

think:act CONTENT

Fresh thinking for decision makers

Chasing a moving target

| The global market place
offers new opportunities |

But the stakes are high

| Have you understood
the changing rules of the

game? | Reacting early

can tilt the scales toward

success

VALUE CREATION: SEEING THE WHOLE PICTURE

Following the corruption scandal that has most recently implicated government officials in Nigeria and Russia, the global electrical and engineering giant Siemens has had to pay EUR 1.4 billion in risk reduction and compliance payments. It is paying the price for incomplete risk assessment and is reacting as quickly as possible to contain the damage to the company's reputation and global reach.

Elsewhere, toy maker Mattel sees its revenues decline by USD 40 million with analysts estimating a landslide in losses throughout the key holiday shopping period. The company is struggling to curtail the damage done following its widely publicized recall of several products due to faulty design and a failure to meet Western health and safety standards. What these cases show is just how complex managing all elements in a globalized value chain has become. Even internationalization pioneers are not immune to the pitfalls of global manufacturing and trade. In a world in which transnational products promise the greatest growth potential, companies struggle to achieve high margins through low-cost sourcing. At the same time, they face an increasingly globally aware consumer, whose demands are driven by a sense of ethical, social and environmental responsibility. But corporate responsibility is only part of the global value creation game. Those that picked up on these trends early in the game – like The Body Shop – were often ridiculed, but have since proven how effective their strategies were. Today, The Body Shop operates 2,000 stores in 50 countries. L'Oréal recently bought it for EUR 190 million in an effort to expand the cosmetics giant's "eco-friendly" image.

Companies must create a holistic global footprint that respects new principles of sustainability and is backed by strong corporate ethics. Otherwise they will have difficulty competing in a market in which low cost is no longer the solution to every problem. A seismic shift is occurring – values are actually driving value creation. The rules of doing business have changed. And managers need to face a number of key questions to ensure long-term success.

UNLOCKING THE SECRET OF GLOBAL VALUE CREATION

Value creation is a global enterprise. If "low cost" were still the only factor driving the process, then Burkina Faso and Burundi would rank high on the list of most attractive places to do business. Neither country is known for its exports or for attracting direct investment. The interdependence of factors influencing business success today makes many managers uncomfortable. Globalization is driven by highly differentiated factors, adding to the existing complexities of doing business around the world. Managers are thus wondering what will drive value creation tomorrow and in the future.

CAN THE INTERNATIONALIZATION OF VALUE CREATION:

- Make a valuable contribution to the core business?
- Mitigate and spread out current financial, currency and product risks?
- Achieve sustainable tax advantages over the long term?
- Produce sustainable capital and labor cost advantages?
- Help the company tap into current and future innovation and knowledge potential?

To be effective, managers must create a roadmap that integrates global value creation and sustainability programs into the overall business strategy. They can thus direct their capital and talent toward the most profitable and sustainable growth opportunities.

MAJOR TRENDS PROMOTING THE GLOBALIZATION OF VALUE CREATION

There is no infallible recipe for securing value creation over the long term in a globalized world. However, a number of key trends indicate the direction global value creation might take in the coming years. Managers must respond honestly to the questions highlighted above, or risk putting their reputations on the line. Not all of these trends will affect companies to the same degree. Companies need to concentrate on understanding the drivers in their own business and markets.

1. GLOBALIZATION'S NEW WORLD ORDER

Technology has shrunk the world; how companies navigate this smaller space is critical.

THE INTERNATIONAL FACTOR: Each company must decide how much of their operations they can afford to keep close to home and which parts should be outsourced. Staying in higher-cost locations or near-sourcing has its advantages, including tighter control over productivity and quality standards. But outsourcing may eventually become unavoidable. For Sanofi Aventis, its European market suddenly became more attractive: The pharmaceutical giant used improved labor conditions and tax breaks arising from political and economic reforms in Europe to its advantage, investing in a new plant in Germany. It will likely become one of the largest insulin producing facilities in the world.

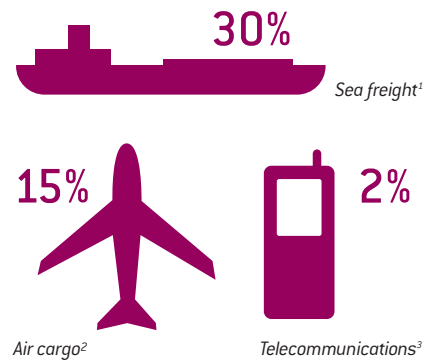
Managers will increasingly be preoccupied with deciding which links in the value chain should be distributed to specific regions and the degree of local content these should have. US automaker Ford has decided that 65 percent of its manufacturing costs should come from low-cost countries by 2010. Around 20 percent of this, managers feel, should be sourced from China. Ford's competitors, too, have stepped up their game.

GLOBAL FOOTPRINT DESIGN: Shaping the size and spread of the footprint also becomes crucial to global success. While each company has to design its own unique set-up, there are a few hallmarks of success: A footprint must be flexible enough to adjust to changes in the business environment. It should be based on a top-down understanding of the strategic drivers that force a company to expand or redesign its footprint globally. And it should assess the feasibility of expanding the manufacturing and sourcing network at the operational level, paying attention to cost structure and risks.

To calculate the in-house production capacity in target countries, companies must be able to assess their core competencies and weigh the relevant costs of each factory's own global footprint. An example: Fragrance and flavorings manufacturer Symrise reduced the number of its worldwide production locations from 26 to 17. The general shape of its footprint changed as it closed down locations in European countries and expanded capacity in Asia and Eastern Europe. The choice was preceded by a thorough examination of its business model from a cost-to-serve and cost-to-innovate perspective.

GLOBAL SOURCING: Companies have never had so much choice when it comes to purchasing opportunities. But sourcing strategies must harmonize perfectly with the global footprint selected by a company. Imagining just how complex sourcing has become is hard. Consider the IT and technology company IBM: It has a global sourcing volume of around USD 36 billion in more than 80 countries spread over 400 locations. Almost 10 percent of its human resources capacity is dedicated to buying from third parties and managing these relationships. "The growth opportunity provided through entering low-cost countries is paramount for the CEO's agenda," said Leo Steiner, the General Manager at IBM Austria. Clearly, coordinat-

TODAY'S TRANSPORT AND COMMUNICATION COSTS (1930 = 100%)



Source: BPB 1] Average transport costs and port duties
2] Average sales per passenger and miles 3] Cost of a 3 min call from New York to London

55%

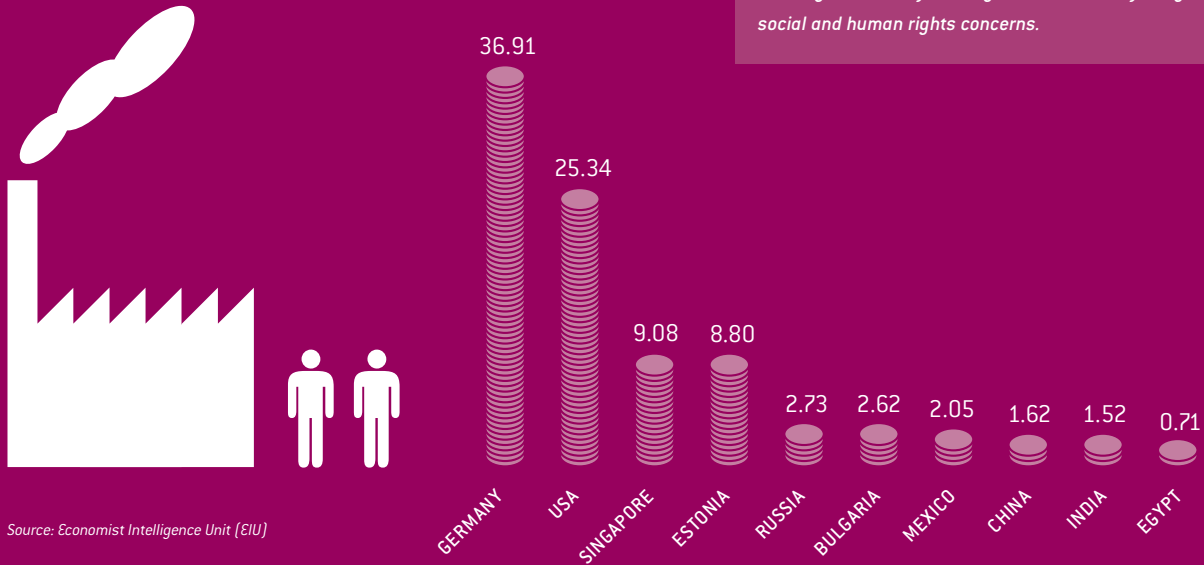
of new Mercedes C-Class parts should come from low-cost countries, according to parent company Daimler.

3,000	NORTH AMERICA EMPLOYEES
500	BUYERS IN SOUTH AMERICA
2,000	BUYERS IN EMEA
+ 2,000	IN ASIA
7,500	PURCHASING EMPLOYEES

IBM has stepped up its human resources capacity around the globe

COMPARISON OF LABOR COSTS IN SELECTED COUNTRIES

Manufacturing labor costs per hour, 2007 [USD]



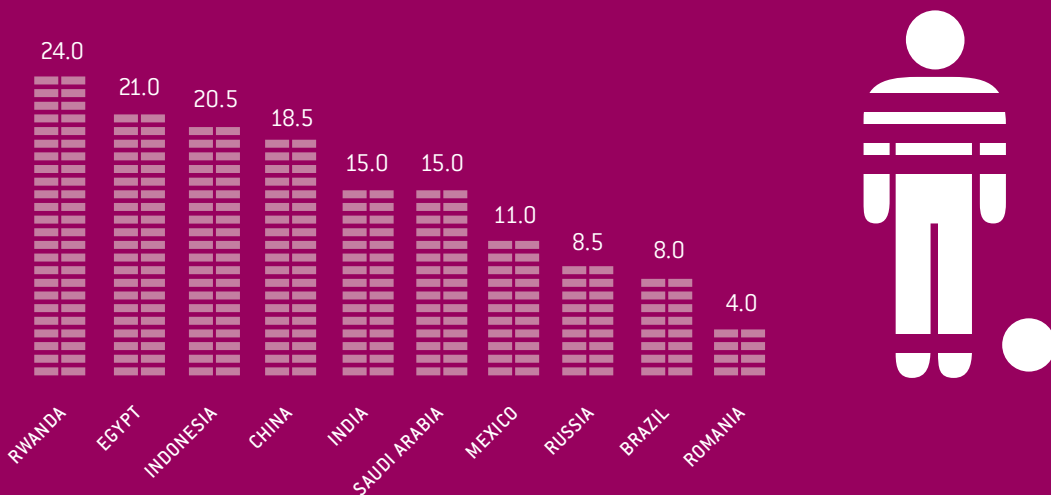
Source: Economist Intelligence Unit (EIU)

[DIFFICULT DECISIONS]

Deciding on new production locations is a tricky business. Managers want to improve their bottom lines and satisfy customers that demand ethical corporate behavior. They must therefore weigh economic benefits against social and human rights concerns.

THE SEVERITY AND FREQUENCY OF HUMAN RIGHTS ABUSES IN DEVELOPING COUNTRIES DIFFERS SIGNIFICANTLY

Relative intensity of human rights abuses¹



Source: The Guardian

1) A high score represents a high relative intensity of human rights abuses based on a weighted index

ing such a vast array of products and services is no small feat: Transparency is paramount. To remain viable in the long term, IBM is aware that it has to commit itself to a sustainable global sourcing strategy and live by this pledge.

FOLLOW YOUR CUSTOMERS: Knowing who your customers are is important – but knowing where the sales market of the future will be is even more vital. Consumer goods companies are engaging in a race to develop a reputation in emerging markets. They want to create a global brand that is available, well-known and highly regarded even in the most remote corners of the globe. Finding new lucrative regions and markets has become the key goal. But entering new territory is both attractive and risky. While first movers might be brave, they tend not to be foolhardy. They first shift small value-added units to new regions and gradually build these up over time.

Following the customer is not a new trend, but the pace has stepped up. It's no longer just consumer goods manufacturers and automotive suppliers that are scouring the planet for new market opportunities, but other companies too.

2. FINDING NEW ADVANTAGES AND SOLUTIONS

Naturally, the business climate in a certain country influences investment decisions. Besides providing tax incentives and lowering import duties, governments are also setting up economic zones to attract foreign investors. Smart companies use this to their advantage.

MAKE BETTER USE OF TAX AND IMPORT TECHNICALITIES: Tax regulations are in constant flux. Companies need to keep a close eye on developments and act quickly to use the tax opportunities in such a way as to create long-term advantages. In the absence of a harmonized tax base in Europe, Danish pharmaceutical company Nycomed decided to manufacture its blockbuster drug Pantoprazole in Ireland in 2004. German company Haniel moved the sourcing activities of some of its business areas to Switzerland – because of a favorable tax climate for that specific arm of their business. Competitive wages, a skilled workforce and massive investment in the years since German reunification have played a role in luring solar energy companies to Eastern Germany, but tax incentives were the most crucial aspect in the creation of Solar Valley.

SUBSIDIES, NATIONAL AND SUPRANATIONAL ECONOMIC DEVELOPMENT AID:

Companies should invest time in identifying attractive aid sources and include these in investment and location decisions. Doing this can create substantial value, particularly for internationally active companies. Japan's automaker Suzuki shifted a large part of its own production to Hungary in 2003/2004, encouraged by considerable investment grants. An attractive property deal also sweetened the deal. Companies cannot be complacent. Attractive destinations quickly lose their appeal when other countries offer even better subsidies and aid packages.

3. KNOWLEDGE IS THE NEW NAVIGATION SYSTEM

For many years, companies have been hesitant to offshore R&D activities for fear of having their best ideas stolen. Intellectual-property piracy remains a real threat, but new market forces compel companies to consider all opportunities – even in high-risk areas.

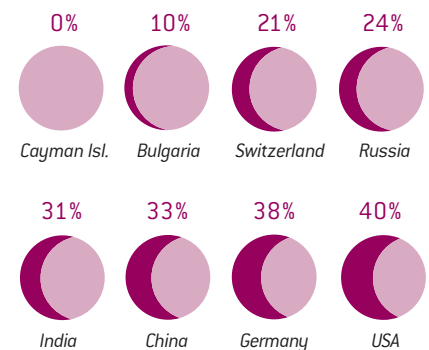
INNOVATION/R&D: Going where the knowledge is will drive the trend toward relocating and expanding R&D centers in emerging markets. In an attempt to capture business opportunities and market share, technology leaders such as GE, Oracle, Lucent, Nokia, Procter & Gamble and Panasonic are building up R&D capacity in Asia to the tune of



Smart companies are looking beyond the BRIC countries to assess new markets among the eleven countries closest to the development threshold.

CORPORATE TAX RATES

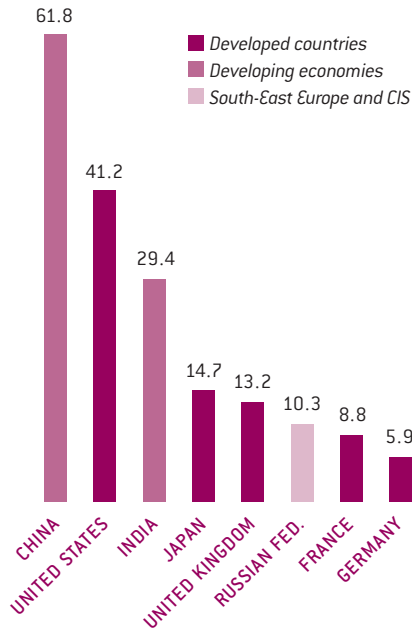
Corporate tax rates in selected countries, January 2007



Source: KPMG

MOST ATTRACTIVE PROSPECTIVE GLOBAL R&D LOCATIONS

UNCTAD survey, 2005-2009 [% of responses]



Source: UNCTAD, World Investment Report 2005: Transnational Corporations and the Internationalization of R&D, figure IV.11.

roughly USD 300 billion. These companies are keen to make use of an extremely skilled workforce. Countries such as India and China are no longer places just for low-end work. As time goes on, sophisticated processes will be steered locally. In addition to offshoring parts of production, many pharmaceutical and biotech companies are falling back on contract research organizations – especially in India – to move ready-for-market processes along as well as to reduce costs. Around USD 75 million was invested in India for clinical research in 2005. Within five years, this investment is expected to climb to USD 300 million. **SERVICE FROM AFAR:** An abundance of intellectual capacity is also likely to be the driving force behind the trend toward offshoring commodity-like administrative service functions. For example, the US automotive supplier Visteon relocated its accounts payable department to India, and other service functions will follow. Cost was a factor, but not the only one. More and more companies are moving R&D and customer service abroad to respond to local market needs more quickly and flexibly. Caterpillar is one such example. The company has installed service points around the world in order to ensure above-average response times for its customers. Customers also benefit from dealing with service staff that is acutely aware of cultural norms and understands local preferences.

4. MANAGING THE ENTIRE VALUE CHAIN

Managing the entire value chain of a global company is a challenge. Understanding how different parts of the chain impact on other links will become increasingly critical to cost management and sustainable value creation. Managers have to balance sourcing, transportation, manufacturing and labor issues – and a whole host of other matters too – based on sometimes competing and counterintuitive information.

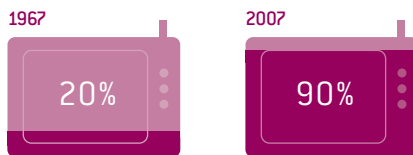
ORCHESTRATING A COMPLICATED ARRAY OF INFORMATION: At the Dutch consumer electronics company Philips, the share of transport costs for a television has shrunk from 20 percent of total costs in 1960 to less than one percent today. This does not look too remarkable until you realize that 90 percent of the parts currently needed to make the television set are produced in low-cost countries. Over forty years ago it was 20 percent. As the business environment becomes more complex and dynamic, managers must increasingly guide different sources of information through the supply chain. In addition, they must master the complicated, global network of in-house production activities, manage procurement from external vendors, safeguard R&D innovation, take care of distribution and transportation and ensure high service standards.

RETAINING STAFF: As the number of companies shifting more sophisticated activities into emerging markets increases, labor costs and turnover among highly skilled workers in these regions are rising as well. Successful companies are realizing that they need to customize their HR policies to local realities. Swiss pharmaceutical company Novartis recruited roughly 400 workers, mostly developers, for its new technology park Zhanjiang in southern China. They receive an incentive package that contains accommodation subsidies, vehicles and other benefits. Companies hope that these measures will prevent high fluctuation rates common among well-educated and skilled workers in the developing world, where competition for labor is high.

Multinational companies today must develop local staff and foster loyal talent to act as corporate role models. This helps them generate the desired value in locations far from a company's headquarters. Getting this right will undoubtedly be key to unlocking the profitability of emerging markets.

PHILIPS

90% of the parts currently needed to make TV sets are produced in low-cost countries.



■ Produced in low-cost countries

5. MASTERING NEW RISKS

Companies are becoming increasingly skilled risk managers, but the nature of today's business environment means that a bewildering array of new threats can arise without warning. At the same time, given extreme global interdependence, known risks can now have a greater impact and must be addressed in different ways.

MANAGING CURRENCY RISKS: Although companies have been using individual financial levers since the late 1990s to reduce dependency on a currency area, this process can be improved in many cases. Hedging strategies, for example, are generally underutilized. Companies need to take steps to minimize their risk exposure. The US DIY chain Home Depot, which sources more than 80 percent from Asia, evaluated its currency risks in 2004. Once aware of the threat stemming from its dependence on the Chinese yuan, the company started to expand into Eastern Europe.

CURBING PRODUCT AND TECHNOLOGY TRANSFER: Every time a company launches a business in another country, it runs the risk of technology and product transfer. Companies need to weigh up the threat of losing their technology-based competitive advantage to a potential rival. In many cases, for instance when companies want to do business in China, FDI is coupled with technology transfer. Companies still need to take steps to protect themselves from product piracy and patent theft using organizational, legal and structural measures. One simple option is to select non-core products or non-core engineering processes for business deals that need to take place in potentially treacherous regions. This is the avenue largely taken by steel and technology conglomerate Thyssen-Krupp.

HARNESSING THE MEGA-TRENDS

Value creation is a global endeavor. Companies that excel at playing this game have successfully erased the "Made in Country X" attitude from their corporate strategy. They know how to harness the new opportunities arising out of changing realities, and how to assess the risks and successfully overcome the challenges associated with "going global." Companies that manage to balance these aspects can achieve sustainable growth and a competitive edge. Navigating the often rough waters of globalization is clearly no easy task for managers. The difficulty lies less in their lack of navigational instruments and more in the environment in which they conduct business. They are chasing a moving target.

In closing, a word of caution: The trends outlined here are relevant today and will likely be relevant tomorrow. But business dynamics are changing radically. Companies that encourage teams to conduct regular scenario planning in which interdependencies are mapped and existing assumptions are challenged will be much better equipped to recognize – and respond to – future trends as they begin to emerge. Gaining this sort of edge is unquestionably a further part of the global value creation equation.

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