PROMISE OR PERIL?

THE LURE OF EMERGING MARKETS

The lure of emerging markets has never been greater. But what are the main issues to be aware of before you take the plunge?

The world faces a period of great uncertainty as the financial crisis that began in the US sub-prime mortgage market continues to spread. Part of the lure of emerging markets is the belief that they may well survive the credit crunch unscathed.

Meanwhile, businesses of all sizes are being drawn to fast-growing economies. What does the future hold for these?

A recent survey for credit insurance specialist Atradius by the Economist Intelligence Unit* shows an overwhelming belief in the sustainability of emerging-market growth. Sales growth is the main attraction; almost 90% of businesses enter emerging markets in search of growth opportunities.

So what is attracting traders and investors?

Some are attracted in the first place by the potential for growth against a context of rising competition and slowing demand at home. Some are importers and exporters, attracted by rising purchasing power or the quality of locally produced goods; others are manufacturers seeking a lower cost base with cheap labour.

That said, emerging markets will still be vulnerable to secondary effects such as slumping US demand, declining trade volumes and falling commodities prices. How severe these effects will be, and how resistant emerging markets will prove to be, are largely a matter of guesswork.

Most survey respondents report that their emerging-market activities, especially in China, outperformed expectations, and they expect the boom to continue. In fact, 42% have enjoyed annual returns of over 15% from their emerging market operations during the past three years, and 55% expect to achieve these levels over the coming three years.

However, though almost three-quarters of respondents doing business in China reported earnings consistently above anticipated levels, this may not last. Rising labour and raw material costs may drive producers to India, Eastern Europe and other second-tier markets. China is increasingly being viewed as a market for consumer goods sales rather than a producer.

A real danger is that the promise of emerging markets may not always translate into profitable business, partly because of rising costs but also because of rising protectionism and domestic competition.

What's more, a downturn in developed markets will harm emerging markets too. The latter have benefited hugely from improved domestic policymaking and a benign global economic environment. They are undoubtedly better prepared to withstand a developed market slowdown than, say, a decade ago. Nevertheless, they are not totally immune, and the optimism of many survey respondents may indicate that they are not fully factoring in the risks of a sharp contraction in global demand.

Furthermore, political and economic instability, poor infrastructure and bureaucracy persist in many emerging markets, despite overall structural improvements. Indeed, survey respondents considered political and macroeconomic instability to be the two main restraints to profitable business. Poorly drafted and applied regulation and bureaucracy are also cited as dissuading factors.

So if emerging markets are luring you, some caution is advised. Beware of being driven more by emotion than by sound risk management. Plan carefully and allow for a downturn in the global economy in your calculations. For example, China's potential is undoubtedly huge but, for some, it is far from the advertised panacea, as costs rise and local interests jealously guard their home market.

The research has been published by Atradius as a detailed 24-page report entitled 'Promise or peril? The lure of emerging markets'. This outlines the risks involved in emerging markets, entry strategies and the crucial first steps to take. For a free copy, simply email cmc@atradius.com with your contact details and say whether you want us to email or post you a copy.

** The survey questioned 300 executives in 19 business sectors across the world. Nearly half of those surveyed have substantial operations in emerging markets, a quarter operate import and/or export businesses in emerging markets, and one fifth have representative offices in those markets.*

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