

# BEYOND

The compendium of Ernst & Young

**November 2007** □ **Managing Growth**

**Interviews with:**

- Joerg Wolle, DKSH
- Peter Steiner, Karl Steiner AG
- Daniel Borel, Logitech

**Growth:**

- Financing
- M&A
- New Markets

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**Prof. Dr Peter Athanas**  
Chief Executive Officer  
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## Commitment to entrepreneurial vision and diligence

Dear Clients and Business Associates

For more than two years the global economy has been caught up in a growth phase which has also left its mark on traditional sectors and regions – such as Europe. Companies have consequently shifted their focus away from the pursuit of mere efficiency gains to the attainment of sustainable and profitable growth. Although visionary energy is evident everywhere, the road to its realization is being subjected to critical scrutiny: visionary expansionary steps have to prove their worth and pay off in day-to-day business.

The latest edition of the “BEYOND” compendium looks at a professional “growth” service provider that has sprung up in the wake of globalization, a traditional company focusing on sustainability and an innovative, market-driven technology group.

Our own in-house experts also provide input on the crucial points surrounding growth, providing specific information on preparing for and financing transactions, the tax and legal implications of a yet uncharted territory, the concentration on specific core business and the withdrawal from nonstrategic business. Often it is only after a company has made its foray into a promising market and created new synergies that it finds itself confronted by more difficulties than it had at first imagined.

We have given this edition of our compendium the title “Managing Growth” not only to give readers the benefit of our experience and findings in this area: the title is our entrepreneurial commitment to growth, vision and its diligent realization.

I hope you find this issue an enjoyable and interesting read.

Prof. Dr Peter Athanas  
Chief Executive Officer



# “Growth: a professional responsibility”

Interview: **Markus Bernhard**, M. A., Executive MBA HSG, Head of Corporate Communications & Marketing;  
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DKSH, created through the merger of traditional trading houses, is now a professional market expansion services provider. In this interview, President and CEO Joerg Wolle outlines what his clients are looking for in new markets and the challenges they must be prepared to face.

**BEYOND:** Mr. Wolle, you call DKSH “a market expansion services provider”. What support do companies need to grow in new or established markets?

**Joerg Wolle:** Every day CEOs and Boards across the globe are challenging their managers to expand their businesses in existing markets and to launch into new ones.

Regardless of how big it is, once a company decides to expand its business in Asia, the chances are that it will need and seek assistance. Our role is to provide such companies with all the knowledge, advice, relationships and on-the-ground logistics they will require to gain a foothold in those new markets or expand their existing market shares.

The kind of services we provide to them is closely linked to the specific needs and size of any given company. For midsize companies offering innovative, high-quality products, but lacking the necessary financial and human resources to access the Asian markets on their own terms, we provide a one-stop shop for all the essential services needed. DKSH acts as a long-term marketing, sales, distribution and after-sales service partner for this type of company.

Big companies are drawn to us for another reason. They focus, quite rationally, on their core competencies, especially product development and marketing. Everything else is outsourced to specialized service providers. DKSH, with its comprehensive Asia-wide distribution 



### *Portrait*

**Dr Joerg Wolle** (50) grew up in Saxony and obtained a PhD in Mechanical Engineering. In 1991, he joined SiberHegner in Hong Kong as Director of Marketing and Sales. In 1995, on becoming a member of the SiberHegner Executive Board, he relocated to Zurich. From 2000, and until the merger with Diethelm Keller Services Asia, he was CEO and President of SiberHegner. Since 2002, he has held the same position with DKSH Group. Dr Wolle is an Honorary Professor for "Intercultural Communication" at the University of Applied Sciences, Zwickau, Germany. He is also a Member of the Board of Directors of UBS and Diethelm Keller Holding. In 2007, he joined the Board of the German Asia-Pacific Business Association, an association dedicated to promoting the activities of German speaking companies in Asia.

Joerg Wolle is married; he and his wife have a daughter and live on Lake Zurich.

**DKSH** was the result of a merger of the Asia businesses of the two long-established trading houses, Diethelm Keller and SiberHegner, in 2002. In 2006, the market leader in market expansion services in Asia grew its group turnover by 9.1% to CHF 8.1 billion and employs more than 22,000 staff in four areas: Consumer Goods, Healthcare, Specialty Raw Materials and Technology. Most of its business is conducted in South East Asia, Japan, China and Asia Pacific, where DKSH has 350 subsidiaries. The Group also has 15 branches in Europe, the USA and South America.



network, is an attractive outsourcing partner for logistics, distribution, delivery and invoicing.

**DKSH has been present in Asia for over 140 years. While everyone is talking about China nowadays, there are some open questions regarding the China market. How do you see China's growth prospects and those for the rest of Asia – both as a market and as a production location?**

Asia will post by far the highest growth rates for any region over the next few decades. As a result many companies will want to get in on the action, whether in terms of sourcing raw materials, selling products or manufacturing. These days, if you open any newspaper, you could easily get the impression that Asia consists exclusively of China; but it doesn't. I have been saying this for

years: please don't put Asia in China's shadow. There are numerous other markets for new entrants to Asia and, indeed, some are even more attractive than China itself. Yes, China is currently the biggest growth market in the world, but that does not make it some sort of El Dorado! Players in the Chinese market have to deal with the smartest negotiators, the toughest competition and the highest pressure on margins.

**You worked in Hong Kong yourself for several years. As a CEO you encounter all types of people and cultures on a daily basis. To what extent do people and their culture define an economy and growth potential?**

The hunger and a desire to succeed are indispensable to achieving economic growth. Cultural sensitivity and the ability to put yourself in someone else's shoes are a must if you want to work abroad. "One size fits all" certainly does not apply, particularly in Asia. The key is not to attempt to force anything on anyone; instead you need to generate a clear understanding of what the client really needs.

**DKSH has grown enormously since the merger. How did you manage?**

Since the merger we have achieved double-digit growth for five consecutive years. Our staff or "footprint" if you like has grown by 50%, and we now have over 22,000 specialists worldwide. Turnover has grown by 74% since 2002 and profitability by 111%. This success was the result of our successful conversion from a trading house to a highly specialized services provider. DKSH reinvented the business model of the old trading houses and, as a result, is now developing a new industry, which we call "market expansion services".

**Did you experience any challenges or difficulties in doing so?**

Naturally – in the past five years alone we created 8,500 new jobs. Moves of that magnitude don't

happen all by themselves. Our main concern is maintaining or improving the quality of our staff and services while growing at such a pace. And, another thing that is particularly close to my heart: our corporate philosophy is based on more than 140 years of trust and individual responsibility. Maintaining the right balance between entrepreneurial freedom and control is a major challenge. We have a very lean headquarters of 15 people for over 22,000 staff. Our growth has obliged us to strengthen our structures in certain areas; but we want to remain lean and unbureaucratic at the same time.

***“The families behind DKSH have a 140-year track record in doing business in the Far East. The value of a long-standing and good reputation cannot be underestimated, particularly when expanding into Asia.”***

*ADRIAN T. KELLER,  
Chairman of the Board,  
DKSH Group*

#### **So how do you do it?**

We always adapt our structures to reflect our size while we introduce systems and tools that make further growth possible. Take our global ERP project, for example: at the time of the merger, 17 different IT systems were running; now the whole group operates on the same platform. This enables us, as the only service provider in our sector, to provide our suppliers with extensive information from the market on consumer behavior and requirements, giving us a huge competitive advantage.

Moreover, we nurture our pool of emerging talent at our own Fantree Academy and through a targeted recruitment policy.

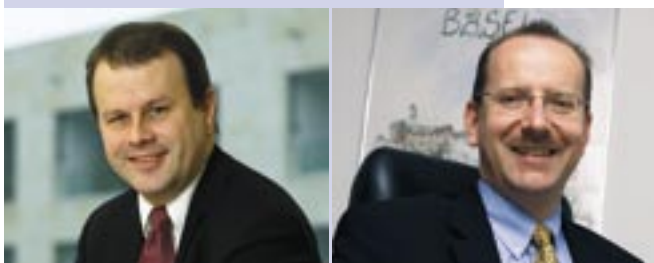
#### **To conclude: How are the growth prospects for your clients and for DKSH?**

They are excellent: Asia will remain the biggest growth region for the foreseeable future, and demand for our services remains strong. DKSH achieves 95% of its turnover in Asia and has been there for over 140 years. We help our clients to expand in those attractive markets. Although we are the first to recognize that size certainly does matter, we do not pursue growth simply for the sake of growth. Critical mass, substantial investments in IT, a good network of relationships and the complete coverage of our markets are crucially important. Such criteria call for size and, as a result, consolidation in our market areas.

We are also staying well ahead of the game because we are the only company in Asia to have a regional network with a comprehensive service portfolio and a modern IT infrastructure. Manufacturers working with us benefit from our strong footprint and the market leverage we can bring to bear in negotiations, when compared to a single service provider.

# Innovation – the power behind success or failure in life sciences

The growth of life sciences companies depends on innovative and successful products and R&D plays a crucial part in making it possible to launch a continuous stream of new products. Unlike in the pharmaceutical industry, in which what matters is the size of companies' R&D departments, their sales networks, and the sort of sales and marketing they do, it is innovation that occupies center stage in biotech – a sector that cannot usually benefit from the economies of scale brought by mass production. Despite their differences, though, these two sectors are working ever more closely together and benefiting from each other's advantages.



From left to right: **Markus Blaser**, Swiss certified accountant and Senior Manager, Audit Services; [markus.blaser@ch.ey.com](mailto:markus.blaser@ch.ey.com)

**Jürg Zürcher**, Swiss certified accountant, Partner and Industry Leader Biotech Central Europe, Audit Services; [juerg.zuercher@ch.ey.com](mailto:juerg.zuercher@ch.ey.com)

**Life sciences: an industry undergoing constant change**

By means of medicines or medical treatments, life sciences companies are striving to maintain or improve life. Pharmaceutical products are manufactured by means of traditional organic chemistry, whereas, for the manufacture of bio-

tech products, biological systems, living organisms, or derivatives thereof are used to make or modify medications or processes for specific use.

The discovery, in 1928, of penicillin, is regarded as marking the birth of the modern pharmaceutical industry, which achieved real significance only in the early 1970s, since when it has grown to become one of the world's major industries on the back of new-generation medicines, an ever-greater proportion of older people among the population and a constant increase in purchasing power. Most modern groups of pharmaceutical companies handle every stage of the value chain – including sales and distribution – themselves, thus acquiring considerable clout in the market.

One can contrast that with the biotech industry, which, although only some thirty years old, has developed at a phenomenal rate. Since 1982, when recombinant human insulin became the biotech industry's first approved product, hundreds of innovative new biotech-driven medicines and vaccines have been brought to the clinic. This extraordinary performance of the global biotech industry in recent years and its recent coming of age have been mainly fueled by constant innovation and strong success on the product front along the way.


The big pharmaceutical companies can generally rely on their own considerable resources when they need to get new and promising substances or therapies through the clinical testing phase and then approved for marketing. By contrast, though, biotech companies often emerge as spin-offs from research departments in universities or pharmaceutical companies and have only limited resources to fall back on. One core strategic challenge has to do with how to get and keep the necessary personnel, know-how and capital, the last of which is often funded by venture capitalists.

### Product portfolio as a core strategic challenge

The life cycle turnover curve of a new medical product is generally characterized by a steep climb shortly after it is put on the market, followed by a period of ample, high-level margins, which can be achieved thanks to the protection of patents. At some stage after that point, though, as a result of successive discoveries of new and better medicines and therapies, turnover becomes more and more eroded, while, when patent protection expires, sales rapidly decline as cheaper generic products are brought onto the market.

Looked at from a statistical point of view, nine out of ten new projects fail during the clinical trials stage, and it is for this reason that life sciences companies have to keep the pipeline full of products by continually reinvesting a considerable proportion of their turnover in new R&D. It follows, then, that successful pharmaceutical or biotech companies give priority to optimizing their product portfolios, with the established and best-selling products constantly being supplemented by new ones, which may in their turn become star performers later on.

### The innovation gap

The traditional pharmaceutical industry has for some years been facing an ever-widening innovation gap, in that the number of new active agents and treatments with the potential to become “blockbusters”<sup>1</sup> is tending to decline, while, at the same time, the sums of money spent on R&D, the costs of clinical trials and those of approval for marketing, are increasing explosively. An additional factor is that the clinical studies required are becoming ever more comprehensive, while the hurdles that products have to pass over in order to be licensed are being set higher and higher. The pharmaceutical industry has for many years been trying to resolve this dilemma – and at the same time to cut costs – by the buying up of other pharmaceutical companies, and it is 

<sup>1</sup> Blockbuster: very successful medical product

this that eventually brought about the present state of affairs, in which ownership is concentrated in the hands of relatively few global operators.

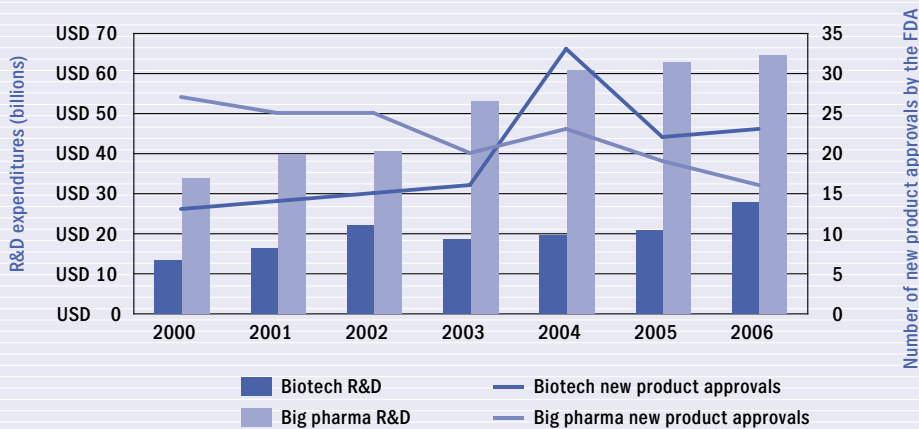
Over recent years, the biotech industry has tended to meet this challenge in a different way, by a clear focus on efficient innovation processes, in which companies focus on picking out from ideas for projects and basic research – of which there is generally no shortage whatever – those projects that not only promise to give them an advantage over their scientific competitors, but also satisfy commercial criteria. They also tend to lay emphasis on the astute allocation of resources in order to make the best possible use of financial and human resources, which are normally in short supply. What they have to do, in the final analysis, is to ensure that projects progress consistently, thereby meeting the venture capitalists’ expectations or achieving the project benchmarks laid

down in their business plans on schedule. One consequence of this consistent focus on innovation processes has been that the biotech industry has now outstripped its pharmaceutical counterpart as regards the ratio of research spending to the number of products licensed (see illustration 1).

**Pharma-biotech cooperation as an effective engine of innovation**

Despite all the takeovers, big pharma is increasingly coming to realize that its own capacities are reaching their limit when it comes to securing sufficient ground-breaking research projects. At the same time, on the other hand, many young, flexible and ambitious biotech companies are working on promising research projects while having to contend both with financial problems and also the fact that they currently lack the expensive distribution network that they need in order to be able to market their own products.

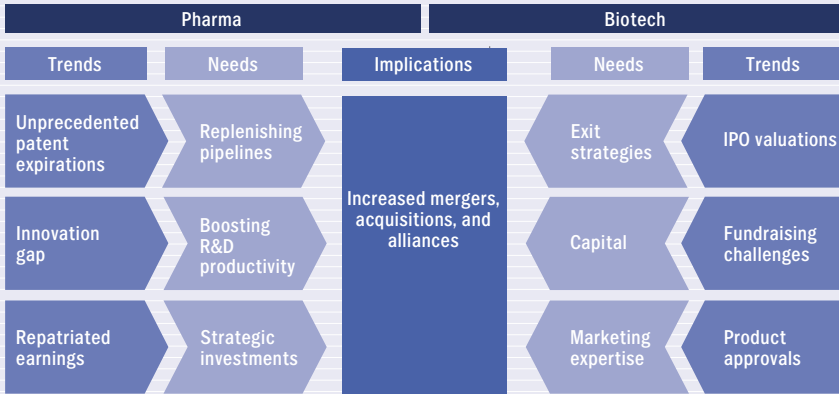
**The innovation gap**



Source: Ernst & Young

Illustration 1: For several years now, the ratio of research spending on the part of pharmaceutical companies to the number of their products licensed has tended to decline, while the opposite is the case for biotech enterprises.

## All roads lead to deals




Source: Ernst & Young

Illustration 2: Agreements between pharmaceutical and biotech companies often bring benefits to both parties.

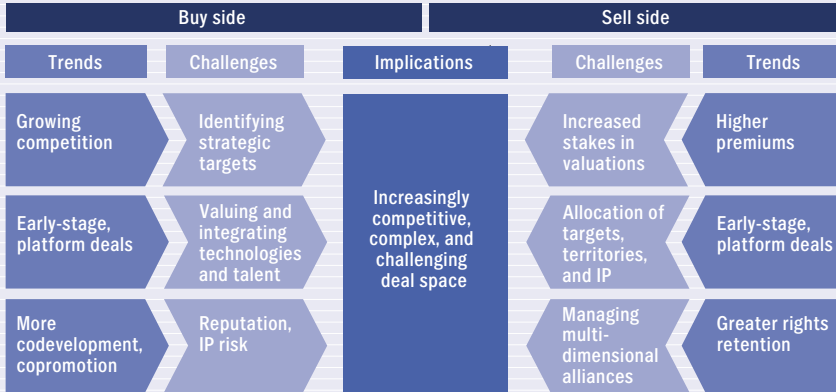
Seeing the writing on the wall, both parties have recognized the strategic potential of working together and this has, in fact, brought about a recent upheaval in the life sciences industry, as pharmaceutical and biotech companies around the world start to do a great deal of business together.

One prominent Swiss example of this sort of cooperation is the cooperation agreement concluded in July 2006 between Actelion and Roche on the continuation of joint research into the active agent SIP1, which is capable of being deployed against a number of diseases of the autoimmune system. Under the agreement, Actelion is to receive from Roche an upfront payment totaling USD 75 million, enabling it to continue to do research into the substance and to get clinical trials and market approval underway. On the achievement of predetermined interim targets, Roche will make further payments of up to USD 555 million in order to help fund clinical trials, which are enormously expensive, and will also pay its partner royalties calculated on the

basis of the subsequent sales of all products, receiving in return a 50% share in the profits from all medical products developed on the basis of this cooperative arrangement. This deal has enabled Roche to secure for itself potential future sales without having to expose itself to more operational risks. Actelion, on the other hand, retains all the patent rights to the active agents and benefits to a significant degree from their sales.

There has been a marked increase in such cooperative arrangements between pharmaceutical and biotech companies. Although the forms of cooperation were initially rudimentary and the conditions often dictated by the pharmaceutical groups – which were, of course, bigger and stronger – agreements have been becoming noticeably more complex over recent years as the biotech firms find themselves in a stronger bargaining position (see illustration 3). 

## All roads lead to deal complexity



Source: Ernst & Young

Illustration 3: Once biotech firms were in stronger negotiating positions, deals became more complex.

### Biotech companies: engines of innovation in the life sciences sector

There is no question that biotechnology is now the main engine of innovation for the drug development industry. If there was any doubt about it before, the headline-grabbing mergers, acquisitions, and strategic alliances of 2006 and 2007 provide ample evidence of the tremendous potential latent in biotechnology’s cutting-edge platforms, technologies, and pipelines.

Many biotech companies are now entering the next phase of their development – they are negotiating on an equal basis with pharmaceutical or other biotech companies on license agreements or mergers, are successfully getting new products through clinical trials and on to the market, and are growing into global market players, thus laying the foundations for a new growth spurt in the life sciences sector.



# “Entrepreneurial risktaking is key to our success”

Interview: **Anne-Catherine Rüegg**, Certified Public Relations Consultant, Head of Corporate Publishing & Advertising; [annecatherine.rueegg@ch.ey.com](mailto:annecatherine.rueegg@ch.ey.com)

**BEYOND:** From your perspective, what are the main reasons for the Steiner Group's success?

**Peter Steiner:** Continuity and sustainability, which we have put into practice and worked to achieve throughout the years, have been key factors in our success. From one generation to the next, we have always aimed to make optimal use of the current situation while also acting to ensure sustainability. We have also concentrated on a specific core competence at each stage – since 1995, we have focused on total services contracting (TSC). This means that we cover all services in the total life cycle of a real estate project along the entire value chain – from product definition through project development, planning, realization, use and operation, all the way to financing. The other key success factor are our employees. We rely on people with solid training, capable of integrated thinking and of mastering challenges holistically. Finally, we have always

**Peter Steiner, Chairman of the Board of Directors of Karl Steiner AG, is examining the possibility of taking the company public to ensure long-term growth opportunities. He explains the biggest challenges to growth and discusses how company growth can be combined with ecological sustainability.**

been prepared to take entrepreneurial risks and to turn promising visions into real projects. The best example is Sihlcity: without our solid financial and technical backing – and without a strong belief that we were doing the right thing – that project would still be a paper tiger.

**What has been the Steiner Group's growth strategy up to now?**

Originally, we were only active in the greater Zurich area. In the 1970s we ventured a move to Geneva to satisfy the needs of our clients. In this way, we gradually began to form a countrywide network of subsidiaries in Switzerland. From our base in Geneva, we took a holding in the Sogelym company in France, starting with a 50% share and then taking over the company entirely in 2004. Sogelym-Steiner is currently one of the leading project developers in France, which makes it possible for us to undertake major projects there.

In general, we must keep our eyes open constantly for promising markets that will allow us to utilize our core competence. This is how Steiner Modern emerged in China in 2005, through collaboration with a local partner, to become one of the larger project developers and general contractors for residential and commercial building construction in Beijing. There, we are able to contribute our extensive ecological know-how, among other skills, since sustainable construction is of growing importance also in China. Our foreign activities have taught us that reliable on-site partners are crucial for success.

**What has been the biggest challenge to growth, and what are the challenges you face in the near future?**

On the market, you always have to be a step ahead of the competition – this continues to represent a huge challenge. We had to realize in good time that, for purposes of risk distribution, we needed to launch a targeted growth strategy outside the main Swiss market. A company should be able to

take advantage of such opportunities independently, at the right moment and with sufficient resources. We have therefore always aimed to grow autonomously, by virtue of our own strength.

I anticipate future challenges in three main areas. First, it is important that we continue to pursue a well-timed entry into new markets. Identification, assessment and decision making must happen quickly. Here, I especially have in mind new areas such as public-private partnerships (PPP). We are already involved in projects like these, one example being the Zurich Kongresshaus. Second, another big challenge is posed by continuous process optimization. While it is technically possible to integrate all partners, in practice this continues to prove very challenging. I imagine it is possible to identify the potential effects on development and operating costs in the planning phase, using three-dimensional representations and varying basic models. Third, we face the challenge of total services competitions on the market. These entail offering total products that link conceptualization and design aspects to realization and operation right from the start. However, this requires the modification of certain rules and basic tenders. A reimbursement system should also be available to provide at least partial compensation for the work that goes into competitions of this kind. This is still not customary in our sector, even though a single project often requests multiple proposals, which can be highly complex and can easily cost up to CHF 500,000. A company can hardly afford to process several such proposals simultaneously without being compensated.

**You have announced that you will be examining the possibility of taking the Steiner Group public – what do you hope to achieve by this?**

First, we hope to create optimal conditions for the future, enabling us to seize capital-



### *Portrait*

**Peter Steiner** has been Chairman of the Board of Directors of Karl Steiner Holding AG since 1990. He has been Chairman of the Board of Directors of Karl Steiner Holding AG since 1991; he was also Delegate to the Board of Directors until the end of 1998. Peter Steiner joined Karl Steiner AG in 1973 and was appointed to Group management in 1976. He is also Vice President of the Board of Directors of ZürichForum AG, a member of the Board of Directors of Sire Holding Ltd., one of the Directors of the Zurich Economic Association and the Zurich Chamber of Commerce, a member of the Management Board of the Swiss Museum of Transport, and is on the Board of the Alberto Giacometti Foundation. He is also Governor of the World Economic Forum, a member of the Board of Directors of the GRI Global Real Estate Institute and a member of the Advisory Board of the John F. Kennedy School of Government at Harvard

University. Before joining the company, Peter Steiner studied at New York University, as well as with the American Management Association, and was then employed by the Turner Corporation in the United States, where he worked in the areas of project management, sales and marketing.

**The Steiner Group** manages real estate projects through all stages, from development through realization and final use. As a leading total services contractor in Switzerland, the Group provides one-stop services for the entire life cycle of a real estate project. In Switzerland, the Steiner Group is represented by its head office in Zurich as well as offices in Basel, Berne, Geneva, Lausanne, Lucerne, St. Gallen and St. Moritz. The Group's international activities focus on France, and since mid-2005 also on China.

intensive growth opportunities quickly, flexibly and in a targeted way and to enter new business segments, as well as to conduct successful project developments in promising markets. This move will also allow us to guarantee good succession planning in the long term. Finally, we would like to offer our employees a chance to hold shares in the company. A public company is attractive to employees.

**You have high expectations of your employees – how do you recruit them?**

One important reason why people want to work for us is our brand name. The Steiner name is well known in Switzerland and boasts a long tradi-

tion; we have been active in the market for 92 years. The projects we take on are also highly eclectic, challenging and diversified, which attracts qualified people. Another key point concerns training: we invest extensively in our employees' training and give them a great deal of responsibility. An example is the Sihlcity project, which was managed by a 38-year-old project leader. For employees in search of such challenges, we offer a high level of variety and a range of interesting projects. We also offer our Swiss employees a chance to work in France or China.

**Speaking of China – what are the main differences between the Chinese and European markets?**

Even within Switzerland, Berne is not the same as Zurich and Zurich is not the same as Geneva. So you can imagine how striking the differences are between the two countries. We have used this opportunity to fill the very gaps created by such differences: for example, in large Chinese cities, there is an increasing market demand for better construction quality and sustainable building technologies, as well as for professional and efficient project management. Those are areas in which the Steiner Group can provide added value, thanks to its wealth of experience. We use our project management role to transfer knowledge and expertise to China. We provide our partners with intensive training, especially intended to strengthen the focus on quality. On the other hand, we have also been forced to realize that effective market penetration in the Middle Kingdom is only possible by working in partnership with a well-established local company. In the Modern Group, we have found an on-site partner well suited to Steiner, and one which shares the Steiner Group's emphasis on market differentiation through quality, technology and sustainability.

**How do you handle cultural differences?**

For instance, with our Sino Swiss Exchange Pro-



gram: in November 2006, Steiner Modern invited 20 representatives from the Chinese building industry to take part in a ten-day trip to Switzerland. The visitors were able to view active construction sites, as well as industrial plants. Each visit focused on a specific topic, ranging from building shells to facades and interior fittings, all the way to building services. A reciprocal visit will take place in the course of the year.

Naturally, our Swiss expats in China also receive on-site support and an introduction to life and culture in the host country. However, our goal is to primarily employ local Chinese workers. We provide them with training to ensure they are able to meet our normal quality standards, even as standards also begin to shift in China.

**Ecological concerns play a key role for you – how do you reconcile ecological sustainability with economic growth?**

Ecological construction and the respectful use of resources are among the main issues in the 21st century. Environmental regulations and obligations are becoming stricter all the time, but technological development is also advancing at a rapid pace. Sustainable building technologies are in demand both domestically and abroad. Ecology and energy efficiency also play an increasingly important role in the optimization of returns. As a market leader, we commit ourselves to forward-looking and sustainable solutions: we always design our projects with a view to feasibility, marketability and, of course, sustainability. And this worldwide trend is certainly not at odds with opportunities for growth. To the contrary: we see this as an area in which we can take systematic advantage of our cutting-edge role. But especially when it comes to the environment, we do not act alone: in our own tenders for subcontractors, we cite the environmental friendliness of building materials as an explicit criterion for determining who is awarded the contract. Where

two prices are the same, the more ecologically sustainable offer will be accepted.

**To conclude, a forecast: how will the Steiner Group look in ten years?**

We hope that we will still play a leading role in the sector ten years from now, thanks to our total services contractor business model. However, we know that we have to extend the value chain to satisfy market demands. We can only accomplish this through innovation, sound partnerships and targeted expansion, which require additional resources. I expect that, ten years from now, we will have a better balance between our Swiss and international business activities. I do not see Steiner becoming involved in production. We would like to remain a pure real estate and construction services provider, and in the future, we would still like to have enough flexibility to work with the best suppliers and subcontractors available, both here and abroad.

# Financing growth: from vision to reality

Given globalization and the changes under way in the markets, a lot of companies find themselves having to grow to achieve critical mass. Although there are a number of ways of ensuring that equity capital keeps pace with growth, getting financing is far from simple.



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□ Growth requires investment: if a company has an acquisition target or has identified a new market, it needs financing to make the purchase or tap into the new market. The decision as to whether to structure and finance the transaction via equity capital, debt capital, mezzanine capital, own liquidity from operational cash flow or via an equity swap essentially depends on the amount of cash flow the acquiring or target company (in the case of an acquisition) generates. More often than not, however, a company does not have enough cash to finance the deal out of its own coffers.

Privately held companies often find that their restricted equity base proves a bottleneck for forward-looking expansion, finding that it cannot keep up with the acceleration in total assets brought about by rapid growth or acquisitions. So

it can make sense to sell off those parts of a company that no longer belong to its core business and use the proceeds to finance expansion or an acquisition.

It is for this reason that companies usually focus on strengthening their equity base (equity financing). Mezzanine capital – a hybrid form of debt and equity capital – is a logical choice as it can be designed with flexibility in mind. However, mezzanine forms of financing, often in the form of subordinated debt, sometimes seem to fail because the structure of the fee and repayment models hinge on the company's economic performance, making them appear extremely complex. In every financing structure taxation aspects and the proposed repayment schedule also have to be factored in at an early stage.

#### **Vision is just one of the ingredients for success**

The most important conditions for successfully raising capital are:

1. Having a clear vision and viable business concept for developing attractive growth markets
2. An enterprising management team
3. Demonstrating transparency in financial management and with regard to taxation and legal issues
4. Using technology that offers clear competitive advantages and high added value
5. Offering services or products that promise economies of scale
6. Providing a credible exit opportunity for the investor

#### *1. Vision and business concept*

In addition to a plausible vision a company needs a realistic business plan that details and quantifies how it plans to attain its goals. The business plan should also outline whether additional rounds of financing are feasible because potential investors want to know right from the onset the entire amount of financing that may be required.

#### *2. Management*

Investors look for a small, highly motivated and effective management team. Any gaps in management can be solved by suggesting that investors participate in a management buy-in. Management often participates in the success of the company, which – if appropriately structured – increases their motivation and credibility.

#### *3. Transparency*

Of particular importance is effective and economically sound financial management that enables the company to satisfy investors' information needs. For this reason outlandish corporate structures designed for tax purposes complete with offshore holdings or foundation solutions should be avoided. Investors usually perform due diligence of the company before committing themselves anyway, which they use as the basis for their investment decision. It goes without saying that a lack of transparency is a huge hurdle to the successful closure of an equity finance deal.

#### *4. Competitive advantages*

The company should be able to prove that it has specific competitive advantages, e.g. of a technological or marketing nature.

#### *5. Products*

The products or services offered by the company should be seen as clearly superior to the alternatives on the market. Ideally the company should also be able to demonstrate how previous success can be leveraged via geographical expansion or the extension of a range of services or products.

#### *6. Exit*

Financing often fails because the exit is unclear: every investor wants a get-out clause. The exit possibilities that can be contractually agreed upon are the subject of intense debate, par-

ticularly among investors with minority stakes, and deserve to be handled with the utmost care.

#### **Exit: difficult obstacles – several solutions**

Seeking a listing via an IPO is an ideal exit strategy for financing major acquisitions. As the launch of an IPO is also influenced by the state of the market, investors find themselves often unable to sell all their shares. As a result, the company in question often continues its search for a buyer during the IPO using the phenomenon of dual tracking. One special type of exit is via the secondary buyout: a venture capital or private equity company sells its stake in a company in its portfolio to another venture capital, private equity company or an investor.

In this case the investor is interested in the so-called tag and drag-along rights: the investor in this case is after all a minority shareholder and thus feels the need to negotiate some sort of contractual right to sell its shares. If a majority shareholder wishes to sell its shares, the tag and drag-along rights enable the investor to sell his or her shares at the same conditions. If the acquirer does not wish to buy all the additional shares, the sellers can sell the percentage of shares that the purchaser is willing to buy. Conversely, the investor who is selling can demand that the other shareholders sell their shares to the interested acquirer at the same conditions (drag-along right). In this way the investor can offer the purchaser a larger block of shares.

#### **Investors: not easy to find**

Once a company has these conceptual conditions in place, it needs to set about finding the right investors in Switzerland or abroad:

##### *1. Business angels*

Business angels are affluent private individuals or institutions which finance or partially assist with research or inventions or which offer seed capital

financing, i.e. assuming all the financing for an idea to evolve into something tangible that yields results and, ultimately, becomes a prototype. This is used as the basis for drawing up a business concept for a prospective company. Switzerland offers a superb environment in this respect. Adequate financial funds are available in the market and some family offices and private individuals are willing to take on the risk of financing. However, it is often difficult to find the right business angels. Platforms such as the Technopark or prizes such as Ernst & Young's Entrepreneur Of The Year® award help to create transparency for business angels; although the search remains difficult and time consuming for companies. The Technopark estimates the overall Swiss financing volume by business angels to be some CHF 30 million per year, which is markedly below paragons of innovation such as Finland and Israel.

##### *2. Venture capital (VC)*

Venture capital providers invest as a rule CHF 3–20 million and thereby help companies of an already substantial size to grow further. In Switzerland investing in biotech is especially popular, accounting for more than half of all venture capital. However, the overall volume of venture capital available is not all that big. According to statistics compiled by Ventureone, it totaled some CHF 30 million per year from 2004 to 2006 which was invested in an average of 30 investments.

##### *3. Private equity (PE)*

Private equity companies are interested in participating in major growth financing projects, although only a small number of PE companies really assume minority stakes.

##### *4. Bank financing*

The much-berated bank financing option is definitely one avenue to explore for debt or mezzanine financing. The Cantonal Banks in particular are

by their very nature – in the interests of promoting the regional economy – often willing to examine financing requests and provide assistance.

#### **Paving the way by adopting the right approach**

Financing growth is, has always been and will always remain difficult. It is little affected by short-term turbulence on the global financial markets. But if a company has the right management team, top-quality products or services, it can access this kind of financing. The following two aspects are particularly important in the search for financing.

#### *Wide search combined with the right image*

After subjecting the business plan to rigorous testing, the entrepreneur or company should be able to picture its realization. A company has to demonstrate considerable staying power if it wants to really convince with potential financing partners to enter into dialogue. Supporters and individuals well acquainted with the financing community can be of decisive assistance on the way to success.

#### *Patience and room for decision making*

The preparations and conclusion of a round of financing can easily take six months and ask for a lot of management's time at the expense of the company. A form of bridge financing which provides sufficient financial leeway and a breathing space can prevent a company being pressurized to opt for a suboptimal long-term and financing solution. ■

# Don't just get rid of it, get your money's worth: a note from the field

With M&A deals capturing so much attention over the last few years, the strategic importance of managing divestitures can easily be overshadowed. Yet, for the long-term success of a company, a properly executed divestiture may be as, if not more important than an acquisition. Find out some of the keys behind well-planned carve-outs, spin-offs, sell-offs and buyouts.



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□ Successful companies not only invest, they divest as well. When managing their business portfolios, executives must consider which businesses to grow and which to shed. Divesting non-core assets permits management to focus its attention on its core business, allowing for better possibilities for growth. For example, the Bayer Group in 2006 shrewdly sharpened its focus by divesting its diagnostics business and the subsidiaries H.C. Starck and Wolff Walsrode, and in the

same year strengthened its pharmaceuticals business through the acquisition of Schering AG of Berlin, Germany. Another benefit of divesting is that the perceived risks of earnings dilution and cash flow are generally reduced. There are plenty of examples of companies that have divested assets and seen significant increase in their stock price thereafter.

Many companies have invested heavily in their corporate development function, creating organizations of world-class acquirers. And in today's headline-driven economy, multibillion dollar acquisitions seem to grab much attention. However, companies have generally spent less time and resources on managing divestitures.

While the impulse may be to "just get rid of" a nonperforming or noncore business, it may not be the best strategy. Instead, companies should be asking "What should we sell, and when?", as much as they look for deal execution best practices. In fact, maximizing the selling price and successfully managing the divestiture frequently requires more time and effort than acquisitions.

So what does effective divestiture planning and execution look like? How can companies develop repeatable and efficient processes to maximize sales values?

While there has been a lot written about transaction integration success and failures (for example see Ernst & Young articles on transaction integration in the Ernst & Young "Insight for Executives in Financial Services" edition Winter and Autumn), less has been written on how to successfully divest a business. Divestitures are often associated with selling frenzies, bidding wars and asset shedding often leaving corporate executives with few options other than a spin-off. However, corporations have come to realize that facing well-prepared bidders demands equal preparation. The following is an actual account of how transaction strategy and transaction management can be carried out successfully.


### Unbundling options – making the right choice

Companies that are looking to divest for strategic reasons or as an adaptation to regulatory and legal boundaries, have various options to unbundle their operations: carve-outs, spin-offs, sell-offs and buyouts. The divesting mode generally depends on three factors:

- The characteristics of the business unit: Is it worth selling? Does it perform well? Is it related to the parent's strategic directions?
- The characteristics of the parent company: performance, leverage, need for cash and diversification.
- The wider business environment: regulatory requirements, rate of growth and performance of the industry.

A company can unbundle a high-value unit when it wishes to "cash in" some capital, but still retain links with it. In this case, the parent tends to sell the unit via a public offering, but retains possession of a part of the equity (carve-out) of the divested company. When the parent company does not need to raise cash, but wishes to redistribute value to its shareholders, it may prefer to divest a less valuable unit by redistributing its shares to the parent's shareholders through a spin-off. Companies undertake a carve-out or a spin-off if they believe that the market is incorrectly valuing the company in its current organizational form.

A parent company may sell a unit to another company in exchange for cash (sell-off). A sale of a unit to another company often happens when the parent does not want to maintain a relationship with the divested unit. Usually, sell-off units either no longer align with the strategic direction of the parent (as was the case with Novartis selling its Nutrition division to Nestlé) or have poor operating performance.

A divestiture can also be an initiative driven by the unit managers. In such a case, man- 

agers with the support of other investors, replace the public stockholding of the parent company. These management buyouts (MBOs) are normally financed with large debt issues and the involvement of private equity firms. For the unit managers, an MBO is an interesting option when they believe they can make the unit perform better as an independent company. A parent company, on the other hand, will only agree to sell the unit to its managers when the managers are willing to pay a price that is higher than its perceived value.

#### **Transaction strategy – boosting value**

Often both the parent company executives, who sponsor the divestiture, and the managers of the unit to be unbundled (target unit) tend to be reluctant to invest time and resources to boost performance prior to the transaction. However, they are missing an opportunity to change the management rewards and measures of the target unit prior to the divestiture, which in turn can be a tool to not only retain the management team, but achieve short-term results. Also implementing focused working capital and process improvement programs can in a reasonably short period of time improve the balance sheet of the target unit. Private equity firms often use this tool to quickly enhance the performance of a newly acquired company, so why shouldn't a parent company implement some of the same value-boosting strategies with its target unit? Clearly, great care should be given to balancing short-term value with long-term sustainable growth.

#### **Transaction planning – getting ready**

Successful divestiture planning focuses on readiness. Readiness assessment identifies not only separation risk and issues, it prepares management with recommendations for mitigation. One of the main issues in multicountry carve-outs is coordination of work areas. Often each functional area runs off on its own without coordination.

This lack of coordination causes duplicative costs and poor processes, systems and management. To prevent this, Ernst & Young's approach incorporates readiness assessments, especially for Day 1, the day the transaction closes and the target unit is divested.

Actually, a Day 1 readiness assessment typically encompasses listing all critical milestones to ensure interrelated deliverables are considered. The assessment is typically led by functional team leaders in close cooperation with the carve-out management office. Typical issues in a carve-out would be: foundation of the company's tax and legal structure, identification of personnel in transfer, establishment of IT and accounting systems, as well as the definition and clarification of sales coverage, compensation structure and employee benefits. In other words, the carved-out company must be fully operational on Day 1.

If the business is to stand alone, the cost to replace corporate support functions requires significant attention. Transitional service agreements (TSAs) are crucial to support the carved-out business unit until it is completely independent.

Separation issues are identified by interviewing functional leaders. The key to success is identifying key support functions and assigning roles to pinpoint responsibilities. Given the complexity of an intermingled support function, protocols for interactions must be established early on.

As part of the preparation process, it is also key to build a strong story to provide a compelling rationale for potential buyers.

#### **Transaction management – organizing confusion**

Throughout the carve-out, functional teams must be coordinated to implement the transaction strategy.

The carve-out management process is usually set up in four stages: preannouncement, presign, preclose and postclose.

In the first stage, the carved-out business model

must be fully understood and objectives must be set, which can be done by setting up team charters, organizational charts and term sheets.

Shared services and operations are identified in the second stage. A list of priorities is developed to facilitate efficient production of work plans. These work plans are followed throughout the transaction.

The future business model is defined in the pre-close stage. Based on that understanding, TSAs are drafted and formulated. Close interaction with the investors also must be coordinated and strategies communicated.

Postclose is essentially the execution of the planning and the TSAs. At this stage separation plans and TSA exit strategies are developed. The goal of the seller is to exit the TSAs as quickly as possible to shed all obligations.

All of the above must be incorporated into the carve-out financial statements. At the same time the new company must submit a set of stand-alone financial statements (opening balance sheet) to determine the net assets to be distributed.

### **The good and the bad – adjusting the process along the way**

Every divestiture is different, whether it is a large multinational or a small business unit, but they all have one thing in common – the need for the divesting company to have and execute a strategy to ensure maximum value. Only by seeing the divestiture as an opportunity for all involved and having a plan ready for Day 1 can each type of divestiture – carve-outs, spin-offs, sell-offs and buyouts – truly be a success. ■

# “Our linear growth induces exponential complexity”

Interview: **Monica Kremer, M. A.**, spokesperson, [monica.kremer@ch.ey.com](mailto:monica.kremer@ch.ey.com)

Daniel Borel, cofounder and architect of the rise of Logitech’s global prominence, talks about the challenges, opportunities and ambitions he has for his company.

**BEYOND:** Daniel Borel, Logitech has been posting huge growth rates and record profits for years in spite of operating in a highly competitive environment. What would you say are the main reasons for this incredible success?

**Daniel Borel:** Luck definitely had something to do with it: having the right product in the right place at the right time. But the main reason is being able to spot opportunities and create a vision for the company. We started out at a time when IT was redefining the way people would go to work, communicate and enjoy themselves. This democratization of IT and its popularity with the layman made us realize that the interface would be the key to accessing the growing wealth of content in the digital world.

Another success factor was the fact that we provided innovative, quality products at competitive prices. We learnt from our experiences with companies like Hewlett-Packard, Digital and Apple, whom we were supplying and developing mice for, how to meet the challenges of mass production. Original equipment manufacturers (OEMs) were our first target group until 1985/1986, when the growing popularity of personal computers



among the public gave us the opportunity to penetrate the retail market and sell products under the Logitech label. The complementary nature of these two segments enabled us to develop extremely competitive products, as we could offer cutting-edge technology to our OEM clients and give the retail market the benefit of our economies of scale. So it was by putting all our effort into innovation, quality and price that we managed to develop our profitable product range.

**Have your challenges evolved as society has developed? What role have your staff played in Logitech's progress?**

Logitech comes from very modest beginnings. We did not have any start-up capital as such, so we had to manage our resources very carefully to remain competitive. That is why, having been in business for just five years, we founded Logitech Taiwan, our objective being to conclude a contract with Apple. At the time, Apple was the only PC producer to have a graphic interface requiring

a mouse, hence our interest in them. Given that production costs were also advantageous, Taiwan proved to be an excellent strategic option, both for cooperating with Apple and over the longer term. Logitech has a very flexible and decentralized structure today, however, Switzerland is still, to a certain extent, the headquarters of the company's engineering and finance, while the marketing and production tends to be concentrated in the USA and Asia respectively.

Ever since our inception we have maintained a very decentralized structure, which allows us to use the best resources, wherever they may be. When you have a global management team, the overriding objective is the success of the group as opposed to just one entity within the group. That means we do not have any "sacred cows" and we are not interested in retaining any business that does little to add value. That is how we were able to bounce back quickly from the IT crisis of 1992–1994 when PC prices plummeted. Our presence in Taiwan allowed us to link up with



### *Portrait*

In 1981, **Daniel Borel**, a graduate of the Ecole Polytechnique Fédérale de Lausanne (EPFL) and Stanford University, cofounded Logitech, a leading provider of computer peripherals and flagship of Swiss industry. Chairman of the Board since 1988, he was also CEO of the company between 1992 and 1998.

Logitech is a leading global provider of personal peripherals and innovator of PCs, Internet communication, digital music, digital gadgets for the home and cordless games and products. Founded in 1981, Logitech International is a Swiss company

that has been listed on the SWX Swiss Exchange (LOGN) since 1988 and the Nasdaq Global Select Market (LOGI) since 1997.

Logitech is a multinational and multicultural company. Headquartered in Apples (Switzerland), with its operational headquarters in Fremont (USA), Logitech has production facilities in Asia and sales offices on every continent. Today the group employs 7,500 staff including 900 engineers.



continental China where we were one of the first companies to obtain authorization to open an entity under our own name. It is due to that office, which we have had for over 15 years, that we have been able to significantly increase our production and remain competitive.

However, our quasi-linear growth in profit and revenue has not been achieved without some profound structural and organizational changes at Logitech. We have had to learn how to manage the growing complexity of our operations, in terms of processes, controlling, production, sales, supplies and distribution. Let me give you an example: in 2006, Logitech sold 150 million products in over 100 countries. Just imagine what that means in terms of organization.

And, last but not least, we have to ensure optimal management of our 7,500 staff throughout the world. Each one of them contributes to our success through their skills and commitment. It is the quality and excellence of this intangible asset that allows us to make a difference. From then on managing and developing equilibrium between the different dynamics, the internal and external forces, individual and collective motivation, becomes of paramount importance. The bottom line is that the real wealth of a company stems from the commitment of its staff, the strength of its brand and the efficiency of its structures.

**This growth must have precipitated your initial public offering?**


In keeping with the high-tech industry as it was at that time, we had two objectives when we floated the company on the Swiss stock exchange in 1988: to finance our growth, and to use stock options to offer a competitive remuneration package that would attract and retain highly sought-after talent. In my opinion this is a win-win strategy, as the employees' interests are aligned with those of the shareholders, namely to increase the value of the shares, which also corresponds with

the company's objectives. In 1997, Logitech gained a listing on the Nasdaq, following the Internet explosion and major growth in our American operations. This triggered some changes, notably in terms of accounting standards (GAAP vs IAS) and the type of information requested. However, due to our American culture, we had already been reporting on a quarterly basis since 1988, so we were already "Nasdaq compatible" to a certain extent.

**How important is diversification to a company that still generates most of its revenue from producing mice and keyboards?**

Actually, the mouse accounts for less than 30% of our turnover and it is only one of the many peripherals used by a person to access the digital world, whose content is continually evolving. The widening of our product range actually reflects the wealth of digital content now available. Take videoconferencing or Internet telephony as an example, or digital music which represents almost a quarter of our turnover. We had not touched any of those categories up to a few years ago because the technology, particularly high-speed communication, was still not so widespread. But today, the multiplication of applications connected to the digital world which we can find in the so-called "digital household" allows us to innovate and supply a vast array of peripherals.

**How do you see the future for Logitech?**

We are still very much at the developmental stage in terms of digital peripherals. So our aim is to make the Logitech brand synonymous with digital peripherals over the next ten years. The best-known and most commonly used applications these days are in music and graphics. We download our favorite songs from the Internet and listen to them in digital format on an iPod or stereo system via the computer. High-speed has increased the profile of videoconferencing 

and Internet telephony (VoIP). Digital photography is also widespread now and anyone with the inclination can make and edit their own photo gallery and share virtual albums. Imagine all the other activities which can be digitized in the long term and you can see how much scope there is for innovation. The mouse has given novice users access to the world of IT. Our current and future products will allow consumers from the first digital era to access the riches of the digital world in an intuitive way. So I am optimistic and I see many opportunities for Logitech... it took us 20 years to pass the CHF 1 billion barrier and 5 years to reach 2 billion. We hope to reach 3 billion by 2010...!



Russia today is totally different from the country we saw ten years ago. The last five years were probably the most successful in Russia since the Soviet Union's breakup in 1991. "The sky is the limit" seems to be the dominant credo in Russia and its surrounding countries. Has everyone forgotten about the financial crisis and economic tenure at the end of the 1990s in Russia? What are the underlying drivers of growth in Russia and how sustainable are they? What obstacles do organizations face when doing "fast-growing business in Russia"? Since similar issues have been faced by Ernst & Young clients, the author deliberately focuses on his own experiences with Ernst & Young in Russia in the following article.

## Emerging market in Russia: "growing pains"

□ In October 1991, as Russia was on the verge of independence, Yeltsin announced that Russia would proceed with radical market-oriented reform along the lines of "shock therapy". Shocking it was. After the disintegration of the USSR, the Russian economy went through a crisis. Russia took up the responsibility for settling the USSR's external debts, even though its population made up just half of the population of the USSR at the time of its dissolution. The largest state enterprises (petroleum, metallurgy, and the like) were controversially privatized for the small



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sum of USD 600 million, far less than they were worth, while the majority of the population was plunged into poverty. It is worth noting that in recent years the government has tried to correct part of these controversial privatizations by regaining control in the oil and gas sector.

### 1998 crisis

The global recession of 1998, which started with the Asian financial crisis in July 1997, induced Russia's financial crisis. Given the ensuing decline in world commodity prices, countries heavily dependent on the export of raw materials, such as oil, were among those most severely hit. Petroleum, natural gas, metals, and timber accounted in those days for more than 80% (today reduced to approximately 60%) of Russian exports, leaving the country vulnerable to swings in world prices. Oil is also a major source of government tax revenue. Clearly, the sharp decline in the price of oil had severe consequences for Russia.

### Recovery

Russia bounced back from the August 1998 financial crash with surprising speed. Much of the reason for the recovery is that world oil prices have risen rapidly since 2000 (just as falling energy prices on the world market helped to deepen Russia's financial troubles), so that Russia has run a large trade surplus during the last few years. Another reason is that domestic industries such as food processing have benefited from the devaluation, which caused a steep increase in the prices of imported goods. Also, since Russia's economy was operating to such a large extent on barter and other nonmonetary instruments of exchange, the financial collapse had far less of an impact on many producers than if the economy had been dependent on a banking system. Finally, the economy has been helped by an infusion of cash; as enterprises were able to pay off arrears in back

wages and taxes; this in turn allowed consumer demand for the goods and services of Russian industry to rise. For the first time in many years, unemployment in 2000 fell as enterprises added workers.

### Putin and petrol

After Yeltsin's presidency in the 1990s, Vladimir Putin was elected in 2000. At the same time, as mentioned above, high oil prices and growing internal demand boosted Russian economic growth, stimulating significant economic expansion domestically and abroad. Putin's presidency has shown improvements in the Russian standard of living over those of the 1990s. Russia has achieved significant successes in its economic development in recent years. The investment climate is growing more favorable, and everyone hopes for continued growth of investment in Russia. However, the perception exists that the reform trend has slowed down. There was little progress in reforms in 2006. This probably has to do with the "Dutch disease" – high oil prices, while creating favorable conditions for structural reforms, simultaneously reduce the incentives for their implementation as macroeconomic parameters look favorable.

At the same time, we see a new redirection of the reforms. Pillars of the economic successes have been concentrated in state hands (oil and gas) and large investment programs (concentration of investment resources) will be controlled as well by the state. However, this does not mean that foreign investors cannot play a role. Via joint ventures in investment programs, numerous opportunities will evolve, especially in high-technology and innovative areas. The strategic reason behind this redirection is to have a long-term investment vision for the economy in Russia as a whole and to use its businesses to enable it to play a more significant role in the global economy. Parallels can be found with the China model,




where many new emerging companies will overtake other companies in the Fortune 1000 list published by Boston Consulting Group. Therefore, we can expect a similar development for large Russian state-owned companies in the future.

There are some perceptions circulating in the Western press and in the business community about the President, the Russian government, and the business climate. Stereotypes using statements like “dictatorship”, “lack of democracy”, “bureaucracy”, and “significant corruption” are seen a lot. Coming from Holland, I see a high degree of hypocrisy in these value statements. Remembering the recent construction industry scandals we saw in the Netherlands, it makes me think of the statement, “Let he who is without sin throw the first stone.” Also, looking at the numerous complaints of Western organizations and their managers about doing business in Russia, the old disease of complaining and becoming part of the problem, instead of playing a part in the solution is still dominating.

#### **“Surfing the waves of fast growth” – obstacles for entrepreneurs**

Having spent almost ten years in Russia, I’ve had the opportunity to gain first-hand experience in building a business in a fast-growing environment. For a professional services firm there are enormous challenges, since the main asset the business is built on is quality human capital. As part of a global organization, I can say my own experience shows that “thinking globally” is the right approach in Russia, as the country has become a major player in globalization – but staying focused on “acting locally” is a key to success in this perspective. The tension between availability of quality human capital and the requirements is evident. Often organizations like ours translate the significant growth opportunities into mass hiring actions and underestimate the need for sta-

bility and retention of employees. In that sense, the need for retention in a fast-growing economy/organization is even more important than in a more stable environment: retention absorbs/feeds the growth and reduces the feeling of instability. Often fast growth is seen as a positive phenomenon. In practice, however, people experience high stress and instability during such periods of growth. Strong leadership plays a role here to compensate for these “negative” side effects. Everybody agrees that speed is essential for success in a fast-growing environment, including speed in decision making. The latter is facilitated by the decision-making process taking place within a relative small group of people, for example one person (less discussion, no compromises, cohesion). This is often seen by the Western business community as undemocratic and has some negative associations. However, when comparing a strong organization led by an individual with a democratic organization, the former clearly demonstrates additional values such as stability, consistency, cohesion, and a psychological feeling of safety – values that are especially appreciated in a fast-growing environment. It is interesting to see how numerous parallels can be found with the political situation of Russia and how the country is being run.

When I was personally starting up a new service line in our organization, I was confronted with the question of scale. Normally you make a business plan for five years and fit your organizational model to it. This does not work in a fast-growing organization, as the differences of scales between the different scenarios are too significant. We therefore chose a model that was by far too significant/comprehensive for the first years, but that clearly could handle any growth opportunities that we would come across later. By implementing this “infrastructure of tomorrow” into our organizational model, we immediately saw another benefit. Our employees got roles 

that gave them a feeling of career growth and importance. Combined with the psychological effect of showing our trust in the future, we experienced an enormous commitment from their side. This in itself improved retention and gave us all opportunities to grow faster than expected, and with that attain success.

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#### What is the limit?

Russia can withstand deteriorating external conditions. The Russian economy, while not perfect, is much more robust than it was ten years ago before the infamous crisis. The Stabilization Fund and currency reserves are huge. Companies, though reluctantly, pay taxes. Inflation, though still in the double digits, is firmly under control. The banking system, though still weak by international standards, is much less dependent on hidden government subsidies. But withstanding crises is one thing – developing the economy is another. Should oil prices and production stop growing, Russia's further economic development can come only through diversification. Foreign investments are absolutely key for improving productivity in Russia and developing noncommodity exports. However, as you know, multinationals

have the luxury of choosing where to invest, so Russia needs to learn to compete.

The Russian economy may be approaching the moment of truth. Oil prices may stop rising (however high they may stay), while oil production growth is decelerating and may even become negative. Soon Russia may face the question people have been quietly asking themselves over the last five years – is there anything to Russia beyond oil (gas, timber, steel, and other natural resources)? The answer to that question comes down to diversification, further development of the financial system, and innovation. Likewise, organizations should analyze today their readiness for a slowdown. With the global warming phenomenon, we know today better than ever that even in the sky there is a limit.

# (Re)structuring for growth

In striving to maintain a high level of growth, companies face a broad range of operational and tax challenges that must be jointly optimized through proper planning and effective execution for continued success in increasingly competitive global markets.

□ In today's markets companies compete aggressively for growth, especially those that compete for capital in international markets and have to show positive prospects for equity and debt holders. The growth can be internally generated, for example through organic growth or through international expansion. But after an initial stage, further growth typically has to be found externally, through entry of new markets abroad, mergers & acquisitions or cooperation with other companies.

A decision regarding the direction of the growth initiative is only the start as the "holy grail" of sustainable and profitable growth requires a continuous adaptation and fine-tuning of the organization in all its aspects. Historically, tax and legal aspects were addressed in the slipstream of organizational change, but nowadays organizational change projects require a holistic and integrated approach. The main drivers for such integration are the short timeframe in which big projects, like overseas investment or M&A activity, need to show financial results and the level integration of modern organizations in which everything and everyone are tied together through an enterprise resource planning (ERP) system.

In Ernst & Young, the part of our practice that focuses on the delivery of tax advisory services

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across the whole spectrum of taxation integrated with operational change projects is called Tax Effective Supply Chain Management or TESCM.

**Example: integrated business and optimal tax design**

One of the “typical” (if such exists) TESCM structures that many companies already use or are contemplating as a platform for profitable growth is comprised of a principal company acting as the central supply chain management unit, supported by lean, execution-focused, operating entities in local markets. Such a centralized business model can be effective and efficient for driving sales growth while avoiding a similar or even higher growth in costs or for managing a manufacturing footprint with specialized plants delivering products to many different geographical markets. Other possible drivers for such an organization are facilitation of systems design, integrated risk management based on better visibility across the business, efficiencies in sourcing and the need for global or panregional coordination across functions.

The principal, which is preferably established in a low-tax jurisdiction, determines the business strategy and bears most of the operational and financial risks. The principal is generally responsible for key functions such as supply and demand planning, arranging logistics and movement of materials and goods, as well as marketing and sales coordination. The principal normally also bears the financial risk of new product launches and the risk that total margins realized will fall short of expectations (market risk).

In a centralized business model, local distributing companies may be set up as agents, selling in the name and on behalf of the principal. Alternatively, they may act as commissionaires, selling in their own name, but for the account of the principal. The distributing entities may also be actually involved in the transactional value chain, buying the product from the principal and selling it to the

customer, but taking very little risk in the process.

**The operational challenges**

One of the first imperatives for any growth plan is to safeguard valuable corporate reputations and brands, especially if one enters new cultural environments or if production is moved to countries with less developed legal enforcement of intellectual property rights or environmental regulations.

For growth to be profitable there needs to be sufficient scope for increased revenues as well as availability of required resources and qualified labor at competitive conditions.

The two main dimensions that management needs to consider to meet the operational challenges are the following:

- 1) Organizational design
- 2) Systems design

The organization of new foreign operations may be different from that in the home country. In most cases, the actual structure will be a mix of various elements, geographical, divisional, functional, etc. and may be subject to change from time to time.

Systems should follow the changing structure, but the high investment necessary typically means that new systems are only put in place once the business has achieved a certain size and stability.

**The tax challenges**

The primary objectives for a company’s tax department are usually to ensure compliance with tax rules and regulations, as well as achieving a competitive effective tax rate at an acceptable level of tax (controversy) risk. Furthermore, the tax department must support an efficient funding and repatriation strategy.

Whereas the last element, building effective



structures for financing and dividend flows, used to be the bread and butter of the tax function, the recent attention to tax risks in financial reporting and the introduction of transfer pricing regulations in more and more countries has redirected attention to building sustainable tax-effective structures that maximize after-tax operating income.

The two main dimensions that management needs to consider in order to meet the tax challenges are:

- 1) Legal and functional structure design
- 2) Transactional design

The legal entity structure will always be an important aspect of a tax-effective design and based on considerations like availability of tax treaty networks and favorable local tax conditions, not only for corporate taxpayers but also for employees, as labor becomes more internationally mobile.

However, in a given legal structure, the actual functional design of the organization, i.e. who performs which functions and in which location, will drive the allocation of profit. The Organization of Economic Cooperation and Development (OECD), which, through its model tax treaty, commentaries and guidelines exercises a lot of influence in international tax matters, points clearly at critical business functions as the key drivers of profitability.

Transactional design for tax purposes depends on the company's legal entity structure and the transactions between the group companies, intercompany transactions, as well as the transactions that the group companies perform with third parties, suppliers and customers. It is generally not feasible to simply use the same rules that were set out in the ERP system of the distributor for determining its customer billing processes and then apply them to the principal for the intercompany billing of the distributor. New processes must be mapped carefully to ensure the correct invoices and charges are reported.

In addition, prices for intercompany transactions need to be established at arm's length. Important factors in determining those prices will be ownership of assets, risks incurred and functions performed, and this is where structure design and transactional design meet.

A major impact of TESCM structures occurs when products cross a customs border. In such a situation legal title is typically still with the principal – since the sale to the distributor generally takes place at a later point in the supply chain. This leads to a requirement to determine the correct customs value of the product in the country of importation. Common methods to keep the intercompany price within the set margins (e.g. retroactive price adjustments) can add further complexities as customs valuation is not fully aligned with the OECD transfer pricing guidelines and thus the two concepts can lead to different results.

#### **Joint optimization**

The opportunity for joint optimization of operations and tax challenges typically occurs when a company assesses or performs the (re)structuring of its organization and its ERP systems, which should be firmly based on the strategic choices made by the company. The process can be summarized as follows:

Recognized need for improvement > Analysis > Strategic choices > (Re)structuring > Implementation

The actual (re)structuring can only start after an analysis of the market, the competition and current strengths and weaknesses as well as strategic choices regarding the business model, product/market combinations and investment areas. Critical elements that every company has to address are:

- Supply chain
- Organization
- Measurement & control
- Systems



## Important tax interdependencies and opportunities

	Corporate tax	Indirect tax <sup>1</sup>	Transfer pricing
Supply chain	<ul style="list-style-type: none"> <li>- Optimized footprint, for activities like sourcing, R&amp;D and headquarters</li> <li>- Maximize favorable tax treatments based on requirements in local jurisdictions</li> </ul>	<ul style="list-style-type: none"> <li>- Lowest possible customer price incl. taxes</li> <li>- Efficient refund procedures</li> </ul>	<ul style="list-style-type: none"> <li>- Align transactional profits with key business risks</li> <li>- Optimize profit allocation to low and moderate tax jurisdictions within legal framework</li> </ul>
Organization	<ul style="list-style-type: none"> <li>- Avoid risk of double taxation through proper people/function/location design</li> </ul>	<ul style="list-style-type: none"> <li>- Lowest possible compliance burden</li> </ul>	<ul style="list-style-type: none"> <li>- Design key roles and responsibilities regarding location and decision-making authorities</li> </ul>
Measurement & control	<ul style="list-style-type: none"> <li>- Design and maintain appropriate controls for tax function</li> </ul>		<ul style="list-style-type: none"> <li>- Align performance measurement systems with allocation of key roles and responsibilities</li> </ul>
Systems	<ul style="list-style-type: none"> <li>- Optimized (typically simplified) legal entity, warehousing and plant infrastructure</li> <li>- Appropriate process and functional design</li> </ul>	<ul style="list-style-type: none"> <li>- Design of tax codes and reporting requirements for transactional structure</li> <li>- Automation of VAT determination logic in the ERP</li> </ul>	<ul style="list-style-type: none"> <li>- Transactional algorithms for inter-company pricing</li> <li>- Appropriate process and functional design</li> </ul>

Each of these topics has interdependencies with different tax areas and a coordinated design is necessary to avoid high tax costs that could negate other benefits or, more positively, greatly improve after-tax income and cash flow. Some of the important tax interdependencies and opportunities are listed in the table on top.

After the combined design has been completed, the actual implementation of the envisaged structure(s) requires a joint project structure, but also expands the areas of tax expertise required to make the endeavor a success.

Furthermore, big projects can put a strain on tax, finance and IT departments and other company staff. In many cases, support can be provided by outsourcing all or part of the company tax compliance function so the people can focus on the strategic project. On a smaller scale, seconded

personnel can provide the necessary help during an interim period.

Another factor that can make or break the implementation is the quality of change management, as changing roles and responsibilities can cause a lot of anxiety among personnel. Understanding and acceptance of the strategic direction, the potential benefits to the business and, ultimately, to the individuals working in the business are critical.

Finally, in TESCO practice the key to integrated project success is the right scoping and timing of the tax advice in relation to other project work streams and the willingness to address many details early enough in the process to avoid costly redesigns in operations or systems.

<sup>1</sup> Indirect tax: value added tax (VAT), goods and services tax (GST), customs duties or similar levies

# India: managing growth challenges

Sixteen years post 1991 – the second round of reforms that India implemented – India has emerged as an important player in the world economy. With a rising currency and burgeoning foreign exchange reserves of over USD 200 billion, India has entered into a high-growth phase, with GDP touching USD 920 billion and growth rate averaging 8.6% per annum in the last four years.

□ The acceleration of growth during the last four years has been accompanied by a significant moderation in volatility, especially in industry and services sectors and with a moderation of inflation. The headline inflation rate, in terms of the wholesale price index, has declined from an average of 11.0% during 1990–95 to 5.3% during 1995–2000 and to 4.9% during 2003–07.<sup>1</sup> Indian business has gained a lot of self-confidence and international perceptions of India are better than ever before.

Multiple factors have contributed to India's rise over the past two decades. India's growth has been mainly driven by domestic consumption, contributing on an average to almost two-thirds of the overall demand, while investment and export demand are also accelerating.<sup>2</sup>

India, with a population of 1.1 billion is the world's second most populous country. In contrast to China, India's working age population

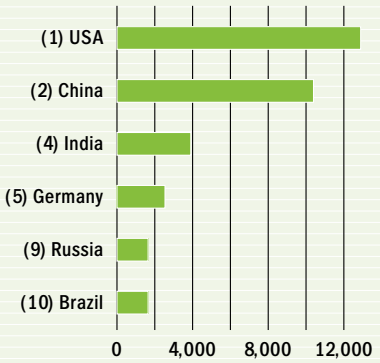


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<sup>1</sup> RBI Chairman Dr. Y. V. Reddy speech, Indian Economy: Review and Prospects

<sup>2</sup> Ibid.

### GDP in PPP (global rank in brackets), USD bn



Source: IMF WEO

(ages 15 to 64) is projected to grow by 53.9% from 691 million in 2005 to 1.064 billion in 2050. Due to India's linguistic diversity, English remained the preferred language of instruction which led to a large pool of educated, highly skilled, English-speaking managerial, professional, and technical workers.

Also, India encouraged knowledge-intensive business services and software industries and capital-intensive manufacturing of capital goods and high-tech goods to exploit its comparative advantage in educated, highly skilled, English-speaking workers. This strategy created a developed sector of India's economy that supports 190 million Indians in middle-class lifestyles. The services sector today contributes nearly 55% to India's GDP and the overall industrial growth has been 11.7% during 2006/07.<sup>3</sup>

#### How sustainable is India's growth?

India's financial sector too has acquired greater stability, strength and efficiency. The government securities market is deep, liquid, vibrant and well developed in terms of instruments, processes and

participants. The stock market has been opened to foreign institutional investors and is comparable with major international equity markets in terms of market capitalization, turnover and systems and processes.

However, questions are now being raised on the sustainability of this growth. While the direction of economic policy is clear, the liberalization has been slower than many policymakers would like. India still faces multiple challenges on its way to become an economic superpower.

#### Many obstacles to overcome

The key roadblocks that India continues to face are in terms of inadequate infrastructure, further need for human resources development and the need for financial inclusion for all.

India's airports, ports, railways, and roads are grossly inadequate. It has been estimated that India must spend around USD 320 billion over the next five years to construct or upgrade the airports, ports, bridges, roads and other facilities it needs to support 10% growth. The government alone cannot come up with the investment needed and hence public-private partnerships and significant private investment are essential. Government has taken strong initiatives to drive investments in infrastructure through changing political will, raising resources through taxes and multilateral funding, encouraging private-sector investments and promoting lending to infrastructure projects.

India also continues to face acute power shortage. The Economic Survey of India (2005/06) pointed out that power shortage is responsible for an approximate GDP loss of USD 68 billion every year. The Investment Commission of India (ICI) estimated that India needs to spend USD 200 billion over the next seven years to build 90 gigawatts of generating capacity. India needs foreign direct investment (FDI) to supplement central government plans to increase generating capacity by 67 gigawatts.<sup>4</sup> Currently seven Ultra

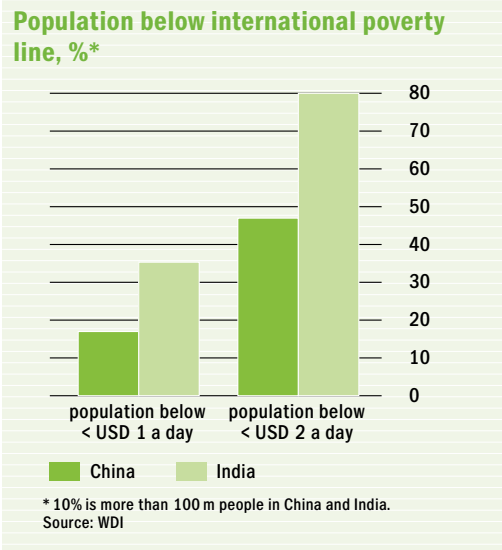
<sup>3</sup> United States Congress, Joint Economic Committee Report, [www.house.gov/jec](http://www.house.gov/jec)

<sup>4</sup> Goldman Sachs, Global Economic Paper No. 152, [www.usindiafriendship.net/viewpoints1/Indias\\_Rising\\_Growth\\_Potential.pdf](http://www.usindiafriendship.net/viewpoints1/Indias_Rising_Growth_Potential.pdf)

Mega Power Projects with an individual capacity of 4,000 MW each, requiring an investment of USD 3.6 billion each, are in the process of being bid out on a competitive basis. Several independent power plants and captive power projects for industrial use are coming up across the country. Hence, the share of private sector in power generation is growing steadily to meet the power shortage. Private participation in distribution has also picked up and is further envisaged in transmission.

Slow financial sector reforms and government-dominated financial system: India has an impressive saving rate of 32.5% of GDP, but only one half of household saving is channeled through banks and other financial institutions. Government-owned banks control more than 74% of India's banking assets. India limits foreign direct investment to 74% in private banks, 20% in government-owned banks, and 26% in insurers. India strictly regulates asset allocation. However, India is expected to liberalize its financial sector in 2009 as part of its World Trade Organization commitment and also usher in full capital account convertibility closer to 2012.

Human resources development: A further constraint to growth is human resources. While India has a large population of educated people, given the thrust on knowledge- and service-based sectors, companies are competing for a limited pool of employees. This is driving up the cost of human resources. There is a need to improve the quality of education, both at the primary and secondary levels. More emphasis is needed on secondary education by way of expanding the supply of secondary school teachers, investment of large resources in school buildings and in the preparation and distribution of education materials. There is a need to provide vocational training. India's rigid labor laws are a major impediment to labor-intensive manufacturing. These laws slow the transition of the substantial percentage of Indian



workers who are employed in agriculture or the informal urban sector into generally higher productivity jobs in the formal urban sector.


Ability to raise capital: To support the rapid growth in demand, corporates across several sectors have embarked on expansion through organic and inorganic routes. While accelerating economic integration with the global marketplace has been at the heart of India's GDP growth acceleration story in the last five years, it has made monetary management by RBI difficult. The aggressive monetary tightening via policy rate/cash reserve ratio hikes has increased the cost of raising domestic debt. On the other hand, the sharp appreciation in the rupee since early March 2007 has prompted RBI to come out with several measures to slow down the inflow of capital into the country like a clamp-down on the external commercial borrowing (ECB) route. This would adversely affect the fund-raising capabilities of corporates and slow down their expansion through organic and inorganic means.

### Rapid growth vs poverty

Need for financial inclusion is critical. A rapidly growing economy is often accompanied by an initial increase in income inequality (the famous Kuznets curve), which in India's case can manifest itself in a growing rural-versus-urban and an educated-versus-uneducated divide.<sup>5</sup> 32% of India's population still lives below the poverty line. With rising aspirations, it is critical for the economy to have "inclusive" growth, with employment opportunities for all. Otherwise, rapid growth could lead to rising social tensions, political pressure to slow down the reform process and increasing protectionism from reservations in education and jobs.

While these challenges persist, the next round of economic reforms needs to be ushered in at a brisk speed.

Other challenges continue to remain in terms of reforms for agriculture, providing basic primary education to all, health services to its entire population, high level of corruption in its bureaucratic system as well as chronic large fiscal deficits. The relatively high fiscal deficits limit the ability of central and state policy makers to fund education and necessary investments in infrastructure.

In conclusion, India is well positioned to emerge as an economic powerhouse and to reap the benefits of favorable demographics, including an "urbanization bonus", and a further rise in capital accumulation, in part from an upsurge in foreign direct investment. India is expected to have a sustained GDP growth rate of 8%.<sup>6</sup> However, the growth faces political risk in terms of political discontent spawned by dissatisfaction with the unequal distribution of economic growth. How effectively the political process manages these risks will be central to India's economic performance. 

<sup>5</sup> Goldman Sachs, Global Economic Paper No. 152, [www.usindiafriendship.net/viewpoints1/Indias\\_Rising\\_Growth\\_Potential.pdf](http://www.usindiafriendship.net/viewpoints1/Indias_Rising_Growth_Potential.pdf)

<sup>6</sup> Ibid.



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