ISMEA Quarterly Newsletter

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BRUNSWICK

Introduction

Welcome to the September 2017 edition of the Brunswick ISMEA Group newsletter, a quarterly publication featuring news and analysis from some of the world's most exciting emerging markets.

As demonstrated throughout the year, this region presents numerous opportunities and risks for businesses seeking to benefit from its commercial potential.

The region is changing at a rapid pace, as evident from shifting geopolitical alliances, to the implementation of new technologies, to opportunities in business and society. To truly understand the impact of all these changes, businesses need insights and analysis to remain at the forefront of this dynamic part of the world.

As always, Brunswick examines the driving forces of the region – Commodities, Connectivity and the Rising Middle Class – and the implications these have on the billions of people who work and live across ISMEA.

We hope this latest edition will provide readers with an objective view of these trends, while asking – and hopefully answering – the questions that matter most to you.

Please take a read and let us know your thoughts!

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Rising Middle Class

East Africa reframes economic relations with China

In the space of two decades, China has become Africa's most important economic partner.

According to McKinsey's recent "*Dance of the lions and dragons*" report, there as many as 10,000 Chinese businesses operating in Africa, dwarfing previous estimates. Of all sizes and operating across numerous sectors, 90% of these firms are privately owned.

"China's influence is increasing," says Matthew Birtch, a lecturer at Johannesburg-based business school, the Gordon Institute of Business Science (GIBS).

Chinese funders and entrepreneurs are poised to take advantage of the slow-down in investment from traditional Western partners. They are expanding from telecoms, construction, resources and manufacturing into new areas like agriculture, fintech, logistics and even gaming.

"China is the new normal. I would not be surprised to see the renminbi replace the US dollar to become the reserve currency of some African markets" says Birtch.

Since the financial crisis, there has been an acceleration of African economies reorienting towards the emerging rather than the developed world, agrees Martyn Davies, MD for Emerging Markets & Africa at Deloitte. He adds that while China's resource-intensive growth model underpinned the former "Africa rising" narrative, China is rebalancing its own domestic economy, and this has created new promises for aspirational African economies.

While trade and investment between the two continents has declined recently due to lower commodity prices and slowing economies (there have been reports of an exodus of Chinese migrant workers returning back home), the Sino-Africa relationship remains important.

This is driving new types of investments and regional integration across East African in particular.

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>
> – Matthew Birtch, GIBS

Due to its strategic location on the East African coast, Kenya has already benefitted from China's ambitious "Belt and Road" infrastructure investment strategy. A newly opened Chinese-funded railway will eventually link the port of Mombasa to other inland trading hubs. Nearby countries Ethiopia and Rwanda have also been proactive in seizing opportunities to access new Chinese investment, technology and know-how, as they position themselves for a new wave of global trade. All have been vying for a chunk of the US$60 billion that Chinese President Xi Jinping pledged in 2015 for African investments over three years.

As wages in China have increased, offshoring low-end manufacturing to Africa is one driving force of this new relationship. Ethiopia has been quick off the mark, with the China Africa Development Fund (CADFund) financing US$2 billion to create a footwear and clothing light manufacturing zone on the outskirts of Addis Ababa. This is set to create significant exports and as many as 200,000 jobs.

The buzz around tech and innovation

Much of the excitement is around high-tech and innovation. Alibaba's founder Jack Ma used his first visit to the continent to announce the creation of a $10 million African Young Entrepreneurs Fund. Quartz Africa described the welcome Ma recently received in Kenya and Rwanda as "almost fawning in a way that Mark Zuckerberg's surprise visit last September was not."

The reason may well have something to do with Ma's inspiring personal story, which resonates with a newly emerged middle class. Ma, who struggled to attend college and find work, is today one of the richest men in the world thanks to the e-commerce behemoth that he started from his apartment. Ma was accompanied by a delegation of Chinese billionaires, investors and real

The influx of Chinese investment has profoundly impacted East African business hubs such as Nairobi (image credit: Shutterstock).

estate tycoons, all of whom were looking for opportunities in East Africa's growth nodes.

But it is the enticing prospects coming out of the Internet that's making headlines. Alibaba, Baidu, Tencent (partially owned by South Africa's Naspers group) and other Chinese start-ups are beginning to rival what's come out of the US's Silicon Valley.

The China-Africa relationship could grow to $440 billion by 2025, up from $180 billion today

"The stuff coming out of China is fantastic. They are an ultra-competitive society. Their brightest people go into tech and we are seeing exciting new software, hardware and biotech innovations. Some of these will start to make their way into Africa as these Chinese companies internationalise," said Birtch.

He adds: "The Chinese are pragmatic and hard working. They want things done yesterday. They have critical mass in their home market; can test their products with an enormous number of users and scale services fast, as we have seen in the online payments space, which has gone ballistic in China."

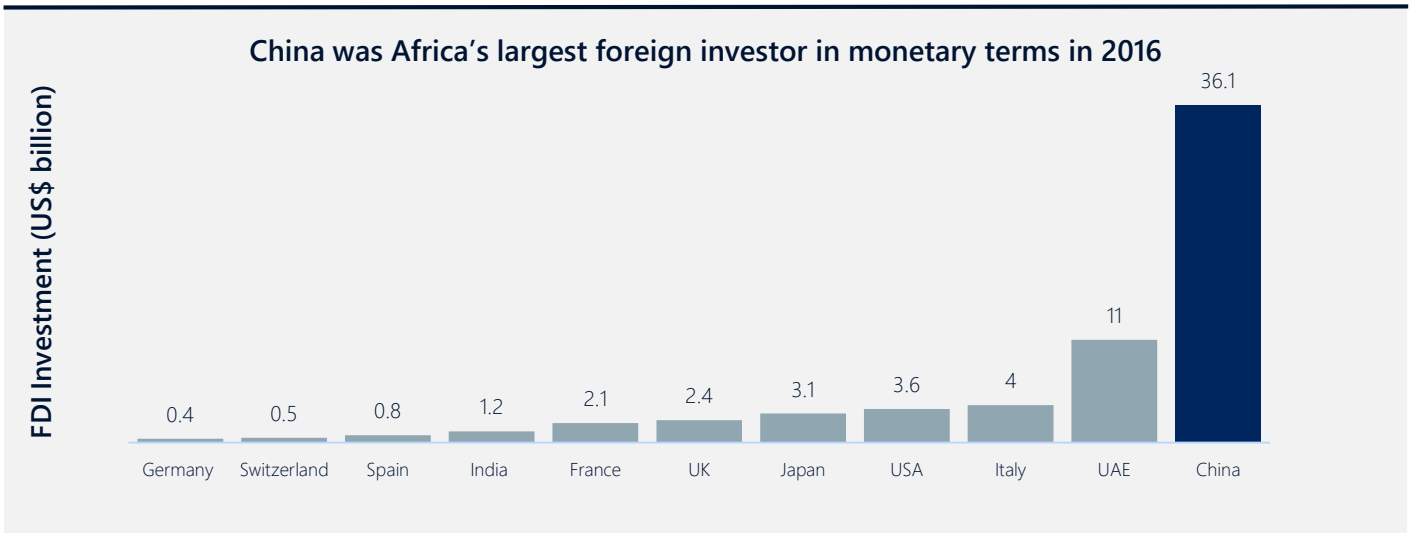
With 730 million Internet users, most of whom access services via their smart phones, cash is losing its currency for small payments in large Chinese cities as consumers turn to a host of mobile money solutions. African countries, with still large under-banked populations, also provide new markets for expansion.

Reputation matters

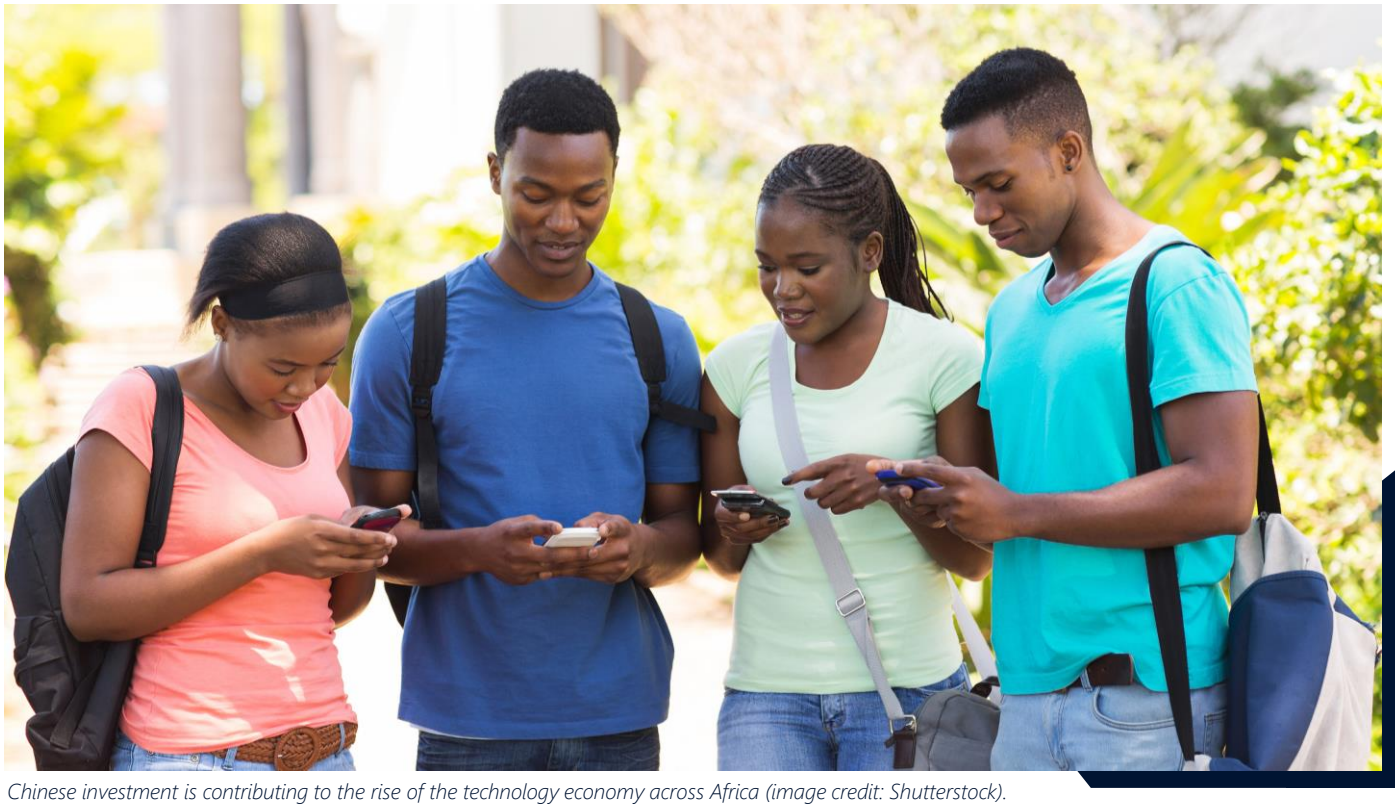
Despite the potential of increased Chinese investments, there remain areas for improvement.

Chinese companies have received negative headlines due to a lack of localization – that is, not sourcing enough from local African firms, rather relying on Chinese imports or exporting commodities without beneficiating them in country. While McKinsey says there have been improvements in upskilling local staff, their promotions into management are still rare.

There have also been reports of corruption, and also of labour and environmental violations. That said, Western and African firms are not blameless and they too have been accused of similar governance failures and malpractices in the past.



Sources: ATLAS, Ernst & Young's Attractiveness Program Africa 2017.



Chinese investment is contributing to the rise of the technology economy across Africa (image credit: Shutterstock).

McKinsey says the key areas to focus on are strengthening the role of African managers and partners in the growth of Chinese-owned businesses.

Both Chinese and African actors will also need to address corruption in some countries, concerns about personal safety of Chinese immigrants, and language and cultural barriers.

"There are massive cultural gaps," says Davies, "For growing Chinese investment to be sustainable such gaps must be addressed."

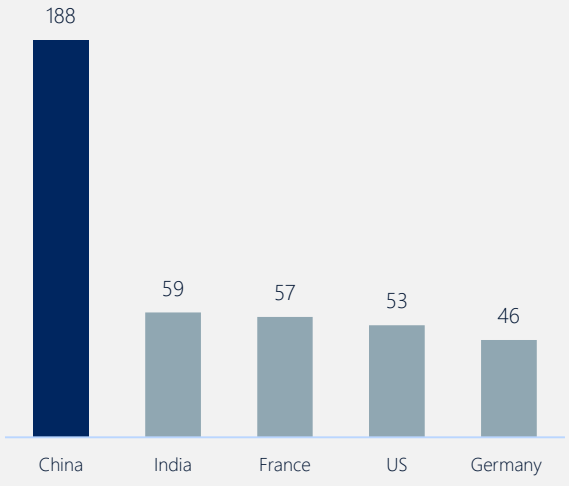
"We must be careful of pre-conceived stereotypes. These tend to be isolated incidences," says Birtch. "We must find ways of building trust and understanding, and overcoming cultural barriers."

"The leaders back in Beijing understand that they need to improve the 'China brand'. Negative headlines have not fallen on deaf ears and there is an increasing realization that managing perceptions is almost as important as the truth," adds Birtch.

If these issues are addressed, there is considerable upside for those African countries that diversify from resources into other sectors through increased capital investment, skills transfer and improved competitiveness. If McKinsey is right, tens of millions more African workers could gain stable employment and the China-Africa relationship could grow to $440 billion by 2025, up from $180 billion today.

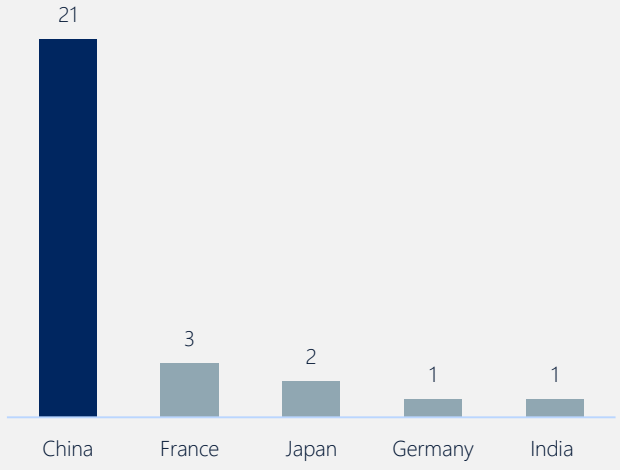
Marina Bidoli is a partner with the Brunswick Johannesburg office.

Africa's top economic partners by segment
Goods trade (2015, US$ billion)



Source: McKinsey & Company.

Infrastructure financing (2015, US$ billion)



Source: McKinsey & Company.

Connectivity
E-Commerce in India

The promise and prize of e-commerce in a market of the size of India's has attracted dizzying superlatives, and capital too.

Big bulge investors such as Tiger Global, Softbank, Microsoft, eBay, Tencent and DST Global have invested billions of dollars in Flipkart, making India's home-grown pioneer the world's third most-funded company, valued at US$11.6 billion, just behind taxi aggregators Uber and Didi.

It has come with a high price: Flipkart's young Indian founders were side-lined by Tiger Global, which after mounting troubled and another funding round, took the reins of management. The company has since stabilized, the founders have a role but power lies elsewhere. In reality, Indian e-commerce companies remain only notionally Indian.

SoftBank has been the key architect of e-commerce investments in India, investing in all the top domestic companies - Flipkart, PayTM and Snapdeal - as the Japanese financial powerhouse headed by Mr Masayoshi Son creates a portfolio to take on Amazon.

Amazon entered the India market in 2013, with Jeff Bezos, the US retailer's founder, committing an investment of US$5 billion.

Amazon's deep pockets, superior customer service, wide product offering and high decibel marketing, has enabled it to grow at an astonishing pace in India. It has also obtained a digital payment wallet license as well as a food retail license from the Indian government. Amazon is now running neck and neck in sales with Flipkart, the Bangalore-based platform that has responded to the Amazon challenge by acquiring several smaller players including Myntra, Jabong, Letsbuy, as well as eBay's India business.

This consolidation looked to have taken a final, nationalistic twist earlier this year with Flipkart's protracted efforts to swallow its weaker Indian rival Snapdeal, only for negotiations to collapse at the final hour with Snapdeal's founders opting for independence with a different operating model.

Snapdeal, once a close second behind Flipkart, had itself been bulldozed by Amazon: the Indian player could not sustain funding and amid rising losses it failed to make its much-marketed differentiation tell. Its main investor, Softbank, tried to orchestrate a merger with Flipkart, valuing Snapdeal at US$950 million, but the deal was torpedoed by resistance from the founders and minority investors

The fallout is an e-commerce oligopoly: Flipkart, Amazon and PayTM Mall lead, while smaller players face impending wipe-out or a merger.

Investor optimism remains undimmed: 30% Y-o-Y growth since 2011, mushroomed to triple digit growth in 2015. Core to the optimism is the digitization of India driven by a government strategically focused on making India an online environment. The consequence is an unrelenting uptake of internet users reflecting better network connectivity and improved digital infrastructure. A demographic of young tech-savvy users, affordable data and smartphone costs, easy availability of products and services, all within a fast-growing economy, completes the benign environment.

According to a recent IAMAI report 'Internet in India 2016', India had 432 million Internet users as of December 2016, with overall internet penetration

India's 432 million Internet users are creating new opportunities for e-commerce companies in the country (image credit, Shutterstock).

A wide range of technology and e-commerce brands are looking to capture India's burgeoning domestic market as shown above. (image credit: Shutterstock).

of only 31% (59% in urban and 17% in rural areas).

Yet for now, despite the hype, there is a disappointing side: the rise in the number of Internet users is not translating in any comparable way in the number of online shoppers. And while the expanding Internet base in India looks attractive, making money from online shoppers remains a significant challenge for all leading e-commerce firms.

This is partly explained by the start-ups' scorching of billions of dollars of investor capital on marketing, service delivery and a widening array of products, in anticipation of a faster take up by consumers. Yet the number of online shoppers stands at meagre 69 million presently. In the year to March 2016, Flipkart, Snapdeal and Amazon India had collectively incurred an aggregate net loss of US$1.4 billion.

Behind this red ink has been extraordinary hype around the start-ups by an incredulous media eager to inflate an Indian champion, fanned by the start ups themselves and their PE sponsors. India business media routinely grand-stand the young leaders, heralding another wave of resurgent consumerism.

This has suited the political classes as much as lay readers, both noting the vibrant optimism and its impact on wider sentiment.

The number of Internet users in India is expected to increase to 730 million by 2020

Recent events in the Indian tech sector has shown that this fragile mix can easily unravel. Investors supporting endless customer acquisition and brand building are now demanding efficiencies and fiscal discipline and, in exchange for more funding, a clear roadmap to profitability.

One consequence has been a shift in e-retailers' focus from GMV (gross merchandise value, the total worth of goods sold over a period of time) and customer acquisition at any cost to unit economics and business sustainability. Many start up leaders have eaten humble pie.

Systemic stresses have also been exacerbated by government interventions such as a cap on discounts and sales by the e-retailers' captive selling arms, as well as by demonetization, last year, that invalidated large denomination currency notes, prompting a spending slowdown.

These drags prompted US research firm Forrester to slash projections for the e-tailing industry in India by more than a third to US$48 billion by 2020.

It scarcely feels like it. Amazon India grew at 100 per cent in FY 16, is looking down on troubled rivals and buoyed by its founder's capital-backed promises to make India Amazon's biggest prize.

Karan Bhirani is with the Mumbai office of Brunswick.

Events

Top business events throughout ISMEA

FT Africa Summit

London, UK

8-9 October 2017

Thomson Reuters African Summit

Cape Town, South Africa

11-12 October 2017

World Economic Forum India Economic Summit

New Delhi, India

17 October 2017

Global Digital Banking Conference Singapore

Singapore

5 October 2017

Abu Dhabi International Petroleum Exhibition and Conference

Abu Dhabi, UAE

13-16 November 2017

Global Entrepreneurship Summit

Hyderabad, India

28 November 2017

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