



M&A in Emerging Markets

The Human Capital Challenge



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For the growth-oriented enterprise, there are opportunities aplenty in the developing economies of the world. But maximizing them through M&A transactions is challenging if you are an outsider who does not know local regulations and customs and lacks relevant information — particularly on the people side of the business. HR-specific due diligence and integration planning, guided by people with local insight can improve your chances of success when entering these markets.

Mergers, acquisitions, joint ventures, and other transactions are crossing borders at a rapid pace. And many are taking place where economies are in the early stages of industrialization and consumption. These include most of Asia, Eastern Europe, and Latin America. The motives for these deals are familiar: to achieve lower manufacturing costs, to gain a strong foothold in growing customer markets, and to tap new workforce pools. The emergence of Brazil, Russia, India and China (BRIC) and a few other countries as centers of industrial

production and rising consumer spending has fueled this business phenomenon. Even though a growth-oriented company might accomplish the same goals through direct market entry, M&A transactions involving local partners are generally a faster and less risky route. Emerging markets present dealmakers with the usual set of key challenges: the financials must make sense, cultural differences must be dealt with, and the right degree of integration must be implemented at the right pace. To create value, a deal must master all three — no

matter where the enterprise is located. But as many have discovered, emerging markets compound the dealmaker's challenges in these five critical areas:

- The regulatory, political, and economic environments
- The availability and accessibility of key information
- Cultural integration
- Local leadership
- Change management

Key HR Challenges in Emerging Markets

Regulatory, Political, and Economic Environments

Seasoned business people understand their own domestic environments at many levels. They know the rules of the game with respect to hiring and firing, bringing in skilled foreign nationals, benefit obligations, and dozens of other issues. They have a clear sense of what politics and regulation will support. And they are attuned to the economic factors that affect the human capital side of their businesses — including wage rates, labor availability, severance obligations, and what it takes to attract and retain top talent.

All markets, whether emerging or not, are driven by different regulatory, political, and economic forces. However, the more a country falls into the category of emerging markets, the more likely it is that the following apply:

- Political red tape can slow the pace of progress
- Labor laws vary from one jurisdiction to another
- One country may impose high severance costs; another may strictly limit the number of foreign nationals that can be brought in for critical jobs. Elsewhere, an acquirer may find that it must offer a substantial “stay bonus” to avoid a mass exodus of employees.

- And for U.S. firms, there is the problem of Sarbanes-Oxley. Most companies in the emerging markets are not compliant with that regulation, and making them so can be expensive.¹

The macroeconomics of the particular market must also be understood: GDP growth, wage rates (and their trajectories), inflation, and the quantity and productivity of labor frame the potential of the enterprise. Executives accustomed to low wage inflation in their home markets are often dismayed to discover explosive wage rates abroad. Social benefit costs are also part of the economic picture in emerging markets. Few developing countries offer their citizens anything more than rudimentary health and retirement benefits; they look to employers to provide them, while other countries (some Eastern European countries for example) still provide their citizens with some form of cradle-to-grave support. Foreign acquirers must be prepared for these costs.

The lack of transparency combined with the greater overlap between political, regulatory, and economic policies in emerging markets add to the unpredictability of current information and of future events.

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Availability and Accessibility of Key Information

For anyone contemplating an M&A transaction abroad, information is essential. Without it, the dealmaker is at a huge disadvantage. Information is needed in four critical areas: macroeconomics, labor availability, legislation/regulation, and the target company. In developed economies, we take easy access to this information for granted. Government economic figures, inflation data, labor reports, 10-K filings, and so forth are readily available. Companies in developed countries usually have well-organized information on financial performance, employee demographics, compensation, and other HR data. With some exceptions, the same information in emerging markets is much less reliable and less accessible. Depending on the locale, data may be incomplete, outdated, misleading, contradictory, or nonexistent. (For a summary of information availability in Brazil, Russia, India, and China, see Appendix on page 9.)

Economic and Labor Information

Consider labor market data. In Brazil, labor information for major cities is sometimes available from government sources. That is the good news. The bad news is that city-specific information may be out of date or incomplete. Labor market information for the rest of Brazil is scarce, incomplete, outdated, and/or inaccurate. In Russia, the government provides minimal labor market data; it must be obtained from private sources such as HR consulting firms.

Accurate data on national economic performance is likewise difficult to obtain. In some countries, private analysts have one set

of figures, while the government has another, forcing the dealmaker to ask, “Which data should I believe?”

At the company level, HR data and written employment policies in emerging economies are often incomplete. Some workers receive part of their compensation in cash, making the outsider’s assessment of total payroll questionable. Also, some executives are given verbal assurances on compensation and perks that will elude the eye of HR due diligence. And employment agreements are often vague.



Regulations

Clear and accurate information on business regulations is also essential for acquirers — particularly for anyone trying to get a handle on present and future HR obligations. These include the following:

- Termination rules and notices (for example, works council consultations, “at-will-employment”²)
- Severance costs
- Employment contracts
- Limitations on bringing in skilled foreign employees (i.e., from the acquirer)
- State-mandated benefits imposed on employers.

Some emerging market economies, India being one, make information on these regulations accessible; others do not. Even when such information can be found, regulations may be ambiguous, even in the native language. And some of today’s regulations are being revised — a consequence of government efforts to keep pace with rapid economic change.

Some countries have different rules for domestic and non-domestic enterprises. China is an example. As a result, a foreign acquirer may have costs that a local competitor does not.

What can you do about information problems in an emerging market? Here's our advice.

Before the deal:

- Agree on an information exchange protocol with your target or partner
- Determine where the information is located
- Avoid relying solely on documents and verify by cross checking information
- Involve a local partner who knows the terrain.

As you move toward the close:

- Anticipate delays
- Always have a plan B — if the other side drags its feet in providing internal data, or provides questionable data, ask yourself, "What is this telling us about the target company³ and its employees?"
- Communicate, communicate, communicate!

Cultural Integration

Survey research indicates that cultural integration is a major impediment to success. Every organization has a unique business culture. That culture may be entrepreneurial and freewheeling or it may expect people to do things by the book. One company is dominated by a sales mentality; in another, engineers rule. Some companies have a culture of paternalism while others are more democratic and participative.

Bringing two different business cultures together in any transaction can create frictions on the people side of the business, producing the familiar "us against them" syndrome. However, this problem is compounded when differences in national customs and language are added to the mix. It is not an issue that is unique to emerging markets, rather, it is the added layers of complexity, compounded by poor data or preparation that can make it seem quite impenetrable.

Fortunately, cultural differences are not insurmountable. Deal-makers can reduce the potentially negative impact of culture differences if they take the following steps:

- **Anticipate cultural challenges.** If you go in prepared, for example, by having performed an in-depth cultural due diligence, as well as an Executive and Employee Survey Cultural Assessment, you'll have much less trouble with integration. And you will have identified, assessed and planned for the challenge.
- **Ask for guidance on cultural issues.** You will earn respect and diminish the problem if you (1) demonstrate sensitivity to the target company's culture and (2) admit ignorance of cultural nuances.
- **Understand that cultural differences can exist within the same country.** In India, for example, the business cultures of northern and southern companies vary widely.

Mercer recently partnered with the Economic Intelligence Unit to prepare a report entitled *The Great Buy-Out: M&A in China*. For that white paper, 231 senior executives were surveyed across the world. Three human capital related challenges stood out in the results: (1) managing cultural integration, (2) retaining and focusing on key talent, (3) maintaining relationships after the deal.

"Culture, and the integration of cultures, is the major reason behind the failures and the most difficult area to get right in combining organizations."

*Chinese Entrepreneur
September 5, 2005*

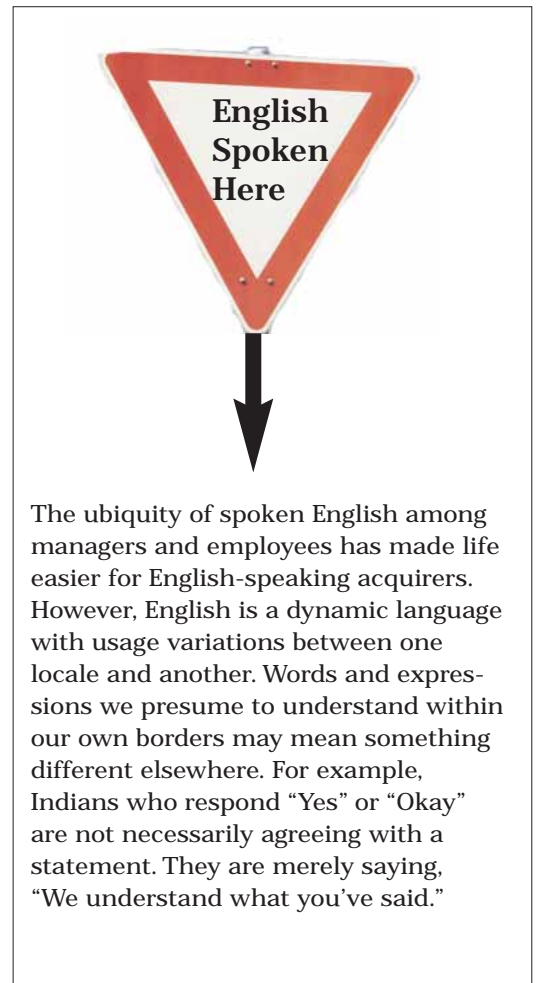


- **Have a strategy for overcoming cultural conflicts.** Cultural awareness and other programs that help people understand and respect each other can mitigate cultural conflicts. And remember that a culture that enables effective work processes in one country may not be easily transferable to another country, or even worse, may suppress productivity.⁴
- **Remain alert to the symptoms of post-deal culture clash.** Here are a few of those signs: “It takes forever to make decisions.” “Key talent is walking out the door.” “Strategy cannot be executed because management cannot agree.”
- **Recognize that business culture in emerging markets does not stand still.** Life in these emerging markets is changing rapidly, and business culture is changing with it. So think a step or two ahead.

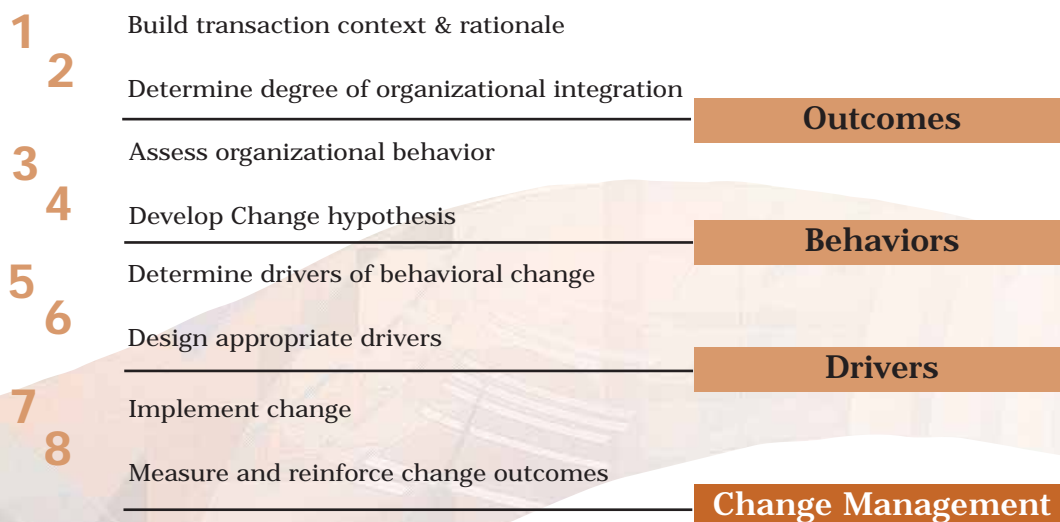
The best way to handle the challenge of cultural integration is through actions taken in each of the three transactional phases: pre-deal, doing the deal, and post-deal. The exhibit below indicates eight significant steps that acquirers can take to overcome cultural barriers to success.

Local Leadership

One of the issues that M&A transactions in emerging markets have in common with businesses everywhere is that leadership matters. More than anything else, local leaders determine the success or failure of a cross-border deal. These top managers know their customers, suppliers, and employees, as well as their customs and cultures, and they function as the critical link between the buyer and those important stakeholder groups. Pulling them out and replacing them with foreign nationals breaks all of those links. The savvy acquirer retains competent local leaders and uses clear incentives to align their interests with its own interests and business goals.



Mercer’s 8-step Cultural Integration Process



Because leadership is so important, dealmakers should ask these questions during pre-deal due diligence: “How qualified are the target company’s leaders?” “Is there a strong pipeline of leadership talent or the potential to develop one?” “Are these people with whom we can do business?” Assuming that those questions produce positive answers, a fourth question is in order: “What will it take to retain these leaders and encourage them to perform well in the months and years ahead?” Mercer has proprietary tools and a proven methodology to assess the quality of leadership and predict future leadership success for all types of organizations. In addition, we can work closely with you to build a customized leadership development plan that is closely linked to your company’s strategic agenda and your leaders’ day-to-day work to increase your company’s performance.

Change Management

Change is an inevitable consequence of M&A transactions — in any part of the world. Achieving the full value of your M&A transaction usually requires some changes in organizational structure, operations, reward systems, and personnel. Change, however, is upsetting and dislocating; and vigilant management is needed if change is to produce measurable benefits. Entrants to emerging markets should approach change with a solid understanding of the forces driving the market and a clear understanding of local rules and how the local workforce expects to be treated.

From the acquirer’s perspective, some change management problems can be avoided by solving them before the deal closes. For example, if due diligence reveals

that workforce reduction or a change in local leadership is necessary, the acquirer might insist that the target company handle those issues as a precondition to a deal.

The epicenter of change is also important. In cultures where participative management is common, as in the United States, success is more likely when top management and mid-level managers jointly identify problems and create change solutions. In other cultures, including many in emerging markets, a top-down approach to change is more appropriate — and it is what their employees expect (refer to Jollibee Foods’ experience on page 15). Nevertheless, an acquirer should involve local management in the change process. Parachuting in a squad of expatriates to run the process is likely to create resentment and resistance.

In all cases, management should observe the principles of successful change management:

- Communicate with employees on the necessity of change
- Explain how change will benefit them
- Provide visible incentives for change
- Manage the stresses that go hand-in-hand with workplace change

In emerging markets, the gap in understanding between leadership and the stakeholder groups is magnified, and without proper preparation and a clear communications plan for the entire process, that gap can erode shareholder value.

- Get it done quickly, even as the market environment is changing
- Establish a clear and visible link between change and business improvement.

These are universal principles. They can guide successful change anywhere in the world. But in emerging markets, the gap in understanding between leadership and the stakeholder groups is magnified, and without proper preparation and a clear communications plan for the entire process, that gap can erode shareholder value.

HR Trends

The emerging economies are rapidly evolving, and several important human resource trends are now visible. Dealmakers should keep these trends in mind as they analyze new developing markets for business opportunities:

1 A growing shortage of skilled workers. Rapid economic growth is absorbing the supply of skilled personnel and will soon create supply-demand imbalances. India, for example, now forecasts a shortfall of half a million IT professionals by 2010.⁵ This is also a serious problem at the middle manager level where rapid growth and development tends to be most exposed by inexperience. And a shortage of HR professionals with practical experience in managing effective, efficient HR functions is already a fact of life in these markets.

2 Rising wages. Demand for labor — skilled and unskilled — is driving wages higher in many regions. China provides a striking example. There, a combination of government push and demand pull is causing wages to grow at an 8 percent annual rate — and 10-plus percent for managers and

technical professionals.⁶ Do not count on wages standing still as you do your financial projections. In addition, over the next 20 years more people will migrate to China's cities for higher-paying jobs. These working consumers, once the country's poorest, will steadily climb the income ladder, creating a new and massive middle class.⁷ But note that today there are still hundreds of millions of Chinese who work on the land for less than \$1 a day.⁸

3 Aging populations. While the workforces of the emerging nations are generally younger than those in Japan and the developed West, there are exceptions. In Russia, 13-17 percent of the population is now 65 or older (as compared to 5 percent in India, Indonesia, and Malaysia). Demographic trends point to even greater aging of these populations due to low birth rates. And while the mainland Chinese are relatively young today, with only 8 percent in the 65-plus category⁹, the elderly percentage will grow rapidly due to the government's one-child per family policy.¹⁰

4 Rising expectations among employees in terms of Total Rewards (compensation, benefits, and careers). Take a look at Japan where over a number of decades, the increasing wealth and confidence has changed many aspects of their culture. The old hierarchal approach is fading, the legendary savings rates are disappearing among younger Japanese workers, and the desire for basic pay (to simply pay the bills) is being replaced by a desire for career opportunities to achieve greater personal satisfaction. This will matter for deals, because it is likely that emerging markets will eventually become mature economies like Japan. Mercer's extensive client experience has

Look for China-like transformations elsewhere in the years ahead.



Shanghai



Rio de Janeiro

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taught us the importance of having a total rewards framework which includes benefit, compensation and careers. This offering helps satisfy employee expectations and delivers measurable business value.

Each of these trends has important implications for the people side of business. Enterprises in emerging markets will find that they must work harder to recruit and retain key talent. Skilled worker shortages may force some companies to develop some critical skills at their own expense through employee training programs. Indeed, a number of high-tech companies operating in China today are already spending upwards of \$30,000 per person per year to upgrade the skills of some native engineers.¹¹ And the cost of labor will go up across the board and remain a major enterprise expense, often the largest.

How Mercer Can Help

Though the issues we have identified are challenging, hundreds of American, European, and Japanese companies have demonstrated that they are not insurmountable. Maximizing the potential of emerging markets, however, requires attention to due diligence, the ability to cope with cultural differences, and a recognition that the workforce in these markets is changing fast.

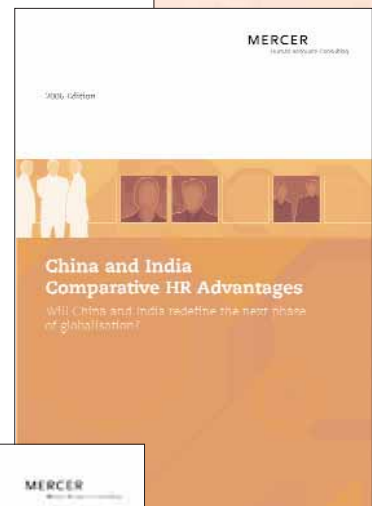
Many of the risks associated with M&A transactions — in any market — are on the people side of the business. Those risks are dramatically magnified in emerging markets, where local regulations, customs, and labor market peculiarities have their greatest impacts. Mercer helps its clients manage those risks. With offices in 190 cities and 41 countries around the globe, our local experts can guide

you through unfamiliar terrain. Mercer professionals can help you with due diligence, post-deal integration, and other human resource issues such as cultural integration, assessing leadership, attraction and retention of key talent, and successful change management.





Some of our proprietary intellectual capital that will be useful to you include the following publications:

- M&A HR Issues Country Guide Reports
- China and India — Comparative HR Advantages
- Worldwide Benefit & Employment Guidelines
- The Great Buy-Out: M&A in China

These can be obtained by contacting any of the global contributors listed on page 16.



Appendix – Summary of Data Availability in the BRIC Countries

	Macroeconomic	Legislation	Labor Market	Target Company
Brazil 	<p>Data is widely available from both government and private sources. Some variation and discrepancies exist between local and international sources.</p>	<p>Available, but changing. Sometimes lack specific rules for practical application of the laws (time gaps.)</p> <p>Protectionism is still present.</p>	<p>Information for the major cities is sometimes available from government sources, although it will not necessarily be updated or complete. Information for the rest of the country is scarce, incomplete, outdated and/or inaccurate.</p>	<p>Varies substantially from small to large private corporations (local/MNC), and from governmental companies to private corporations (which may be either publicly or privately held). [p1]</p>
Russia 	<p>Information is available on macroeconomic indicators. However, there is a lack of reliable information on foreign direct investment (FDIs).</p>	<p>Available but English-language documents are often outdated or unavailable. Even in Russian, the language can be very ambiguous and often misleading.</p>	<p>Limited information available from government sources.</p> <p>Information is available from consulting firms.</p>	<p>Limited information.</p> <p>Russian stock exchanges do not demand or enforce certain disclosures.</p>
India 	<p>Data widely available from both government and private sources: Ministry of Finance, NCAER, Research Foundations, UN reports.</p>	<p>Available but difficult to search and disseminate. Sources restricted to ministry websites and government publications (not easily accessible to foreign nationals.)</p>	<p>Well researched and available through government and international bodies: Ministry of HR Development, ILO, and Economic Survey published by Ministry of Finance.</p>	<p>HR information available but many companies lack sophisticated HRIS. “Data rooms” must often be supplemented by meetings and fact-finding discussions.</p>
China 	<p>Generally good; various sources available (Ministry of Commerce, World Bank, investment banks, Web sites, year books, etc.). Consulting firms provide certain data as well.</p>	<p>Evolving and becoming more “western”, however, information often remains incomplete and sometimes indefinite or lacking in clarity. Generally available at websites and publications.</p>	<p>Local laws and practices vary; labor supply very different across geographies; hard data might not be available. Government at various levels and branches labor bureaus, Ministry of Labor and Social Security (MOLSS).</p>	<p>MNC, SOE, and private companies can be quite different. Generally incomplete and unreliable at local companies where “data rooms” often do not exist. Therefore, it is important to allow more time for doing HR due diligence including interviews and meetings.</p>

We wish to thank our global contributors:

Roberto Cudemus, Latin America roberto.cudemus@mercer.com

Peter Horan, United Kingdom peter.horan@mercer.com

Stephen Lee, Canada stephen.lee@mercer.com

Larisa Muravska, Eastern Europe larisa.muravska@mercer.com

Sunit Sinha, India sunit.sinha@mercer.com

Bruce Wang, Greater China bruce.wang@mercer.com

Endnotes

¹ Even when a deal takes place outside U.S. borders, the entity is subject to Sarbanes-Oxley if U.S. debt or equity were involved in its financing.

² Employment in some countries is “at will,” or terminable by either the employer or employee for any reason whatsoever. The employment-at-will doctrine avows that, when an employee does not have a written employment contract and the term of employment is of indefinite duration, the employer can terminate the employee for good cause, bad cause, or no cause at all. Shane and Rosenthal, *Employment Law Deskbook*, § 16.02 (1999).

³ “Company” in this article and context may refer to a business unit, joint venture, etc.

⁴ “Organizational Culture” by Paul M. Sanchez, excerpt from *The IABC Handbook of Organizational Communication* edited by Tamara Gillis, Ed.D, ABC, published by Jossey-Bass, 2006.

⁵ Ranajoy Punja, VP, marketing, Cisco Systems, India and SAARC. *Domain-B.com*, 30 May, 2006.

⁶ *China People's Daily*, Wednesday, July 09, 2003.

⁷ *The McKinsey Quarterly*, June 2006.

⁸ <http://www.ilo.org/public/english/bureau/inf/magazine/51/china.htm>.

⁹ EIU; *CIA World Factbook—age profile*; *China Statistical Yearbook/Consumer China*, 2005.

¹⁰ <http://www.ilo.org/public/english/bureau/inf/magazine/51/china.htm>.

¹¹ “Watch Out, India,” *The Economist*, May 6-12, 2006, 69-70.