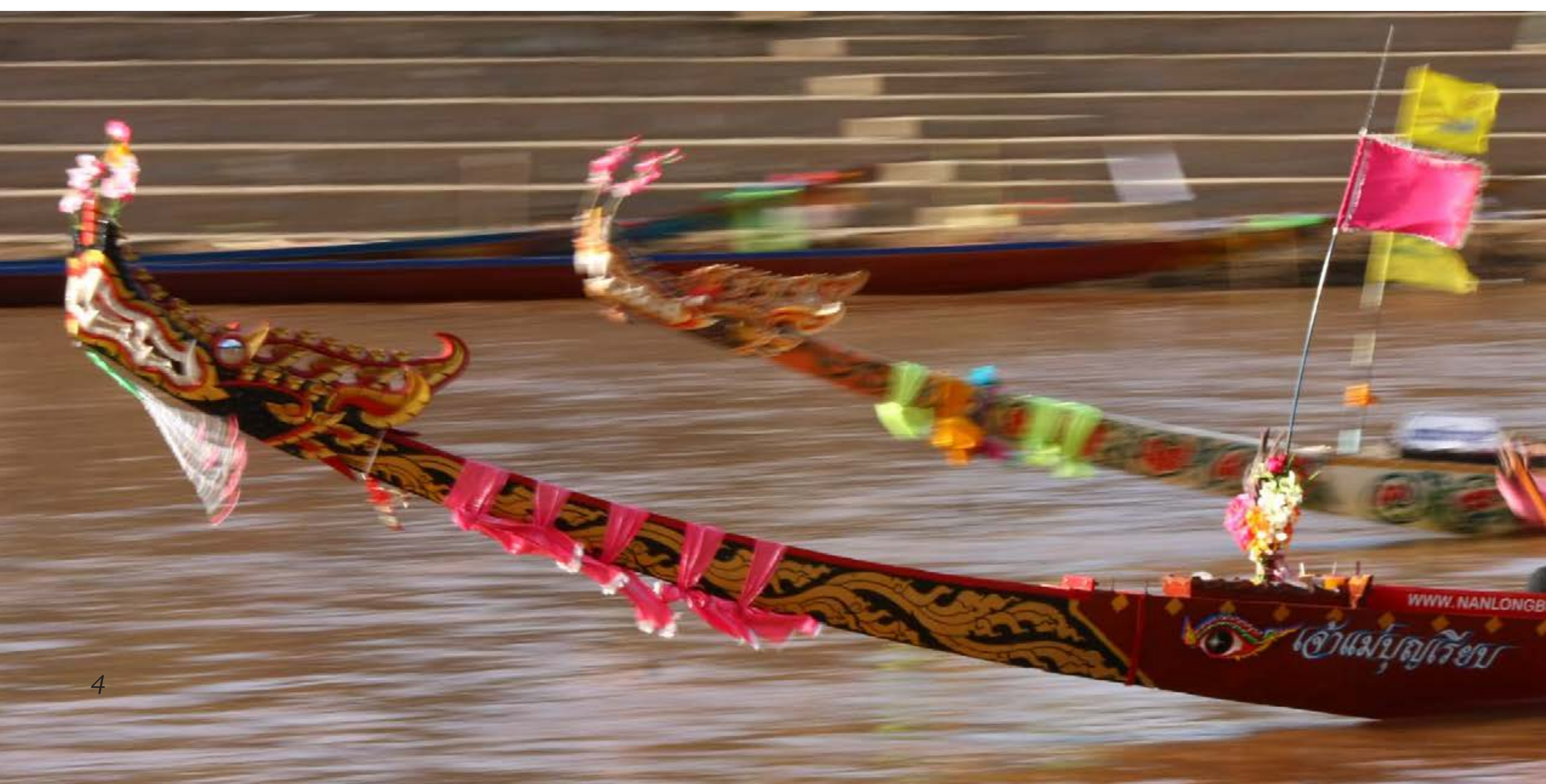
Southeast Asia comes of age
Moving to the forefront of the global economy

Sizing up Southeast Asian business opportunities, mitigating risks

As advanced economies continue to limp out of recession, Southeast Asia, like many other emerging markets, is a rising star of the global market, led by its five fastest-growing countries: Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. After decades in the making, economic, political, and market factors, combined with a landscape more focused now than ever on attracting capital and development, have converged to create a mature environment ripe with opportunity—though still fraught with complexity and challenges.

Southeast Asia, home to nearly 9% of the global population, is also home to a large and growing pool of highly skilled, low-cost workers, shaped over years of domestic and foreign capital investment. Compared to China, the growth of Southeast Asia's labor force in the 'fastest five' (Indonesia, Malaysia, the



Philippines, Thailand, and Vietnam) has been more than twice China's growth rate each year from 2005 to 2009. This confluence of advantageous factors has rallied Southeast Asian development and remains its greatest competitive strength.

Southeast Asia is a rising star of the global market, led by its five fastest-growing countries: Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

Local industries and foreign multinationals eager to capitalize on the region's favorable labor profile have also spurred growth and sophistication in manufacturing and licensing agreements there. This emphasis has rendered Southeast Asian business partners more reliable and boosted their appeal to foreign investors. A growing number of companies are also seeking to tap into Southeast Asia's middle class, which is gaining in population and wealth, stoking domestic demand for and consumption of goods and services.

Foreign investors looking to capitalize on these revenue and operational opportunities are progressively seeking local business partners, as evidenced by increasing levels of foreign direct investment (FDI) and a fast-paced trend toward closing international deals with local businesses. In fact, the growth rate of FDI inflows into Southeast Asia has outpaced that of China in 2010.

Companies are increasingly using local partners' market knowledge and relationships with customers and governments to adopt international business and put Southeast Asia's manufacturing competitiveness into the service of global demand. With momentum shifting toward Southeast Asia, early movers stand to reap the benefits. In PwC's 15th Annual Global CEO Survey 2012, half of CEOs based in developed markets believe that these emerging economies are more important to their company's future.[1]

But opportunities are not risk free. For starters, the region's governments have only recently accelerated liberalized trade and investment policies and introduced transparent regulations to combat corruption and ease the landscape for doing business. Increased progress toward risk reduction will occur over time, not instantly. Companies should be prepared to proceed with appropriate caution, for example, by performing risk assessments of local contractors' activities as they pertain to possible corruption.

Small businesses in these economies still tend to operate without the benefit of well-structured industrial processes and organizational procedures. Such weak internal organizational structures heighten the risk of counterfeiting and asset misappropriation. Similarly, technology infrastructure deficits can breed cybercrime, reinforcing the importance of risk monitoring and mitigation. In the case of licensing agreements, licensors need to perform local royalty compliance audits to assess and manage the activities of local partners.

In addition to these regulatory and business realities, the region also presents a number of geographic challenges, particularly the threat of natural disasters. Historically, environmental catastrophes have affected local economies, motivating local authorities to improve their disaster response infrastructure. A company's risk management strategy should include an evaluation of its exposure to risky environmental events and an assessment of their potential impact.

Finally, Southeast Asia is culturally and geographically diverse, encompassing a multitude of terrains, languages, governments, histories, and traditions. Addressing these variances from country to country requires a keen eye and deep cultural awareness. Therefore, it is imperative to understand the array of social, political, and economic issues that might influence the labor relations and business relationships that will likely be central to investing successfully in the region.

1 PwC's 15th Annual Global CEO Survey

An army of talented producers and consumers
The competitive advantage of a burgeoning population

Diving into a large pool of low-cost, skilled labor

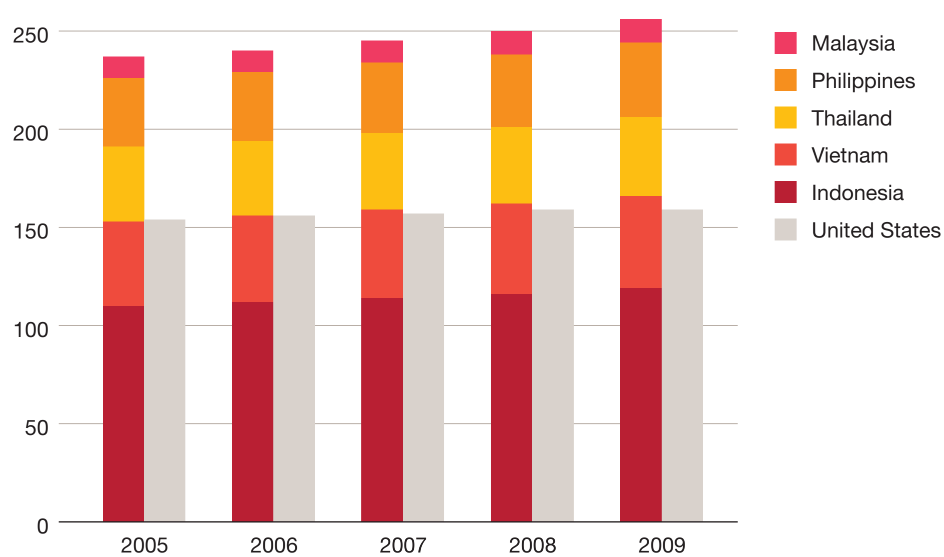
Southeast Asia's export-driven growth and industrialization was catalyzed by multinational companies in search of low-cost labor. Recently, companies began leveraging Southeast Asia's pool of low-cost, skilled labor as a cheaper alternative to their home country suppliers and manufacturers. The region's fastest five share a serendipitous labor scenario: 1) large labor pools; 2) highly literate and skilled labor, owing to past investments by state actors and first-mover foreign investors; and 3) relatively low-cost and untapped labor resources. We'll take a look at each of them.

Large labor pool

Southeast Asia, approximately half the land mass of the United States, boasts nearly two times the US population and nearly 9% of the world's people. The combined population of Indonesia, Malaysia, the Philippines, Thailand, and Vietnam is roughly equivalent to 40% of China's population.

The region's thriving labor pool reflects its robust population. Indonesia alone has a labor force that is on par with that of the United States or all of Europe; the combined labor force of the 'fastest five' eclipses the United States and all of Europe and totals about one-third of China's sizeable workforce. During the 2005–2009 period, the labor force for the fastest five grew from 237 million to 255 million, a growth rate of 7.4%. This growth in the labor force is more than twice that of China's 3.2% growth in the same period.

Figure 1: Labor force, in millions



Source: World Bank database

Low-cost labor

Long recognized as a low-cost production platform, Southeast Asia will continue to reap the benefits of its competitively priced labor pool, which is expected to endure as the region's greatest asset.

Labor costs in Southeast Asia are considerably lower than in North America and Western Europe; most importantly they are lower than in China. The hourly wage rate in China is USD 1.56, compared to only USD 0.81 in Vietnam and USD 0.51 in Indonesia, according to International Market Assessment. We also see significant labor cost disparities between Southeast Asia and Western countries, where a 12 times multiple in talent costs is common.

Data from the International Monetary Fund (IMF) World Economic Outlook shows that average annual wages in the fastest five Southeast Asian countries is between USD 1,000 and USD 4,700.

Globally competitive labor costs enable multinationals to use Southeast Asia as a hub for global production and manufacturing and to access the Asian markets. As a result, for example, Thailand has positioned itself as an auto manufacturing hub of the region, manufacturing all ranges of auto supplies and exporting finished goods worldwide.

As the region continues to grow more deeply integrated with the global economy, we expect its competitive manufacturing capability and competitive labor costs will help meet a global demand for goods and labor.

Highly skilled labor

Indonesia, Thailand, and Vietnam have all experienced steady increases in adult literacy rates, averaging at around 95% in the most recent survey by the United Nations Education, Scientific and Cultural Organization (UNESCO).[2] Each of the fastest five countries showed an average percentage of literacy rate of 93% between 2006 and 2008, according to Asian Development Bank. Additionally, English is either an official language or favored as a secondary language in the Philippines, Malaysia, Thailand, and Vietnam.

2 UNESCO Institute for Statistics, National Adult Literacy Rates.

Figure 2: Average wage in Southern Asia, USD

Source: IMF World Economic Outlook, October 2011

The fastest five also spend a greater proportion of their government budgets on education relative to developed countries such as the United States. For example, based on World Bank data, the United States' average spending on education as a percentage of government expenditures is 14%. In contrast, the average for the fastest five is 18%. Examples of the major education investments and programs in Southeast Asia include the following:

- Thailand's education system includes more than 37,000 educational institutions and nearly 20 million students, 2.2 million of whom take part in the higher education sector, an enrollment ratio of 56%.[3] Undergraduate programs see even greater participation, with 91% of students pursuing such programs.

- In Vietnam, the number of college/university students increased by 120% to 1.66 million students from 2000 to 2008.[4] This trend is due to a shift in Vietnam's policies designed to expand its higher education system. In Vietnam, the number of students who can afford overseas education is increasing very quickly; each year around 25,000 students apply for international educational programs.

- In the Philippines, 75% of students who enroll in the first year of high school go on to complete their secondary education.[5]

In Vietnam, the number of college/university students increased by 120% to 1.66 million students from 2000 to 2008.

3 Towards a Learning Society in Thailand, an introduction to Education in Thailand. Ministry of Education

4 World Bank Education Statistics and UNESCO Education Statistics.

5 PwC 2010 Investors' Guide, "Running the Winds of Change: Doing Business and Investing in the Philippines"

Figure 3: Real GDP growth (annual percentage changes)

	2010	2015	Average 2003–2007	Average 2011–2015
Indonesia	6.10	7.10	5.50	6.60
Malaysia	6.50	5.30	6.00	5.50
The Philippines	6.00	4.40	5.70	4.60
Thailand	7.00	5.10	5.60	5.20
Vietnam	6.80	7.20	8.10	7.10

Source: OECD Southeast Asian Economic Outlook

Tapping into a wealthier middle class

Southeast Asia has emerged strongly from the global financial crisis of 2009. For example, the average economic growth rate of the fastest five is projected to reach an average of 5.8% annually from 2011–15.(Figure 3)

Southeast Asia's largest economies, Indonesia, Malaysia, the Philippines, and Thailand, along with Vietnam and Singapore, had a 2010 combined gross domestic product (GDP) at purchasing power parity of approximately USD 3 trillion, equivalent to nearly three-fourths of Japan's and one-third of China's economies. Despite this large market base, the region remains relatively untapped and underserved. For example, in Indonesia, which is the fourth most populous country in the world after China, India, and the United States, industries such as automotive and banking still have low penetration; most people do not own a car, nor can it be assumed that they maintain bank accounts or use credit cards. In fact, according to respondents in a 2011 survey in Indonesia, senior banking executives identified their number one strategic priority to be the expansion of the banking network in Indonesia in order to tap into the local population.[6]

Part of Southeast Asia's large market potential emanates from its rapidly growing middle class. In Indonesia, for example, the middle class comprises approximately 40% of the population, or more than 90 million people. Within the next four to ten years, this block of consumers is expected to grow to more than 150 million.[7]

Along with its climbing numbers, the middle class has experienced a rapid income rise. Within the next decade, some 58% of households in Indonesia are expected to have annual disposable income between USD 5,000 and USD 15,000; currently, approximately one-third of Indonesian households have disposable incomes within this range.[8]

6 PwC's "Indonesian Banking Survey Report 2011"

7 US Commercial Service. Doing Business in Indonesia: 2011 Country Commercial Guide for US Companies.

8 Ibid.

More importantly, this newly “rich” middle class is spending their disposable income. Growth of the middle class and its income are generating increased demand for more technologically advanced products and services. For example, Indonesia has become one of the largest markets for smartphones and scooters, both of which are in high demand with the population’s affluent middle class. And though most people do not yet own them, car sales are increasing rapidly, up to approximately 750,000 vehicles in 2010. Even in Vietnam, rising income, cheaper phones and IT devices are making telecommunication services more affordable. In Malaysia, sales of smart devices are expected to have grown by 35% in 2011. International Data Corporation (IDC) estimated that 26% of all the phones shipped last year were smartphones.[9]

With these trends poised to continue across Southeast Asia, ever-greater spending power will support demand for services and higher value-added products. Some Asian countries have been exceptionally successful in reducing poverty, enabling people to start consuming goods and services that transcend basic needs. Particularly notable have been achievements in Indonesia, Malaysia, Thailand, and Vietnam, where dramatic gains have been made recently.

9 PwC’s “Making Waves: Southeast Asia Series—Spotlight Vietnam.”

At the vanguard
The advantage of early entry into emerging markets

Gaining the early-mover advantage by investing in the Southeast Asian region

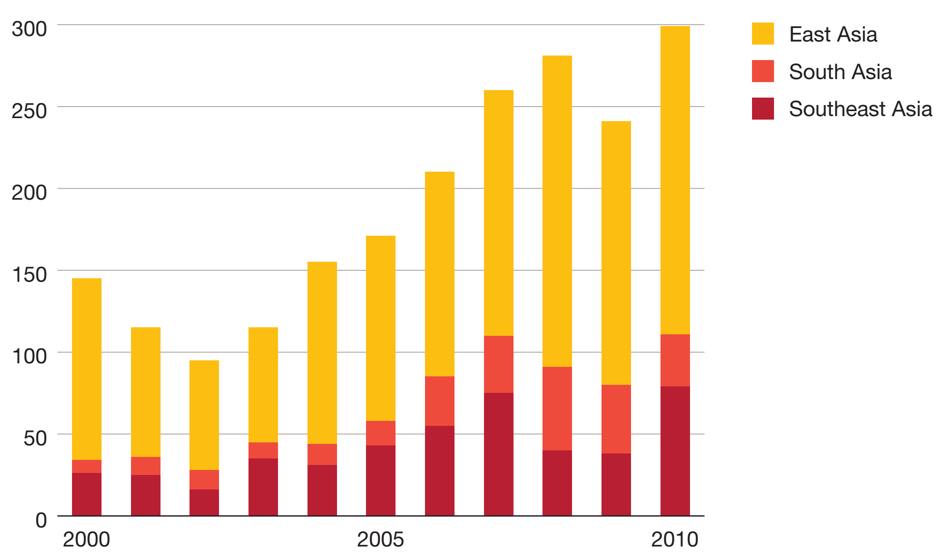
In Southeast Asia, engaging good local partners as agents, distributors, franchisees, joint venture partners, or general partners is a common and effective market entry strategy. Accordingly, early movers can gain an advantage by tapping into established, capable, and reputable local business partners.

Given Southeast Asia's large and growing pool of skilled, low-cost labor, early-mover multinational companies looking to conduct business in the region have continued to rapidly enter into subcontracting and other arrangements with local partners to pursue investment opportunities and take advantage of production and manufacturing capacities. One CEO from PwC's 2012 Global Survey stated that, "In emerging markets, we have primarily adopted an 'attack' strategy. That means we have to pay more attention to market share at the beginning instead of profit."[10]

The escalating pace of global interest and expansion into Southeast Asia is reflected in the level of FDI entering the region. Indonesia, for example, experienced record FDI levels in 2011. FDI inflows to South, East, and Southeast Asia the previous year rose 24%, to USD 300 billion (Figure 4). And in 2010, FDI into Southeast Asia alone surged over 100%, from USD 38 billion to USD 79 billion. In comparison, FDI inflows into China only grew by 12% over the same period, a growth rate that is over nine times lower than that of Southeast Asia.

10 PwC's 15th Annual CEO Survey 2012

Figure 4: Foreign inflows, 2000–2010, USD Billions



Source: UNCTAD, "World Investment Report 2011"

In 2010, Vietnam surpassed China to become the largest production venue for Nike, while Coach announced plans in 2011 to shift half of its production from China to neighboring Asian countries.

Such foreign capital inflows are also influenced by government initiatives designed to attract inbound investment such as Malaysia's Economic Transformation Programme, which is focused on transforming 11 economic sectors in order to attract foreign investment.

At the same time, rising production costs in China have shifted manufacturing and production momentum to Southeast Asia, where countries in the Association of Southeast Asian Nations (ASEAN), such as Indonesia and Vietnam, have gained ground as low-cost production venues, especially for labor-intensive manufacturing. In 2010, Vietnam surpassed China to become the largest production venue for Nike, while Coach, citing rising labor costs, announced plans in 2011 to shift half of its production activities from China to neighboring Asian countries.[11] In 2010, Intel opened a USD 1 billion assembly and testing plant in Ho Chi Minh City, and Nokia announced plans to build a hand set manufacturing plant in Hanoi.[12]

11 UNCTAD, World Investment Report 2011

In addition to manufacturing and production, Southeast Asia's large pool of low-cost yet skilled labor has also created opportunities for the offshoring and outsourcing of services. Investments in the last decade have positioned the Philippines, with its pool of highly literate, English-speaking, low-cost workers, to provide services across the value chain, including back-office support, call center services, engineering design, and software development. These service sector growth opportunities have also created complementary growth opportunities in other enabling industries such as hardware, software, networking, security, and related providers.[13]

Southeast Asia's rich reserve of highly skilled workers will also spur the introduction of new and advanced technologies for producing high-value goods. This can, in turn, increase the region's gross national income and raise internal demand for international goods. Thus, early investors can gain not only the opportunities of saving cost, but they also can maximize revenue through sales made in local markets.

12 PwC's "Making Waves: Southeast Asia Series—Spotlight Vietnam"

13 US Commercial Service. "Doing Business in the Philippines: 2011 Country Commercial Guide for U.S. Companies"

Corporations continue to expand across Southeast Asia in a bid to capture maximum profit and growth. To effectively capitalize on these opportunities, investors need to remain aware of potential risks and establish defenses against them. Many companies underestimate the risk of illegal practices in the international marketplace, exposing them to bribery and corruption. Almost every company—regardless of size or industry—that chooses to enter these emerging markets is exposed to some degree of corruption risk. Even the most experienced corporations often fail to properly assess corruption risks when entering these markets, with their diverse cultures and unique operating environments.

Each of Southeast Asia's fastest five scored below five in Transparency International's 2011 Corruption Perceptions Index, indicating relatively high levels of public sector corruption. With governments more vigorously enforcing laws against corruption and imposing stiffer penalties on a global scale, multinational companies can no longer afford to turn a blind eye to the risk of violating local, US, and global anti-corruption regulations. In addition to fines, corporations prosecuted for bribery and corruption are at risk of real and lasting damage to their corporate reputation, operations, and profitability. Additionally, concerns regarding labor conditions, worker mistreatment, and wage abuse at local manufacturing facilities in the region also put multinationals at risk of legal and reputational harm.

As part of their entry strategy into Southeast Asian markets, companies may also enter into different collaborative contractual agreements with their business partners and vendors. Accordingly, market participants should establish strong ethical and anti-corruption compliance programs as part of this market entry strategy. Doing business in Southeast Asia will also require extensive due diligence to vet the reputation, financial stability, and technical capability of local business partners. Such an undertaking may prove to be difficult without appropriate assistance in overcoming the lack of transparency that veils many enterprises in Southeast Asia.

Investors can position themselves to derive greater recourse in the event problems arise by proactively performing business partner due diligence, including contractual terms and conditions that require appropriate behaviors. In addition to negotiating the finer points of contracts to their advantage, companies should spend enough time performing post-deal management and analysis to ensure that those advantages are being realized. Frequently, business partners may not be complying with the terms of the contract or are interpreting elements of the contract to their advantage, causing the company to lose money. Also, certain contracts often require the business partner to self-report in a manner that is difficult to verify. Vigilance in the form of third-party audits of business partners can therefore serve as deterrents and early warning signals to allow the detection of potential issues. Contractual relationships that are frequently subjected to such third-party audits include contract manufacturing, co-marketing, co-development, distribution, franchising, leasing, sourcing/supply arrangement, and outsourcing as well as overall anti-corruption compliance by the third parties.

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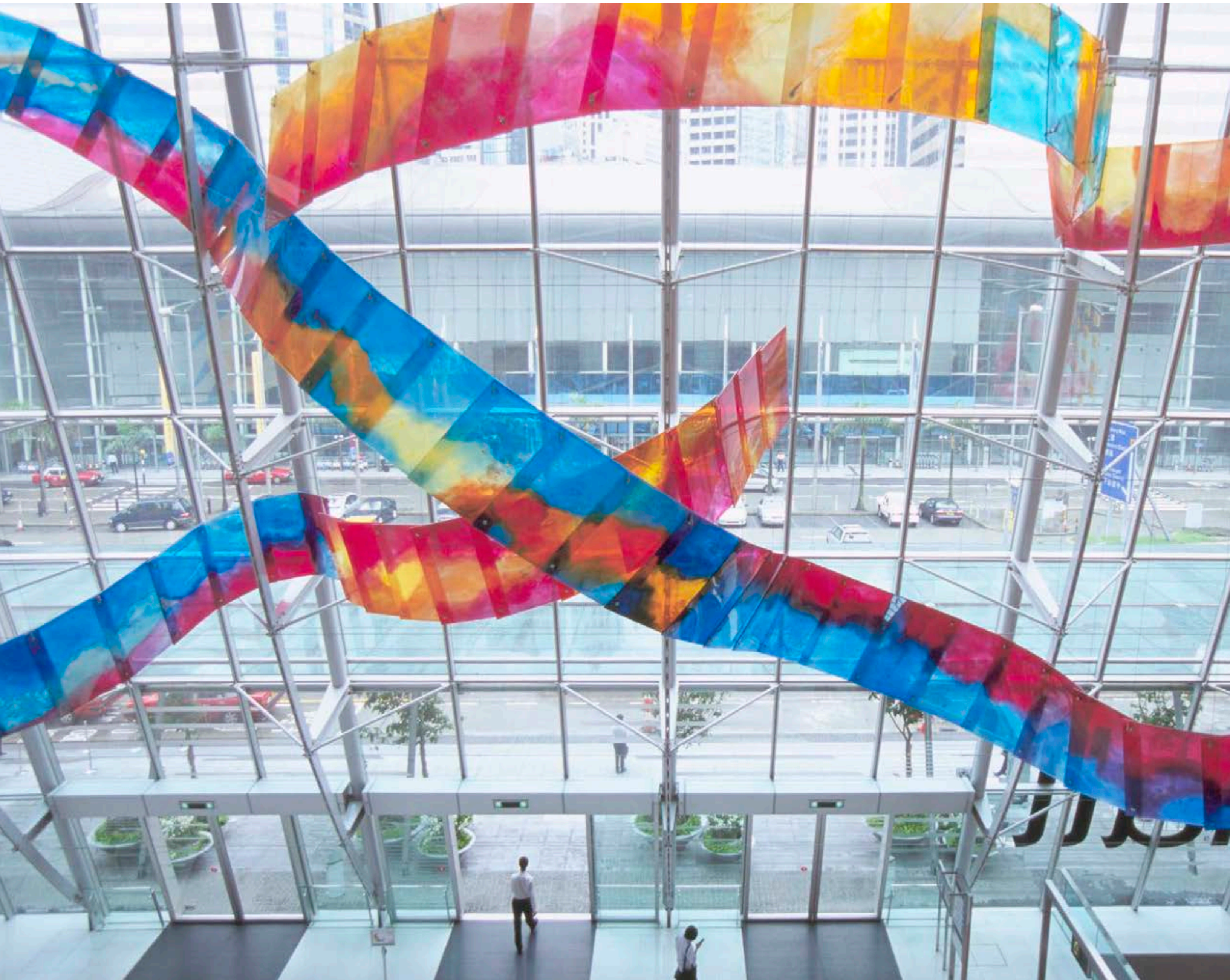
For example, with respect to foreign franchisors, a franchise compliance exam may help prevent underpayment of franchising fees. Franchise compliance exams may result in increased royalties, improved contract compliance, better purchasing consistency, an opportunity to identify business improvements, and an ability to provide training and support. As previously noted, the franchise compliance exams inherently serve as a monitoring control for franchisors. In other words, if franchisees know that the franchisor may be looking into their financial results and related royalty calculations, they may be less inclined to knowingly under-report fees due.

Opening the door
Southeast Asia opens up to deals, foreign investment, and trade



Opening doors and building bridges

Also stoking Southeast Asia's emergence as a legitimate market opportunity has been the actions of the various nation states to open the door to investments. While decades of local industry and multinational investment have undoubtedly tipped the scales in favor of Southeast Asia's rapid growth, recent government deregulation and liberalization have amplified current market interest.

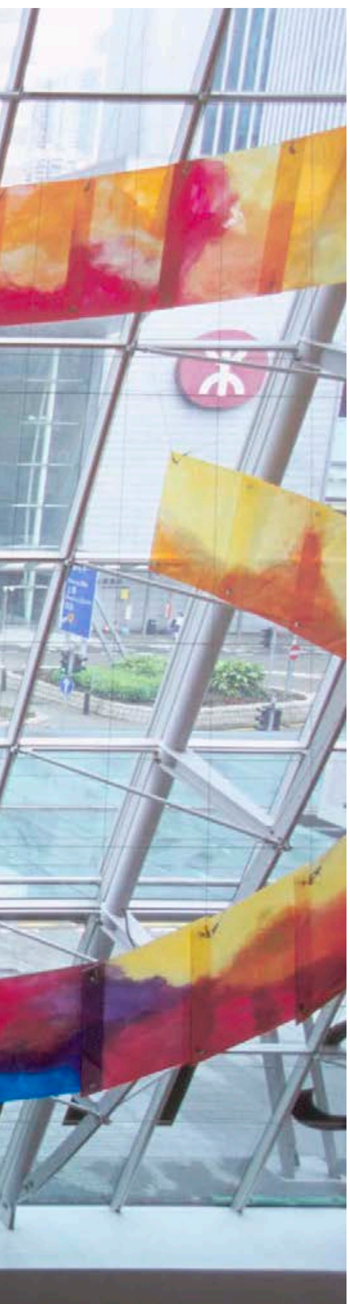
Southeast Asian countries are sending the message that they are open for business. The World Bank reported in its 2012 Doing Business in a More Transparent World study that Indonesia, Malaysia, Thailand, the Philippines, and Vietnam have instituted reforms intended to make it easier to start businesses, enforce contracts, protect investors, and resolve insolvency. These reforms include:

- Simplifying business application processes
- Reducing paperwork and establishing one-stop shops
- Streamlining and accelerating processes for obtaining general trading licenses and business registrations
- Increasing standards of accountability for company directors
- Computerizing court systems
- Updating liquidation and reorganization laws

Governments in the region have continued to lower trade barriers and tariffs over the last five years, while negotiations progress toward a free-trade agreement with the European Union.[14] Cooperation among the Southeast Asian economies has also improved via multilateral institutions such as the Asia Pacific Economic Cooperation and ASEAN. As Southeast Asian states continue to become more open and accommodating to foreign investors, regulations may continue to become more investor friendly in a bid to attract greater FDI.

Infrastructure improvement and development has also emerged as a significant area of opportunity in Southeast Asia. The Philippines, for example, launched its Public–Private Partnership program, which encourages private corporations to invest in infrastructure projects by providing private resources with incentives to finance and undertake construction, operation, and maintenance of infrastructure and development projects normally performed by the government. Sectors presenting opportunities include public works, transportation, education, and health.

Indonesia's parliament, seeking to further the country's rise as an emerging market, recently approved a law to facilitate government acquisition of civilian land for much-needed infrastructure projects, including the construction of roads, ports, power plant, airports, railways, dams, and oil facilities. Primary contractors and related industries such as cement, steel, chemicals, equipment, and other industrials stand to benefit from Indonesia's efforts to enhance its infrastructure; consider that in 2009, the country's infrastructure spend was approximately 3.9% of its GDP, compared to China and India, which spent approximately 10% and 7.5%, respectively that year.



14 World Bank, "2012 Doing Business in a More Transparent World"

Doing business with government entities is complex and fraught with rules and bureaucracy, a challenge that only intensifies with foreign government involvement. Although Southeast Asian governments have already adopted political measures to attract the FDIs, more efforts should be made in order to improve transparency and efficiency.

Establishing a local presence, whether through a branch, subsidiary, franchising or licensing arrangement, joint venture, or foreign representative office, requires registrations, permits, and licenses, all of which costs time and money. Investors might also come up against limitations on foreign equity ownership and further restrictions in the activities it can perform, including signing contracts, collecting payments, selling, establishing bank accounts, and other business transactions, depending on the kind of presence it establishes in the country.

When doing business in Southeast Asia directly with a government or government-owned entity, corruption is a constant and very real concern. Tender processes may not be transparent, and project execution may be fraught with bureaucracy. In addition, lack of uniformity and consistency in government policies may also pose a challenge.

Foreign providers may be limited to projects with certain scope and magnitude, while at the execution stage, requirements regarding local sourcing of materials or labor can complicate operations. Billing and reporting requirements for government contracts can be exacting and time-consuming, with tax and statutory filing requirements potentially presenting additional complexities. With these inherent risks and pressures associated with doing business with government or government-owned entities, it becomes even more imperative to foster a culture of compliance in its local operations and with its business partners. Establishing and consistently enforcing clear and specific compliance requirements, monitoring for adherence to policies, and conducting due diligence and periodic risk assessments will contribute to the overall success of such government ventures. As a foundation, clearly messaging and demonstrating to local employees and business partners a company's top-level commitment to ethical behavior and compliance, along with frequent training programs, serve as the bedrock that anchors the pursuit of opportunities and the management of risk.

Infrastructure projects, one of the more common business ventures in Southeast Asia, may also result in construction-related disputes arising from project delays and cost overruns. These disputes require specialized financial and engineering analyses to evaluate causal links between technical issues and related cost impact as well as substantiating and quantifying associated damages.

Another cautionary note is that, in some countries in the region, political stability may be fragile. As such, despite a number of attractive opportunities, companies should be prepared for a range of political, security, bureaucratic, and corruption-related hurdles in these markets.

Doing business with government entities is complex and fraught with rules and bureaucracy, a challenge that only intensifies with foreign government involvement.

Finally, just as investors follow opportunities into new markets, so should they pursue them within the safeguards of solid risk management programs. They should, for example, consider that their new venture also exposes them to the risk of catastrophic events—such as earthquakes, flooding, and typhoons, which may be quite common in Southeast Asia. Accordingly, companies should proactively perform an analysis to evaluate whether their insurance coverage is sufficient, whether it covers relevant risks, including property damage and business interruption, and whether new locations will be covered by existing policies. In the event that catastrophic events do occur, companies will be required to prepare and assemble detailed insurance claims packages that quantify the value of their business impairment and loss.

Thailand, where severe flooding in 2010 crippled manufacturing and production facilities and deflated consumer confidence, is also under pressure to upgrade its infrastructure and to demonstrate swift and effective crisis response, rebuilding not only roads and buildings, but also confidence.

These ventures will occur only at the intersection of the private and public sectors. Successful companies integrate more deeply by forging relationships with government, building regional distribution and services networks, and, most important, pursuing business aims that twin with regional priorities.[15]

Deals, deals, and more deals

As foreign investors eye the region with accelerating interest, Southeast Asia has become a crucible for vigorous cross-border M&A deal activity. Acquisitions have provided opportunities for rapid international expansion and a platform that enables companies to gain competitive advantage through access to technology, local brand names, logistics, and distribution, while neutralizing local competition.

Thailand and Malaysia had the highest total M&A deal value in 2010 (USD 1.3 billion and USD 910 million, respectively), while Indonesia saw the highest number of deals (USD 800 million total value), followed by Vietnam (USD 70 million total value).

State entities are also moving toward free enterprise and privatizing stakes through initial public offerings and sale transactions.[16] For example, Malaysia's sovereign wealth fund, Khazanah Nasional Bhd, announced plans to sell its stake in the national car manufacturer, Proton Holdings, to strengthen the car maker's competitive position in the marketplace.

15 PwC's "10 Minutes on Expanding Business in Asia Pacific"

16 The Wall Street Journal. "Malaysia to Sell Stake in Proton." January 16, 2012

Figure 5: Deal volume and deal value

	Deal value (USD millions)				Deal volume			
	2007	2008	2009	2010	2007	2008	2009	2010
Worldwide	4,169,287	2,886,972	1,980,347	2,434,204	43,817	41,045	39,841	40,660
Asia Pacific	596,582	512,190	438,776	573,808	13,157	12,987	12,949	12,777
Southeast Asia	75,675	73,670	44,099	85,849	2,001	2,115	2,318	2,486
% of Southeast Asia on Asia Pacific	13%	14%	10%	15%	15%	16%	18%	19%
% of Southeast Asia on worldwide	2%	3%	2%	4%	5%	5%	6%	6%

Source: Thomson Reuters M&A review, full years 2010, 2009, 2008

Watch out

Most Southeast Asian countries have undertaken initiatives to strengthen their intellectual property regimes. For example, member states of the ASEAN have cooperated to implement the ASEAN Intellectual Property Action Plan 2004–2010 and the Work Plan for ASEAN Cooperation on Copyrights. They also have worked together to establish an ASEAN filing system for design to facilitate filings by users and promote coordination among intellectual property offices.[17] Still, enforcement of intellectual property laws in emerging markets remains less stringent relative to developed nations.

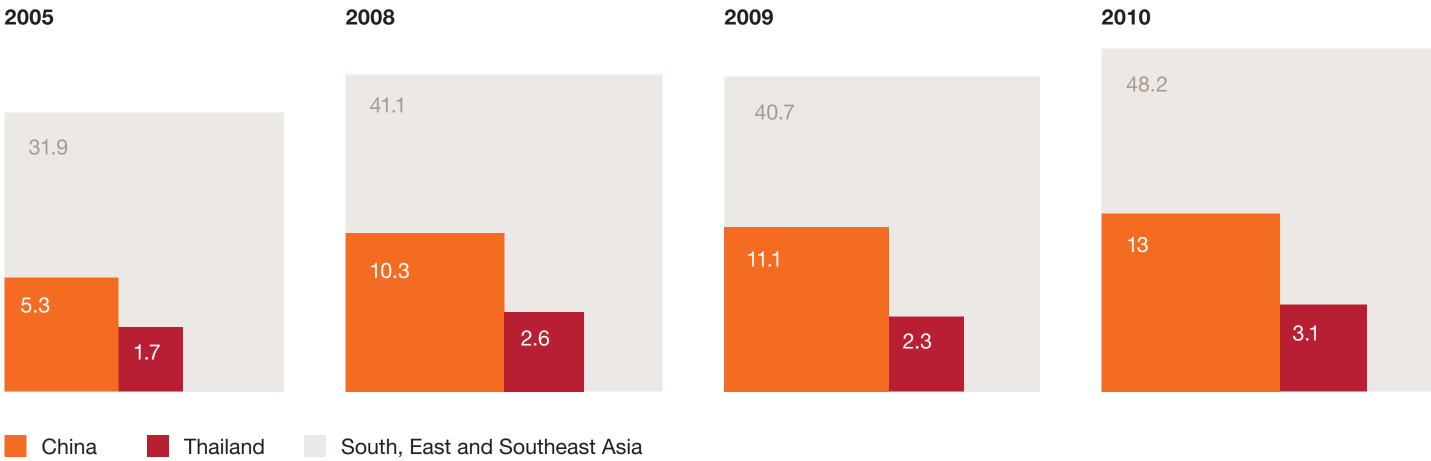
Southeast Asian countries remained on the US Trade Representative's Priority Watch List (Watch List) in its 2011 Special 301 Report. Multinationals doing business in emerging markets take on the risk of infringement of intellectual property rights through theft, piracy, and counterfeiting. Local licensees in emerging markets may also have poor internal security infrastructures, further heightening the risk. Intellectual property holders should take proactive, vigilant, and vigorous measures to protect their rights by working closely with local enforcement agencies, performing careful diligence in selecting local partners, and scrupulously managing local registration and royalty compliance audits. A proactive royalty management program is often critical to successfully navigating international licensing arrangements. The benefits are improved dispute resolution, enhanced compliance, and more accurate reporting. In 90% of the license agreements, royalties paid by licensees to licensors are underestimated due to clerical errors, accounting mistakes, or contract misunderstandings.

Additionally, while the commodities sector presents rich opportunities in Southeast Asia, the rule of law and contract enforcement in emerging markets continue to pose challenges for investors. Government fragmentation, for example, can result in regional government policies that stand at odds with federal mandates; regional administrations may resist or ignore authorizations from national authorities. In one recent example, no sooner did a UK mining company uncover the second-largest coal reserve in Indonesia than the local government invalidated and revoked the company's licenses.

Enforcement of intellectual property laws in emerging markets remains less stringent relative to developed nations.

17 ASEAN Economic Community Factbook. Association of Southeast Asian Nations

Figure 6: Royalties and license payments, USD Billions



Source: UNCTAD, World Investment Report 2011

The proposed buyer is a Malaysian conglomerate that had recently entered into a partnership with a major German car manufacturer. The Proton deal would, therefore, provide the German multinational with a manufacturing base in Southeast Asia and access to state-of-the-art production facilities in the region's largest market for passenger cars.

The culmination of decades of financial, political, and market reforms in Southeast Asia, combined with economic and political malaise in Europe and North America, has also forged a new landscape in bond markets. Foreign investors have pushed long-term bond yields for Indonesia and the Philippines to record lows, bettering those of developed nations such as Italy and Spain. Foreign capital investors are viewing Indonesia in particular with growing interest amid recent debt rating upgrades that reached investment-grade status in 2011 for the first time in 14 years.[18]

18 The Wall Street Journal. "Reversal of Fortunes in Debt Market." January 12, 2012

Wrestling with intangibles

Southeast Asia is setting its sights on becoming not just a low-cost manufacturer, but also a producer of sophisticated goods, a sentiment recently articulated by Indonesia's minister of trade, who stated, "We need to climb up the value chain and make sure that we are able to produce goods and services," when discussing plans for tighter safety and labeling requirements on imports into Indonesia.[19]

Southeast Asia provides fertile ground in which multinationals deeply focused on innovation, research, and development can capitalize on their intellectual property assets amid the region's low-cost manufacturing and growing technical capabilities and know-how.

19 The Wall Street Journal Asia Business, "Trade Minister: Indonesia Isn't Turning Protectionist," December 9, 2011.

Today's confluence of factors, three decades in the making, has tipped the scales toward Southeast Asia as the next global frontier.

For example, Thailand has become a global hub for the production of complex auto and electronic parts and components, with manufacturing relationships governed by licensing agreements[20] that grant the intellectual property owner protection while enabling access to low-cost manufacturing labor.

International licensing spans a wide range of industries and activities, touching on nearly every link in numerous global value chains for multiple industries.[21] The geographic dispersal of licensees (based on royalty payments) is broad, although South, East, and Southeast Asia composed nearly 70% of the total from developing and transition economies in 2009. Increasing numbers of manufacturing and licensing agreements between local industries and foreign contractors have boosted local expertise, making these business partners more reliable and attractive to foreign investors. As shown in Figure 6, the value of licensing agreements in South, East, and Southeast Asia has increased significantly in recent years.

In addition to low-cost, skilled labor, Southeast Asia is rich in natural resources such as coal, palm oil, copper, nickel, aluminum, and other minerals that are in deep demand worldwide. Monetizing these commodities by securing mining rights and development licenses presents opportunities for the mining, energy, construction, agribusiness, and equipment sectors. Regulatory changes intended to increase confidence and attract foreign investment by providing more legal certainty have eased restrictions on foreign ownership, expanded concessions, and streamlined and shortened permitting processes for obtaining exploration, development, and construction licenses.

The way forward

Today's confluence of factors, three decades in the making, has tipped the scales toward Southeast Asia as the next global frontier. The first wave of foreign and domestic investment during those decades served as ground breakers to develop human and production capital. Infrastructure development and improvements have matured to allow for the stable movement of materials and information. Political, financial, and government reforms are opening barriers and easing the way for foreign investors eager to do business in the market.

In a region characterized by large population pools, the growing middle class translates into growing consumer demand—demand that remains relatively untapped, compared to other markets. That fact, combined with an abundant labor supply, has created a low-cost, highly skilled workforce. Significant opportunities continue to beckon early movers in Southeast Asia's production sectors, such as manufacturing, infrastructure, construction, mining, logistics, agribusiness, and telecommunication, as well as service sectors such as business process outsourcing, healthcare,

20 This refers to contractual relationships in which an international firm (licensor) grants to a host country firm (licensee) the right to use intellectual property (e.g., copyrights, trademarks, patents, industrial design rights, trade secrets) in exchange for payment (a royalty). Licensing can take various forms, including brand licensing, product licensing, and process licensing. In-licensing refers to when a company acquires a licence from another firm; out-licensing entails sale of intellectual property to other firms.

21 UNCTAD, World Investment Report 2011

Proceed with caution

An overall lack of transparency heightens the challenges and risks associated with doing business in Southeast Asia. The region's tendency toward secrecy and a scarcity of publicly available information tend to hamper cross-border deals involving unlisted target entities. Even when these entities are publicly listed, potential buyers accustomed to Westernized investor protections will face relatively weak financial transparency and lax corporate disclosure standards, rendering thorough due diligence on potential partners even more critical and challenging.

At the same time, foreign involvement in deals, especially in privatization bids, may stir up nationalistic sentiments. Cultural norms tend to favor domestic companies whenever possible. Should the deal team overcome this hurdle, post-merger integration is likely to emerge as an additional challenge amid significant cultural sensitivities.

Entering into M&A transactions in emerging markets such as Southeast Asia requires extensive pre-acquisition due diligence to evaluate, understand, and mitigate a range of risks, including:

- Financial—Availability of local financing and liquidity of local markets
- Foreign trade and payments—Capital controls, trade restrictions, and tariffs
- Tax policy—Tax rates, transparency, and predictability
- Macroeconomics—Inflation, currency, and interest rate volatility
- Legal and regulatory—Rule of law, contract enforcement, and investor protections
- Political stability—Transfers of power and authoritative regimes
- Government effectiveness—Red tape, corruption, and cronyism
- Infrastructure—Availability and quality of roads, ports, air transport, and utilities
- Security—Violence, terrorism, and kidnapping
- Labor market—Unions, labor laws, and availability of skilled workers

Such enhanced pre-acquisition due diligence—incorporating corporate intelligence—assists global companies in mitigating their business, reputational, and regulatory risks in a deal by providing critical information to help make sharper risk-based decisions. It also serves to demonstrate to regulators that the company is committed to integrity and corporate governance.

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To successfully execute a transaction, the deal team should include individuals who can address these risks, in addition to those who have local knowledge and experience in the country where the deal is being contemplated. Specifically, the deal diligence team should be adept in: M&A strategy and investment; commercial, financial, tax, operational, and IT; anti-corruption; human resources; valuation; financial reporting; and post-deal integration.

Post-deal disputes may also arise. Typical post-deal disputes include issues related to purchase price adjustment clauses, earnout provisions, and breaches of financial representations and warranties.

medicine, and tourism. As noted in PwC's 2012 Global Survey, CEOs acknowledged that their multinational companies are simultaneously building local capabilities in important markets; extending operational footprints; building strategic alliances; and expanding networks for new markets that include research and development (R&D), manufacturing, and services support. They are adapting how they go to market, reconfiguring processes, and at times entire operating models.[22]

Still, the pursuit of these ventures would be capricious without meticulously girding the enterprise against risk. While overseas operations create market presence and provide access to local supply and demand, they also expose a foreign entity to local practices, cultural sensitivities, and forces of nature that transcend the enterprise's capability and control. Local business partners, who are integral in many aspects of establishing, marketing, and operating a business in Southeast Asia, can also expose a foreign entity to corruption and intellectual property loss. Thorough due diligence of business partners and M&A targets is the first line of defense, along with thorough contractual provisions and ongoing monitoring. Establishing strong ethical and anti-corruption compliance programs, clearly communicating and providing training on them, and consistently enforcing them at all levels of the organization and across the spectrum of parties and counterparties should be integrated into the market entry strategy for these markets. Third-party compliance and royalty audits also signal vigilance and commitment to contractual protections.

As Southeast Asia continues to emerge and evolve in the heat of unprecedented growth, attractive labor costs are, perhaps, the most obvious draw. But further scrutiny reveals far more favorable factors for foreign growth, many of them 30 years in the making. Out of the shadow of China, the region, led by the fastest five, is on the rise. Approached with due circumspection and the right risk management mindset, Southeast Asia presents a compelling case for those multinationals exploring strategic opportunities.

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22 PwC's 15th Annual Global CEO Survey 2012

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