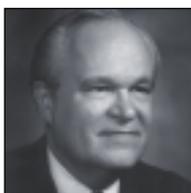




## Emerging Markets Case Study: Assessing When and to What Extent Asian Markets will Recover



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The aim of this article is to provide an assessment of what it is hoped will be the recovery of Asian markets following two years of crisis. First, it will look at some of the key economic indicators from the region and evaluate whether or not the recent optimism is warranted. The article will focus on four indicators in particular:

- Gross Domestic Product (GDP);
- vehicle builds;
- currency movements; and
- stock market performance.

The article will then discuss some of the strategies one might use to capitalise on the opportunities presented by current conditions and will conclude by giving an cautious assessment of the region.

The information is based on Dana Corporation's (the "Corporation") 'step-by-step' approach in its supply of automotive components and system in 40 Asian countries. In 1998, of Dana's total sales of US\$12.5 billion, only US\$340 million came from the Asia-Pacific region. This figure reflects the recent economic collapse and is down considerably from 1997 when there were regional sales of more than US\$500 million. For 1999, there are signs of improvement, with sales at more than US\$400 million. Some of the Corporation's larger customers, both in the Asia-Pacific region and globally, are Isuzu, Nissan and Toyota, so we are certainly interested in a strong Asian economy.

Turning to the question of whether Asia is recovering, we should start with a brief analysis of GDP. With nearly half of the world's population and about 25% of the world's GDP, per capita GDP ranges from about US\$1,600 in India to more than US\$23,000 in Australia and US\$26,000 in Hong Kong.

There are certainly indications that the worst is over. The increase in GDP for all Asia is 1.3% for 1999. Excluding Japan, the growth in GDP is a surprising 4%. But it is not in our best interest to ignore Japan when considering Asia. Japan's GDP

accounts for about 60% of the total for the 10 largest Asian economies.

Both aggregate demand and aggregate supply in Japan are moving in a positive direction and consumer spending remains fairly constant. Yet, in spite of a startling first-quarter growth report of 1.3%, the pace of Japan's recovery will continue to be slow as restructuring efforts take precedence over growth.

It could be concluded from this brief analysis of GDP that the Asian markets are beginning to recover, although perhaps not as fast as the rest of the world had hoped. A full recovery – measured by GDP – will take at least another two years if other variables remain unchanged.

That said, there is enough volatility in these economies, and enough room for ill-conceived government policies and intervention, that we should be reminded how easily this progress could be wiped out again.

Of course, one of the most important indicators to the Corporation, as an automotive supplier, has always been the number of vehicle builds and the projected vehicle builds in the region. In 1998, vehicle builds were off 17% from 1997 for all Asia. The trend for 1999 shows an encouraging 6.6% rise over last year's collapse. Vehicle builds should continue to increase modestly, with 2.8% growth projected for 2000. In addition, 3.9% growth is projected for 2001. These figures are very close to the projected growth for GDP growth mentioned earlier. It is anticipated that vehicle builds will not recover to pre-collapse levels until at least 2002, and possibly not until 2003.

One of the things that tempers the optimism of this recovery is the performance of most of the major Asian currencies. The currencies of all five of the crisis countries – Indonesia, Malaysia, the Philippines, South Korea and Thailand – as well as those of Australia and India, are valued lower than they were in June 1996, which was prior to the collapse.

Each of these currencies has recovered slightly and levelled off for the time being. The Indonesian rupiah, which fell the farthest, is having the most trouble recovering and still has a way to go. The performance of these currencies as a group hints of a continuing fundamental weakness in the region's economies. The single exception is the Japanese yen, which has recovered to pre-collapse levels, but with substantial intervention from Tokyo.

In stark contrast to the performance of the currencies, we see that most of the major Asian market indices have run up substantially in 1999, with first-half returns averaging 40% in some markets. Certainly, even healthy stock markets can be driven to an extent by speculation. But we count on long-term market growth to be based on solid fundamentals such as strong economic growth, rising productivity and internationally competitive businesses.

the deal buoyed the stock market, which had been on the decline. It should be noted that the apparent strength of the Korean market following the announcement of the bailout may be an illusion.

A second factor influencing the growth in Asian stock markets is heavy deficit spending – especially in the five crisis nations. The interest rates of these countries have fallen an average of 7.3% during the past 12 months and average budget deficits in the five nations will range between 5% and 6% of total economic output in 2000. According to Jean-Michel Paul, Asian Research Director of Rabobank International, 80% of Asia's growth this year, and the lion's share of its stock rebound, is a direct result of government stimuli.

The third factor which contributes to the behaviour of these markets is excessive enthusiasm. While foreign bank lending and capital from foreign equity investors have not returned to the markets in any substantial

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The rapid run-up in most Asian indices has been taken by many as an indication that the region is in full recovery. But this conclusion should not be drawn in light of the facts that actual economic growth cannot account for the surge in market prices. Speculation and non-economic factors are primarily responsible for this surge in market prices.

Foremost of these non-economic factors is direct government influence in the markets.

- The stock market in China rose 30% on average in June. This astounding increase was spurred by the government adopting a series of policies to cut trading taxes, allow brokerage firms to borrow new money and slash short-term interest rates. The resulting market run-up is almost certainly intended to build consumer confidence and increase spending in an effort to jump-start a stalled economy.
- A second example of government influence can be seen in South Korea, where the government brokered a deal to keep Daewoo from sinking under its US\$57 billion debt. The announcement of

amount, speculators and individual investors have been quick to leap in where the more cautious fear to tread. The nascent signs of potential GDP growth mentioned earlier are bringing in the global speculators. Japan alone is drawing US\$10 billion a month.

To be sure, some of the investment is non-speculative and based on signs that the worst may be over for the region. But the current enthusiasm and pricing we are seeing in these markets is, in my opinion, out of proportion to the reality of the progress being made.

Taken together, the current and projected growth in GDP and vehicle builds show a picture of a bit of a bounce back this year followed by several years of moderate growth for the beginning of the new millennium. Currencies have stabilised, and even come back slightly in most cases. Whilst this is good news, it is not nearly enough to support the large stock market gains we have seen in the first half of the year. There are potential pitfalls in the road ahead.

One of the results of rising stock markets is a tendency for governments to ease up on reforms and allow businesses to slow their restructuring efforts.

After getting off to a strong start in 1998, the Korean reform drive initiated by President Kim Dae Jung appears to have lost momentum. Efforts to sell insolvent banks to foreign investors are not progressing very rapidly at this time.

Japanese reform efforts have also been scaled back. Tokyo continues to pour billions into bank bailouts and less-than-critical public works projects. In the meantime, Japanese debt has soared to US\$4.5 trillion – more than its entire GDP.

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While a recent poll conducted by the Far Eastern Economic Review showed that 80% of Asian executives believe that foreign investment is essential to recovery, they could find that investment is slow in

yuan would bring – at least prior to the October celebration of the 50th anniversary of the People's Republic. However, I would want to revisit that opinion after September 1999. Given those caveats in the cases of a loss of reform momentum across the region or a potential devaluation of the yuan, it appears that we can look forward to a slow, steady recovery in Asia with cautious optimism.

With that in mind, I would like to discuss some of the strategic options this situation presents in terms of the degree of investment (and thus risk) that they involve.

On the low end of the investment/risk scale, companies may choose to reduce their commitment in Asia for the time being so that they can put more energy into operations in those regions where economic activity is higher. Some firms that are well established in the region are maintaining their presence in a scaled back manner so that they can chase profits elsewhere, while maintaining a

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coming – or that it may come at a higher risk premium – if reforms are allowed to fall by the wayside.

Of course, the great unknown is China and the potential for a devaluation of the yuan. Although Beijing reported that its economy grew 7.6% in the first half of 1999, Chinese exports dropped more than 4.5% for the period, and the country's trade surplus dropped nearly 65% to around US\$8 billion.

China has sufficient currency reserves to avoid the need to devalue the yuan for up to a year, if necessary. But some analysts have taken comments by China's central bank governor this summer as an apparent backing away from Beijing's long-held commitment not to devalue. Externally, tensions with Taiwan could place further economic strain on the Chinese economy. And internal pressures, like those related to Beijing's crackdown on the Falun Gong religious sect and rising unemployment, may have other unforeseen consequences.

Personally, I do not believe that China will allow itself to suffer the loss of face that a devaluation of the

foothold on which to build in better times. By consolidating operations and implementing restructuring programmes, companies that choose this route can achieve better efficiency now, while creating a foundation for future growth. This strategy may be particularly appropriate in some of the smaller markets in the region such as Thailand, Malaysia, Philippines, and Indonesia.

On the opposite end of the investment/risk scale, companies may determine that this is an opportune time to seek out regional acquisitions before their valuation fully recovers. This strategic option is particularly attractive in those countries where local industries will have to undertake large-scale restructuring. In this environment, the opportunities for foreign investment are many, especially in those countries where regulations have previously kept foreign firms at bay. This is one way companies could literally buy their way into the number two or three position in a market through strategic acquisitions. This strategy may be particularly appropriate in some of the existing, high-income, low-growth markets, such as Korea and Japan.

Of course, this strategy comes with all of the risks inherent in a volatile economic atmosphere. Large amounts of capital can be tied up for years before any positive results are seen – if they are to be seen at all. And all or part of any investment could lose its value in the event that the bottom should fall out again. A firm with existing facilities and infrastructure could utilise excess capacity in Asia to achieve lowest-cost global positioning for manufacturing and production. This strategy also requires a substantial tolerance for risk due to the large financial commitments that must be made. This strategy may be appropriate for certain countries with a high skill bases and low production costs, such as China or India.

Between the two extremes of the investment/risk scale lies another option that involves moderate risk, while still providing strategic access to Asian markets, low-cost production and the potential for future growth. This strategy involves identifying investments that create strong local foundations for a very substantial share of the emerging market business once it begins to grow again. This requires identifying the next tier of local market partners – the firms that are ready to emerge strongly onto the scene once adverse market conditions are reversed. This is the course that the Corporation has selected as the best way to position itself for future growth in Asia.

Across the region, business spending is slight. In most of Asia, there are few compelling reasons to invest in new capacity. The investment boom that preceded the current crisis left the region with more than enough manufacturing, distribution and office capacity to meet current and near-future demand. As mentioned previously, the Corporation has traditionally taken a step-by-step approach to investment in Asia. We have determined that the best avenue for entry into the region is through investment in joint ventures with those companies that we have determined to be poised for growth.

Ultimately, a partnership like a joint venture exists because each of the parties has something that the other wants or needs. While the Corporation may have technology or capital to bring to the table, the partner may have already established a presence in a market or may have better access to people and infrastructure. Ideally, partners will be selected on a strategic evaluation, rather than the availability of a tactical opportunity.

But the Corporation's approach has always been one of caution. It has not rushed into Asia like many companies have and, hence, has avoided some of the

effects of economic instabilities. The Corporation has only made that commitment (i.e. locating a facility) to those specific countries it feels are strategic. There are some 40 plus countries in Asia – the Corporation is only in 10; just as it is not in every country in South America or every country in Europe.

In fact, caution can lead you to exit a relationship, as the Corporation did in South Korea. In November 1997, it announced the sale of its 49% interest in Korea Spicer Corporation to its partner, Sung Shin Cement Industrial Co., Ltd. At that time, the South Korean won was trading at 900-to-1 against the dollar. A week later, it fell to 1,900-to-1. That might be something to keep in mind. While timing is important in business, so is a little luck.

The sale of one Korean affiliate does not mean that the Corporation has written off South Korea entirely. Our joint venture simply no longer made sense. But it still has a presence in that country through Dana Korea, and it will continue to grow there – just conservatively – as it will in the whole Asia-Pacific region over the next few years.

Joint ventures are one of the essential ways the Corporation does business in Asia and are an important element of our strategy for the region. It is core to the Corporation's strategy to be located anywhere in the world that its customers need, and be able to bring to the table all of the assets of a US\$13 billion global company. Joint ventures simply seem to be the best avenue for the Corporation to take in the region. Dana will continue to seek out those strategic initiatives that fit its global plan and which meet its regional criteria in terms of performance and market growth. What it tries to do is balance the business around the world so that one region is not able to pull it down.

And that is the primary message I would like to leave. Watching the directional movement of economic indicators such as currency movements and GDP in Asia – or in any region – is absolutely essential for a global company in today's competitive environment.

In the short term, the region will not see a big change due to the political upheaval in some countries and the difficulties in the implementation of economic reforms and restructuring challenges facing governments and corporations. Should the major economic powers in the region choose a cautious, but determined, path in continuing reforms, we could very well see a healthier Asia in 2003 than the one that existed prior to 1997.

And that might pose a whole new set of questions. ■