

Business Pulse

Exploring dual perspectives on the top 10 risks and opportunities in 2013 and beyond

Global report



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Introduction

How can you be confident your company is well placed to meet the risks and challenges currently on the horizon? And how can you know that opportunities aren't passing you by? This report will help you answer both of these questions. It explores the top 10 risks and opportunities for global companies as they begin looking ahead to 2015.

Forecasting the future is risky, but businesses that fail to look forward will almost certainly be left behind in an increasingly competitive, globalized world. This report takes the pulse of current thinking, insights and expectations from industry executives and Ernst & Young specialists. The results can be used as a benchmark for your business and can feed into strategic decision-making.

Based on a large sample survey of companies in 21 countries, and across various industry sectors, we identified a top 10 list of risks and also opportunities, many of which are interlinked. Each ranked risk and opportunity was then discussed with relevant business executives and Ernst & Young specialists, to gather the insights and perspectives on which this report is based.

A shift in thinking is evident among companies this year. Rather than waiting for mature markets to recover from an often-severe crash following the global financial crisis of 2008-09, they now accept that the duration of the downturn is uncertain. Therefore, they are concentrating on optimizing their business by cutting costs and increasing efficiency on the one hand, accepting that they must find a way to be profitable in shrunken markets. And on the other hand they continue to look to grow with new markets: with many mature economies stagnating, they are looking to emerging markets for growth.

This year, we have chosen to present our results and rankings within the context of four key clusters, based on our *Growing Beyond* model. These include: cost competitiveness, stakeholder confidence, customer reach and operational agility. The 10 risks and the 10 opportunities are divided over these four clusters, based on their relevance to each, and discussed in that context.

These clusters of risks and opportunities are previewed in the executive summary, to give an overview and a dual perspective on the themes contained within them. Ultimately, though, the purpose of this report is to provoke discussion and debate about how your company is meeting today's, and tomorrow's, challenges and opportunities. Are the items on the global lists similar to those you are monitoring? Are they your top 10?

Finally, we would like to extend our thanks to all our survey participants who took the time to share their thoughts and experiences with us. We look forward to discussing further the implications of these survey findings with our clients and prospects, regulators and governments, as well as analysts and universities.

Executive sum



Summary



Two years ago, according to Swedbank's Chief Risk Officer Hakan Berg, the general view in international business was that there would be a slump following the 2008-09 financial crisis, and then things would pick up again. Now, more companies – especially in mature economies such as Europe – are accepting that the duration of the downturn is so uncertain that they must fundamentally reposition themselves to survive in a smaller market. This is the main conclusion from the results of our international survey. Such companies are now focused on controlling costs and developing new products to survive in a shrunk, intensely competitive market, while also looking toward rapid-growth markets for new sales and opportunities.

This change in mindset is seen in the difference focus of business activities, especially in Europe where many markets are still performing at low levels amid recession and sovereign debt problems. Such thinking is reflected strongly in our survey results. When asked to nominate the top risks that they face, companies name pricing at the top of the list. This is followed by cost cutting and pressure on profits, as companies adjust to smaller, lower-margin, mature markets.

The flip side to this grim news is renewed interest in emerging-market investment. This is again seen as companies' main source of growth. Indeed, this is now regarded as the second-biggest opportunity, after the innovation necessary to unlock new sales (see adjacent table for a full list of the top 10 risks and opportunities). For example, many consumer products companies are spending heavily on building plants in China. Elsewhere, there is renewed interest in Russia, a country that suffered badly in the global crisis, but which is now seeing investment streaming into a host of sectors, including pharmaceuticals and food production.



Some of the other key findings emerging from our research are as follows:

Risk ranking			Opportunity ranking		
	2013	2015		2013	2015
Pricing pressure	1	1	Innovation in products, services and operations	1	1
Cost cutting and profit pressure	2	2	Emerging market demand growth	2	2
Market risks	3	3	Investing in process, tools and training to achieve greater productivity	3	3
Macroeconomic risk: weaker or more volatile world growth outlook	4	4	New marketing channels	4	4
Managing talent and skill shortages	5	5	Improving execution of strategy across business functions	5	5
Expansion of government's role	6	7	Investing in IT	6	6
Regulation and compliance	7	6	Excellence in investor relations	7	8
Sovereign debt: impacts of fiscal austerity or sovereign debt crises	8	10	Leveraging CSR and public confidence	8	7
Emerging technologies	9	8	Investing in cleantech	9	9
Political shocks	10	9	Global optimization and relocation of key functions	10	10



Cost competitiveness

Facing up to the downturn

Our research suggests that companies are increasingly accepting of the fact that the length of the economic downturn is fundamentally uncertain. Businesses are putting significant efforts into cutting both costs and prices in order to compete in shrunken mature markets and highly competitive rapid-growth markets.

Our survey results show the shift in thinking. Pricing pressure has become the biggest risk noted by companies this year: up from 4th place in 2011 and a lowly 15th in 2010 (when companies were still expecting markets to bounce back). Mature markets nearing saturation have led to fierce price competition, with little or no organic growth expected. Such problems are exacerbated by the strength of both low-cost competition and online rivals, which have made brand-driven price premiums hard to sustain.

Alongside this, high wages and input costs, as well as significant new regulatory burdens on various sectors, mean that the pressure on pricing will impact profit unless companies take firm action. Unsurprisingly, therefore, cost cutting and the related pressure on profits is cited by respondents as the second-biggest risk they face. Five years into the global crisis, most of the simple cuts to costs have already been made. That is now pushing businesses to make tough decisions on how to cut costs without damaging product and service standards. But for those who get this right, the payoff can be dramatic: Ernst & Young estimates that cutting costs by just 1% can yield the same bottom-line results as a 10% boost in sales. Firms are using technology to improve productivity, introducing more flexible working practices and re-engineering supply chains to encourage growth in emerging markets.

However, businesses also accept that the increasing reliance on emerging markets for growth brings new risks. As a result, market risks have risen to third place in our survey, not least with oil prices remaining high and continued volatility in currency markets. All of this poses distinct risks to the bottom line. For the first time, firms list sovereign debt, the impact of austerity and political shocks as among the top 10 risks they face. These fears are especially acute within mature markets. This is most notable within the Eurozone, where the threat of a deep recession remains and some countries face the definite possibility of a debt default.

Stakeholder confidence

Broader considerations emerging

The ongoing global economic crisis has had a big impact on the size of mature markets, but it has also raised questions over the role of companies in society and led to increasingly tough regulation as governments seek to avoid another crisis.

Post-crisis, companies will find themselves needing to listen and engage with a wider field of stakeholders than their shareholders alone. Our research shows that companies are increasingly aware of issues such as the environment and corporate social responsibility (CSR), as well as more immediate problems such as tightening regulation.

The increasing role played by government in business is now cited as the sixth-biggest risk faced by companies (up from seventh place in 2011, the first time it registered as a top 10 risk). This is driven in part by tightening regulation, most obviously in the financial sector. But it is also because governments, especially in rapid-growth markets, are playing an increasingly active role in a host of sectors, from pharmaceuticals through to power and utilities.

This can reshape the nature of competition. In China, for example, some multinationals are required to work in partnership with local firms, as the country seeks to support its local industrial base. As a result, government policy, and maintaining good relations with government, is increasingly important for businesses. This is especially true within mature markets, although many rules increasingly affect global operations too. For example, multinationals face mounting pressure to comply with anti-bribery measures, which in turn can make it more difficult to operate in some rapid-growth markets. Regulation and compliance is listed as the seventh-biggest risk facing companies, down from the top slot in 2011. But this is forecast to remain a concern in the future: executives polled expect this risk to rise to sixth place in 2015.

Companies' broader sense of accountability in the post-crisis world is also reflected in the opportunities they spot. Leveraging CSR and public confidence, a new entry to the list, is ranked eighth overall and expected to rise to seventh in the coming years. This is especially true in rapid-growth markets, where such activities can be an integral part of receiving a license to operate. Beyond this, excellence in investor relations is also seen as a top 10 opportunity. This highlights the importance of a broad funding

base in today's relatively tight-credit world. Certainly, institutional investors now demand greater transparency in areas such as environmental and social issues, which can impact a long-term investment's viability.

Customer reach

In search of the new

With little prospect of organic growth in mature markets, companies are searching for new places to expand. There are opportunities for businesses in new markets in new countries, as well as new niches in established markets.

Innovation offers the most opportunity, both in terms of new products or services and within operations. This is especially important for finding unexploited gaps in existing markets, but it is also becoming an increasingly fundamental part of success within major rapid-growth markets. In evidence of this, spending on research and development is growing four times as rapidly in rapid-growth markets as mature markets.

This is directly linked to the way that firms are tapping the second-biggest overall opportunity: emerging market demand growth. The IMF expects major rapid-growth markets to grow by 5%-6% in 2013-14, or about four points faster than mature countries.

Companies from a range of sectors – from carmaker Fiat through to the cosmetics manufacturer L'Oreal – now accept that the bulk of their growth will come from such markets and are readjusting their businesses accordingly.

In a similar vein, companies are getting excited by the emergence of new marketing channels, such as social media, which is ranked as the fourth-greatest opportunity for business (a sharp increase from eighth overall in 2011). This was especially true of companies operating in rapid-growth markets. Cloud computing and data insights also offer tremendous marketing potential. But inevitably, there are risks too. Emerging technologies are still narrowly considered a top 10 risk, although this is down from fifth overall in 2011. But the disruptive capabilities of ongoing technological development remain a worry for many firms.

Operational agility

Tuning for greater performance

Operational agility remains a crucial part of surviving and flourishing in a volatile world economy. In particular, many companies see room for improvement in bolstering productivity. In mature markets, where companies face the most acute pressures over pricing and profitability, executives cite this as their second-biggest opportunity, ahead of growth in new markets. Likewise, it is also a high priority (ranked fourth overall) in rapid-growth markets.

So too is the need to make sure that decisions reached at the top are actually implemented on the ground. Improving the execution of strategy fell to fifth place in this year's rankings, down from the top slot in 2011. Mature market respondents still consider this more important than their peers in rapid-growth markets (fifth and seventh place respectively).

IT investment, a crucial element of strategy implementation and overall performance, is seen as the sixth-greatest opportunity. It is among the top five in mature markets, although it has eased off from third overall in 2011. But other risks have also eased. Although a perennial challenge for those seeking to expand and innovate, the risk of managing talent and skills shortages fell to fifth overall, down from third in 2011.

The easing of pressure on skills comes in parallel with a new opportunity making the top 10 list for the first time: global optimization and the relocation of key functions. For multinational organizations trying to balance the desire for cost competitiveness in key markets, as well as growth in new markets, rethinking the cost and location of operations from a global perspective can deliver a range of opportunities.

Emerging challenges


Preparing for uncertainty

As our research highlights, companies are increasingly reconciling themselves not only to a long-term downturn in established markets, but also to their increased exposure to a volatile world economy and markets. In turn, this new status quo brings with it several emerging challenges that companies must actively engage with and plan for. Many of these are closely interconnected: a deep recession in the Eurozone remains a threat as the continent struggles to deal with its crippling debt issues. As one example; elsewhere, the Brazil, Russia, India and China (BRIC) group of rapid-growth countries is already seeing a slowdown in growth, most worryingly in China; and all of that could have a knock-on effect on the US economy, with fears remaining that it could enter a deflationary trap. Beyond such macroeconomic challenges, other issues remain highly pertinent: companies are already listing the threat of cyberconflict as one of the top 10 risks they face, while fears of a full-blown conflict in the Middle East remain valid.

In a globalized and interconnected world, companies cannot insulate themselves from such risks. In our *Growing Beyond* research,¹ we found that companies thriving in such a volatile environment share several specific characteristics. They are more outward looking and focused on the market; they respond smartly – and quickly – to change; they understand what drives cost and value; and they engage closely with stakeholders and unleash their talent. All of these remain highly pertinent for executives trying to grapple with an uncertain future.

¹ For more information, please visit www.ey.com/growingbeyond





Ernst & Young risk and opportunity radar

The risk and opportunity radar allows us to present a snapshot of the current top 10 risks and opportunities for global businesses.

At the center of the radar are the risks and opportunities that our survey respondents felt were having the biggest impact on major organizations worldwide. Arrows indicate the extent to which the ranking is expected to increase, decrease or remain the same between 2013 and 2015.

The radar is divided into four sections, corresponding to Ernst & Young's *Growing Beyond* model.

The sections are:

- ▶ **Customer reach:** maximizing potential market opportunity for products and services
- ▶ **Operational agility:** improving organizations' ability to deliver effectively in a quickly changing market
- ▶ **Cost competitiveness:** sustaining companies' economic viability
- ▶ **Stakeholder confidence:** allowing firms to build stronger relationships with stakeholders

The top 10 risks



The top 10 opportunities

2013 ranking and expected 2015 ranking

▲ Up in 2015

● Same in 2015

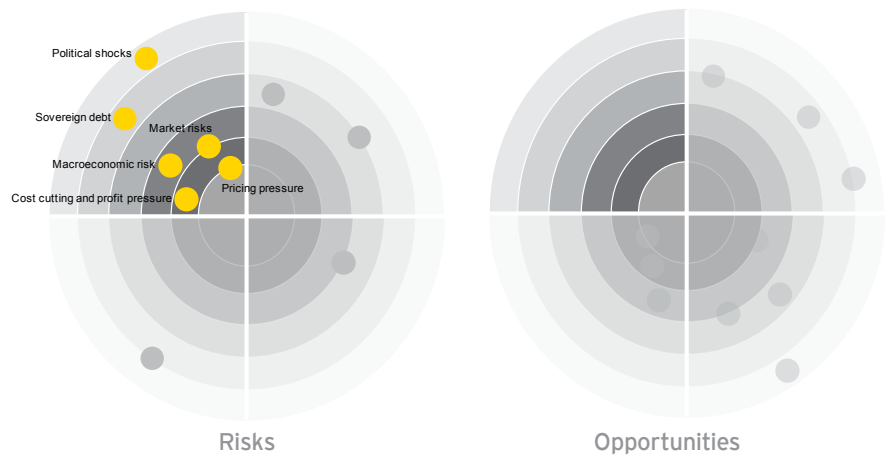
▼ Down in 2015



Cost competitiveness

Facing up to the downturn





The new reality

Five years in to the global economic crisis, companies are facing up to two big things. First, that they cannot just sit back and wait for mature markets to recover; no one knows how long this downturn will last. And second, that volatility – in national economies, currencies, global commodity prices and other things – is now a fact of business life. To succeed, companies must plan around these things. “As much as people are fighting against it, the world will continue to globalize and face velocity and volatility,” says Ernst & Young’s EMEA Risk Leader, Jonathan Blackmore.

Market risks have risen three places on our risk list from the 2011 report. With oil prices remaining high and continued volatility in currency markets, such risks present immediate challenges to the bottom line. The need for a flexible cost structure, price regime and business model capable of operating profitably in a constantly changing world is now imperative.

Three new risks – macroeconomic, sovereign debt and political – have entered the top 10 for the first time this year as companies accept the volatile environment they now operate in. Wishful thinking seems to have been replaced by battle-hardened realism: this sentiment runs throughout the current survey.

Only the lean will survive

More generally, the downturn in mature markets, and the increasing number of companies fighting for market share in rapid-growth economies, means that improving efficiency has become key to surviving intensifying competition. Pricing pressure has surged from fifth spot in 2011 to become the biggest risk facing companies this year – and it is expected to remain the biggest problem through 2015. Cost cutting rises to second, from sixth place last year.

“Wishful thinking seems to have been replaced by battle-hardened realism,” a sentiment that runs throughout this current survey, says Ernst & Young’s Japan Performance Improvement Leader Masahiko Itoh. Technology can improve productivity, working practices made more flexible and supply chains re-engineered to increase revenues, as well as crunching costs. A flexible company can innovate to reach new customers, unlocking niches in mature markets and market share in emerging ones. If companies adapt to today’s volatile and, in some cases, depressed markets they can find new ways to flourish.



Pricing pressure: the biggest threat

Table 1 Ranking from 2011 to 2015			
Risk	2011 ranking	2013 ranking	2015 expected ranking
Pricing pressure	4	1	1

The current downturn is structural, as mature economies in particular pare down the debts racked up during the easy credit years. That will take time to do, meaning that market conditions have changed fundamentally. Mature economies are likely to grow slowly for many years to come, as volumes and margins are under pressure. The overall consensus is that pricing pressure will be a key risk faced between now and 2015. Additionally:

- ▶ The strength of low-cost competition and online shopping has intensified the battle for market share, given changing consumer behavior. Brand-driven price premiums have become difficult and expensive to maintain.
- ▶ High wages and benefits in mature economies have resulted in cost pressure, albeit mitigated in some cases by flexible labor markets.
- ▶ Regulatory action has cut profitability; particularly in the banking and energy sectors.
- ▶ Input costs have remained high and the terms of trade have worsened for mature economies. The era of cheap imports is over.
- ▶ Upward price pressures on company costs have been especially acute in both energy and food markets.

Typical responses to pricing pressure cover both cost management and revenue improvement:

- ▶ Productivity can be improved through technological innovation.
- ▶ Working practices can be made more flexible, or work can be offshored or outsourced.
- ▶ Products and services can be innovated (see “Customer reach”).

- ▶ With slow revenue growth in mature markets, supply chains must create sustainable cost savings to support margins and help pay for growth elsewhere. Innovation in this area is crucial for a business’s sustainability in a globalized environment.
- ▶ The traditional response to downward pricing pressure includes more frequent and aggressive price cuts in response to current pricing trends and competitor analysis.

Saturation point

Fierce competition in markets nearing saturation, particularly in the mature world, means that pricing pressure is high and organic growth slow or non-existent. Therefore, the only way to expand in some existing markets is to gain market share from competitors through mergers and acquisitions (M&A).

However, M&A in response to downward pricing pressure only makes sense if the market outlook is strong, and appropriately priced funding is available. If that is the case, then companies can gain pricing power through M&A, escaping the downward pricing pressure. That is not the situation today, and M&A activity is slight. The number of M&A deals worldwide fell sharply in the first half of 2012, according to Thomson Reuters. A lack of confidence in the future business environment and the inability to enact the highly leveraged debt-based deals commonplace before the global financial crisis of 2008 are key drivers for this trend. M&A activity in mature economies is also likely to be driven more by industrial logic than financial engineering.

Conversely, in the oil and gas sector, strategic divestitures seem set to increase over the next two years. Companies are now thinking hard about their business models, and realize they cannot be present in all countries in all activities. This is having a restructuring effect on the global energy market.



High performers over the next two years must know the difference between eliminating waste and simply cutting costs.

Risk: cost cutting and profit pressure

Christophe Babule, Head of Internal Audit, L'Oreal Group, France



Ever since the beginning of the financial crisis, everyone has felt rising pressure from cost cutting and related profit pressure. But within

our group, we were acting on these risk pressures even before the crisis. It is deeply in our roots to consider these risks every single day, even when the sun is shining.

This risk has to be a constant concern – even when there is not crisis – because you cannot truly solve the problem of cost cutting in one day.

Mitigation

Cost cutting is best achieved through the long-term optimization of costs; but sometimes the payoff is not apparent until 6 or even 12 months later. There are several areas within L'Oreal with important initiatives to mitigate this pressure. One example is in purchasing and sourcing, where there has been much more investment in organizing and streamlining of indirect costs. We're seeing the benefit of this organizational emphasis quite quickly.

We're also investing money in adapting our commercial organization to its given market. We have people in the field to make sure that the organization is well connected to its clients.

Next 2 years?

Profit pressure is always present, but for some firms, a crisis can be an opportunity. It is a way to push the whole organization to act on these risks faster. It is much more difficult to streamline the organization and review standards when everything is good – it is when the rain comes that people invest time in fixing their houses.





Cost cutting and profit pressure: a critical risk

Table 2
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Cost cutting and profit pressure	2	2	2

Five years into the global economic crisis, many of the obvious cost-cutting measures have already been taken. That poses a critical risk to firms, with cost cutting and profit pressure ranked second overall for the second year in succession. The quick wins have been made and that means firms face the need for deeper cuts, without damaging company performance.

These pressures have intensified in recent years, reflecting the narrower margin that firms can absorb and still remain operational. But the payoff for making the right decisions is worth it: we estimate that a 1% reduction in costs, achieved through a sophisticated procurement strategy, is equivalent to a 10% increase in sales.² High performers over the next two years must know the difference between eliminating waste and simply cutting costs.³

Costs do need to be crunched, though. Outside pressures such as inflation will drive up wages and input costs, and cut margins. And companies are now realizing that markets and revenues could remain depressed for a long time, meaning that firms can only survive by cutting costs to match the new, smaller markets. Swedbank's Chief Risk Officer Hakan Berg notes that: "two years ago, it wasn't obvious that this would happen; the general view was that we would have a downturn and then things would pick up again." The fact that this timeline has been thrown off raises serious questions about where best to cut costs or make investments in the operational side of the business (see "Operational agility").

2 For more information, please visit <http://www.ey.com/GL/en/Services/Advisory/Performance-Improvement/Supply-Chain/Driving-improved-supply-chain-results-adapting-to-a-changing-global-marketplace-Catalyst-for-growth-in-emerging-markets>
3 For more information, please visit, www.ey.com/growingbeyond
4 For more information, please visit <http://www.ey.com/GL/en/Services/Advisory/Performance-Improvement/Supply-Chain/Driving-improved-supply-chain-results-adapting-to-a-changing-global-marketplace-Catalyst-for-growth-in-emerging-markets>

A longer-term view

The companies that cope with these risks best are those that have it in their organizational DNA to focus on cost cutting (see **L'Oreal box**). However, there is a risk that the focus gets too narrow and that process improvement is seen as the only consideration. "The key to mitigating this risk is to avoid a short-term view and conduct a vigorous challenging of capital investment, asking how it fits in the overall business strategy," says Ernst & Young Asia Pacific Performance Improvement Leader Nigel Knight. Some of the most robust functions and programs are clearly under pressure; the question is whether they should be sustained or cut out completely?

Other mitigating measures include a serious reconfiguration of the supply chain to create cost competitiveness. This can include testing supply chains against customs duties and fuel price sensitivities, as well as developing mixed far-shore, near-shore and onshore sourcing and production to generate cost savings.⁴ Sixty-six percent of respondents to the survey believed it was the responsibility of C-level executives to respond to this risk, but 27% assigned responsibility for cost cutting to the board of directors.

Cost cutting and the pressure on profits are significantly more impactful in mature markets, where they were placed first on the risk list, than in rapid-growth markets. North American and European organizations rank them as their number one concern. Those in Southeast Asia and South-Central America are markedly less concerned, assigning this area only a medium-risk level.

Market risks: is the worst behind us?

Table 3
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Market risks	6	3	3

Cost cutting and profit pressure are pushed in large part by market risks, including commodity price volatility, interest and exchange rates, and equity risk. Such market volatility was named as the third-biggest risk facing companies.



“Two years ago, it wasn’t obvious that this would happen; the general view was that we would have a downturn and then things would pick up again.”

Hakan Berg, Chief Risk Officer, Swedbank

Commodity price volatility developed rapidly but the worst impact on companies and performance could be behind us. We expect oil prices to moderate at around US\$100-US\$120 per barrel in 2013. We also expect metal markets to deliver stronger performance in 2013.⁵ However, the absolute price of some commodities, including oil and gas, remains high, feeding price pressure and impacting location and distribution decisions. Shale oil and gas development in the United States is being driven by concerns about energy cost and security. It has already had a major tempering impact on wider oil and gas prices.

Currency pricing might remain volatile, however. Many rapid-growth market currencies saw dismal returns in 2012, but they could surge in value in 2013 if the US central bank’s decision to adopt a discretionary balance-sheet growth policy makes the dollar soften.⁶

Wavering interest

Interest-rate volatility remains a key risk, too. With global growth slowing, governments’ willingness to implement fiscal expansion is limited. The burden on monetary policy is particularly severe, but in many mature countries policy interest rates are already at or near zero. A heated debate is brewing on the extent to which the developed world’s low-employment, low-growth economies suffer from a structural problem or a straightforward lack of aggregate demand. If the latter hypothesis wins favor, a much more activist monetary policy approach from the largest Organisation for Economic and Co-Operation and Development (OECD) central banks is likely.

In some countries, it may be difficult to judge whether rapid-market growth is sustainable. For example, several Asian economies have in recent years been concerned about the stability of parts of their real estate sectors. However, this also reflects rising incomes and the formation of a new middle class in these countries. Companies increasingly see their growth prospects as lying in such emerging markets (see **“Customer reach”**). But while few would question their growth potential, the situation remains uncertain and the state of their economies-and markets-volatile.

Macroeconomic risk: the shocks reverberate

Table 4
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Macroeconomic risk: weaker or more volatile world growth outlook	8	4	4

As the shocks of 2008-09 continue to reverberate, so do the scenario discussions. “Normally we should expect to have a U- or V-shaped scenario; we are actually starting to talk about the L-shaped scenario, because we expect the current environment to stay for some time,” says Swedbank’s Hakan Berg. In fact, even such a gloomy prognosis might understate companies’ increasing concern over economic instability.

The macroeconomic outlook is grim. The larger, industrialized European economies have been damaged by falling export growth, along with weakening domestic demand. Visible signs of improvement are unlikely during the first half of 2013. “The next year will be very challenging,” says Volker Barth of Daimler in Germany.

The new normal

Globally, we expect the world economy to grow by 3%-3.5% in 2013. But demand conditions will remain very choppy, keeping suppliers under pressure even if growth is at the better end of the forecast range. Firms must think about the current climate as the “new normal” rather than as a temporary downturn and plan around the possibility of a deep recession in the Eurozone (see **“Emerging risks”**), among other serious potential problems.⁷

To overcome this volatility, “Firms are developing a governance structure that aligns their risk profile and exposures more closely with its strategy. Firms are shifting from a backward-looking view of risks to a forward-thinking one,” says Ernst & Young’s Michael L. Herrinton, Americas Risk Leader.

⁵ Oxford Analytica research.

⁶ Oxford Analytica research.

⁷ The World Bank.



Sovereign debt: defaults ahead?

Table 5
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Sovereign debt: impacts of fiscal austerity or sovereign debt crises	–	8	10

A key question for the global economy is whether some countries might default on their debt. Most of the developed world's new debt burden is a by-product of the 2008 financial crisis. In Europe, debt crises are already raging in a number of countries, forcing governments to focus on access to funding. In addition, the deteriorating economic situation in the Eurozone, including a visible slowdown in Germany, is weighing heavily on the entire region's economic, financial and political prospects.

The slowdown might not be short-lived, as Japan's two-decade-long stagnation shows. Its efforts to put public finances on a sustainable track have repeatedly induced economic contraction, leading to policy relaxations. At the same time, with demographic burdens worsening, public debt has risen sharply, and now stands at 236% of GDP in gross terms.

Reason to worry

Organizations in mature markets (particularly Europe) are significantly more worried by sovereign debt risks than those in rapid-growth markets, simply due to uncertainty about the impacts of the European crisis and how this can be resolved. "If growth comes from the wrong type of stimulus, the benefit will only be short term," says Swedbank's Hakan Berg. As a result, firms have little choice but to plan around long-drawn-out austerity and perhaps recession at one extreme, and a dramatic debt default and breakup of the Eurozone on the other.

Such fears are not limited to the Eurozone, however. The recurring US debt deadlock is one issue, while fiscal risks were placed fifth in Ernst & Young's Middle East survey risk list, reflecting increased fiscal commitments to meet an increasingly stressed social contract following the Arab Spring.

Political shocks: the risks of the new

Table 6
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Political shocks	–	10	9

New in 2013

With established markets flat and sometimes troubled, companies are looking to emerging markets for growth. However, this brings increased exposure to political shocks. Recent examples include the ongoing turmoil in the Middle East, the nationalization of oil company YPF in Argentina in April 2012 and repeated reviews of mining codes in western Africa. At the same time, political turmoil in Europe shows that political shocks are not contained to rapid-growth markets.

More broadly, there is a flight to protectionism. "It's a global thing," says Flavia Landsberg of Bunge, a multinational agribusiness firm. "Nobody's doing too well, so everyone wants to protect their own." Further restrictive measures are likely if the global economy continues to struggle.

Investment into some rapid-growth markets already hinges upon political stability. In Africa, an Ernst & Young analysis of market attractiveness⁸ found that 87% of survey respondents said that political stability had a high impact on the attractiveness of various countries there – higher even than corruption, taxation and access to finance. To mitigate this, *the Africa attractiveness*⁹ survey recommends spreading the risk of political instability in an individual country across the investment portfolio.

Nowhere is completely safe

The current political complications in Brussels underline that no market, regardless of its maturity, is free from the risk of political shocks. Still, the relative stability of Europe continues to attract business. Another Ernst & Young report *Growth, Actually* found that Europe's political stability and transparency was one of the most important factors driving companies to set up on the continent.¹⁰

8 For more information, please visit www.ey.com/attractiveness
9 For more information, please visit www.ey.com/attractiveness
10 For more information, please visit www.ey.com/attractiveness



“It’s a global thing. Nobody’s doing too well, so everyone wants to protect their own.”

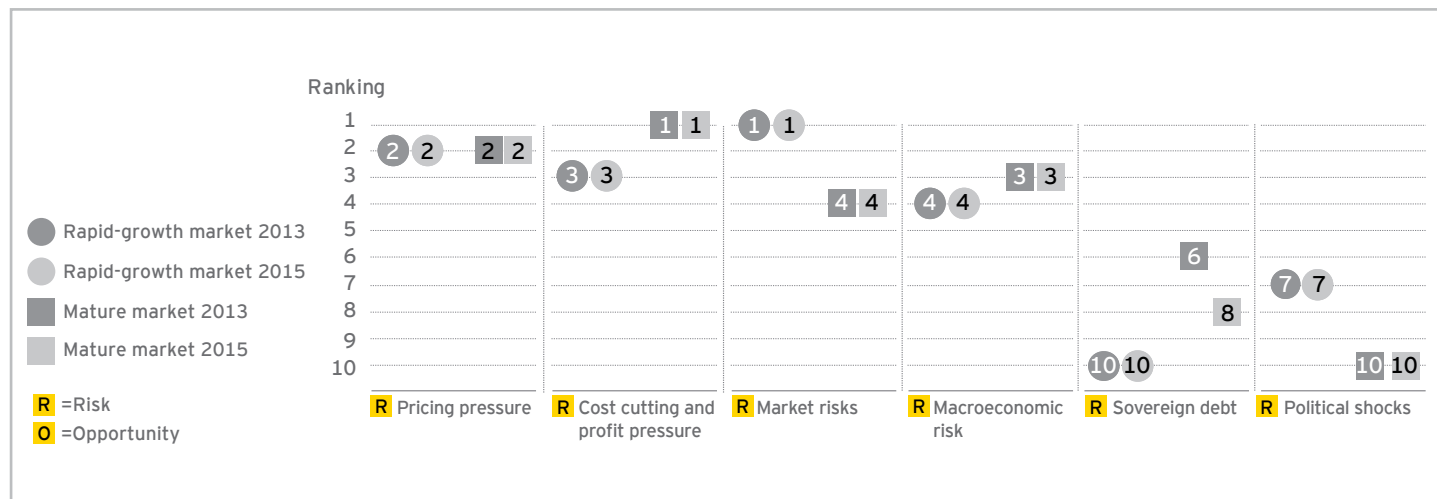
Flavia Landsberg, Director of Risk, Bunge

In some regions, the risk profile has increased over the past two years. The political upheaval of 2011 and 2012 in the Middle East further increased the region’s risk profile; accordingly, political and social risk is ranked second in Ernst & Young’s MENA risk list. Extreme political pressure could heighten the need for companies to respond to their stakeholders or even affect a company’s wider reputation (see “**Stakeholder confidence**”). Egypt’s 2011 upheaval, for example, drew search engines and social networking sites into questions of politics, the law and human rights.

As such risks are inherently less predictable, many companies report that they are enlisting the help of external experts in this area. An alternative, or sometimes complementary, approach is to spread the risk through geographic or sectoral diversification. As Vijay Subramaniam, CEO of International Business at Marico India, says: “One route is to expand your market across sectors; another is to hedge your bets by expanding into more than one market in the region. We try to do a mix of both.”

Chart 1

Ranking in 2013 and expected ranking in 2015 – comparison of rapid-growth and mature markets



“One route is to expand your market across sectors; another is to hedge your bets by expanding into more than one market in the region. We try to do a mix of both.”

Vijay Subramaniam, CEO of International Business, Marico India

What it all means for businesses

Global economic problems created by weak growth in mature market will continue into 2015 with increasing volatility in commodities and currencies putting upward pressure on costs and squeezing profits. Political shocks across both mature and rapid-growth markets will continue to catch those companies without adequate response strategies off guard.

To mitigate the risks related to cost competitiveness companies could:

Areas	Actions
Performance	<ol style="list-style-type: none">1. Evaluate current partner relationships, and create new relationships with partners that foster innovation and security.2. Set up effective planning integrating economic drivers to provide the potential impact on revenue and margins of business events.3. Evaluate major industry trends and leverage insights from successful competitors and market entrants.4. Analyze socioeconomic considerations, infrastructure maturity, supplier management, risk and investment.5. Identify sourcing locations and develop the right supply chain model to meet their needs best.
Risk	<ol style="list-style-type: none">1. Assess customer-facing functions and identify areas for measurable improvement in value, effectiveness, efficiency and quality of services delivered.2. Identify and design areas that can improve core processes and sub-processes within a targeted customer area.3. Undertake enterprise risk assessment to identify, assess and prioritize key business risks across the organization.4. Communicate risk tolerance across the enterprise including their board, senior management, and personnel.
IT and information security risks	<ol style="list-style-type: none">1. Evaluate existing IT costs and systems for opportunities to improve efficiency.2. Include information security in all initiatives focused on growing the top line and cutting costs.3. Reduce the cost of information security and eliminate duplication using a zero-based security approach.4. Develop a system to identify and prioritize security risks while monitoring spend to ensure costs are within specified limitations.

Self-assessment questions

1. How do you ensure you focus on the right strategic relationships (e.g., encourage innovation to design the right products from the best materials and secure critical supply)?
2. How do you sustain margins and operating results in the face of increased global competition?
3. What factors should you consider when expanding globally?
4. Which supply markets and categories should you target? Are you sourcing from the right locations to be cost competitive?
5. How do you preserve value while minimizing costs?
6. How do you balance pricing pressure with excellent customer service?
7. How frequently do you track metrics that can predict fundamental marketplace shifts?
8. How do you determine which objectives and opportunities to pursue while allowing for the organization's appetite for risk?
9. How efficient is your information security controls framework and what could be additional ways to cut costs?
10. Keeping cost-saving in mind, how can you focus successfully on the information security risks that matter?

Stakeholder confidence

Broader considerations emerge





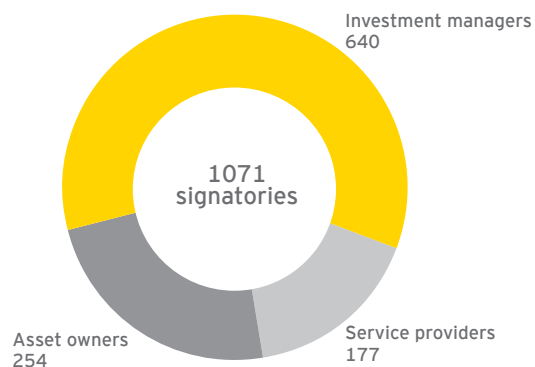
The big questions

Two big questions have emerged since the crisis. First, the public is questioning the role of corporations in society, with many people blaming the banks, in particular, for emphasizing short-term results over the wider economic good. And second, governments are asking how they can avoid a repeat of the financial crisis, as well as dealing with the fallout from the last one. That means tighter regulation, with lax rules widely blamed for the financial problems. Even beyond regulatory compliance, companies are increasingly being held accountable not just by shareholders but also by other relevant stakeholders, including civil society groups, customers, business partners and employees.

In fact, the same is true of the shareholders themselves, who must now look beyond their investments' short-term results. The number of investors committing themselves to consider environmental and social issues in their investment decisions has jumped. Since its launch in 2006, over 1,000 organizations have signed the UN-backed Principles for Responsible Investment (PRI; see Chart 2).

Chart 2

PRI signatories



Source: UNGC, UNEP.



Answering to a wider audience

Our survey finds that companies are increasingly concerned with the risks – and opportunities – posed by answering to a wider audience. Regulation and compliance remain a key concern, although they are becoming less acute as more clarity emerges over areas such as banking and insurance regulation. Regulation and compliance risk has fallen to sixth place, after coming top in both 2010 and 2011. Government intervention has moved up one place since 2011, in contrast, to become the sixth-biggest risk faced by companies. Partly, that is down to tightening regulation, but it also reflects the hands-on role of some rapid-growth market governments in industry.

Companies also think that better stakeholder management can help them, however, especially over finding finance. Excellence in investor relations remains a top 10 opportunity, with companies increasingly aware that they must keep investors informed of broader issues such as the environment, as well as over strategy and results. A new entrant to this year’s key opportunities list is leveraging CSR and public confidence. Companies that can show they are working for the public good can convince consumers, as well as investors, to trust them.

Expansion of government’s role: back by popular demand

Table 7 Ranking from 2011 to 2015			
Risk	2011 ranking	2013 ranking	2015 expected ranking
Expansion of government's role	7	6	7

Few would question that government’s role is escalating most acutely in financial services, where global and local regulations are being tightened aggressively. But worldwide, it is also expanding in pharmaceuticals, and power and utilities, among other sectors. That is particularly true in rapid-growth markets.

Globally, there is widespread popular pressure for government to play a larger role in business, with many blaming the 2008 financial crisis on the lack of government oversight of the banking industry. According to the 2012 Edelman Trust Barometer, almost half of people worldwide believe that government does not regulate business enough. This figure reaches a high of 77% in China, 54% in Brazil, 51% in the United Kingdom and 40% in the United States. Only 4% believed that government should not play a role in business at all.

Rapidly increasing

While many executives pointed out that government involvement is rapidly increasing in the United States, the trend also holds elsewhere. Bunge’s Flavia Landsberg says this has a big impact in Brazil, for example. “[The extent of government influence] changes very rapidly; month to month, in some cases.” Deepening government intervention may discourage investment, especially in higher risk projects.

Government intervention can be more aggressive, including expropriation risk, resource nationalism and growing requirements for more visible and direct benefits to the host country for foreign company activities. Small wonder, perhaps, that companies cite this as one of the biggest risks they face, and are hiking government-relations spending in an attempt to mitigate it.



According to the 2012 Edelman Trust Barometer, almost half of people worldwide believe that government does not regulate business enough.

Regulation and compliance: the most common form of meddling

Table 8
Ranking from 2011 to 2015

Risk	2011 ranking	2013 ranking	2015 expected ranking
Regulation and compliance	1	7	6

Tightening and changing regulation remains the most common form of state intervention, as governments try to avoid a repeat crisis, especially in financial services. Regulatory risk is felt more keenly in mature markets than in rapid-growth markets. But this is a widespread problem, and companies are spending heavily to keep compliance costs under control.

The effects can be far reaching. Multinationals also face mounting anti-bribery compliance pressure, for example. This could make them rethink their exposure to corruption risk, especially in rapid-growth markets. That, in turn, could make them reconsider their governance structure, internal control procedures and expansion strategies. The challenge is not to avoid exposure to problems such as bribery completely. It is to manage and control such problems as part of normal business, keeping the costs down rather than treating each case as a special project.

Capping the cost

Rising regulatory pressures drive companies to look constantly for more efficient ways to manage their regulatory obligations, keeping the cost under control. Traditionally, responses have focused on increasing the available manpower to monitor, assess and mitigate such risks. That means that even incremental regulatory changes can have an outsized impact. "Often, the implications of seemingly simple changes are enormous for banks' compliance frameworks," says Ernst & Young's Japan Risk Leader Yoshihiro Azuma. Therefore, firms will try to manage their risk exposure, and boost their reputation on compliance, by looking to engage outside specialists.

At the same time, companies are increasingly using technology and developing more rigorous frameworks to enable compliance in multiple jurisdictions across multiple continents more easily. Such a framework is necessary to understand the importance of each, as well as the possible consequences of non-compliance. So, too, is a good working relationship with the regulators themselves. "We regularly engage regulators in conversation primarily on the topics of sustainability and safety," says Mark Robins of Anglogold Ashanti.

"The way compliance has been managed in the past was to issue directives and guidelines," adds Rob Perry, Asia Pacific Risk Leader of Ernst & Young. "It's now moving toward a much more hands-on compliance function, where each of these businesses needs managing." The financial crisis means the popular media, and consequently public opinion, is more critical and less forgiving of misdemeanors. Clear links are emerging between firms that diligently comply with regulatory requirements and those that are seen as reputable within the marketplace.

Excellence in investor relations: keeping them informed

Table 9
Ranking from 2011 to 2015

Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Excellence in investor relations	7	7	8

It is not only regulators that must be convinced of a company's good intentions when it comes to compliance. A company's shareholders provide critical investment, and consequently must be kept fully informed of its business practices. To retain shareholders' trust, companies need to give them a full, clear appreciation of their strategic direction and prospects.

Companies see this as a chance to deepen their relationship with their owners, making them more willing to invest, and they expect it to become more important between now and 2015. Excellence in investor relations depends in part on the strength of actual compliance, and in part on how well a company's investor relations function communicates that strength.



Investors who can see that a firm is transparent – especially over environmental and social issues – will be more willing to commit to big, long-term investments. In future, firms will be expected to provide information on social and environmental issues in areas such as management structures, the nature of risks and risk management, key elements of strategy, performance and targets, and projections for company performance – even if they fall outside the scope of their regular corporate responsibility reporting. Full disclosure will reassure investors that the firm is aware of the possible risks, and can manage them.

Leveraging CSR and public confidence: plugging the government gap

Table 10
Ranking from 2011 to 2015

Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Leveraging CSR and public confidence	–	8	7

On top of the interests of regulators and investors, there is a growing sphere of corporate accountability encompassing society as a whole. This is juxtaposed with a widening gap between public demands for social and economic help and cash-strapped governments' ability to provide it. This opens up a space for companies to step up and gain public confidence with meaningful CSR actions, helping to plug the hole left by over-stretched state provision.

Many governments now actively encourage CSR and social entrepreneurship as austerity hits welfare spending. For example, India introduced a law last year requiring companies above a certain size to earmark 2% of their net profit for the subsequent three years to CSR. In the US, seven states, including New York and California, have adopted Benefit Corporation (B Corp) legislation allowing companies to give social and environmental objectives legal standing – with penalties for not making a genuine effort to achieve these goals. Other states could follow

their lead. China includes CSR within its ambition of building a “harmonious society,” mainly expressed through sustainability reporting and corporate charity.

Increasing their spend

In response, companies are increasing their spend on philanthropy. In a survey by CECP, 60% of companies reported increased giving levels in 2011 over 2009.¹¹ Of those surveyed, 40% expected giving to increase over the next year, albeit by not more than 10%. The survey also found that companies gave on average 14% of their total donations outside of their headquarters country. Health, education, and community and economic development were companies' top priorities, reflecting marked overlap with areas typically provided by the public sector.

Most firms have realized that it is not enough to act as a better community member – you have to communicate it well, too. “The responsibility of a company's leadership in this area is much higher than it used to be,” says Daimler's Volker Barth. “It isn't only to do with court proceedings now; with social media, the public will penetrate the company.”

Toyota, the Japanese automaker, had its reputation for reliability dented in 2009-11, when it recalled more than 10 million vehicles due to safety concerns. To turn this around, the company decided to leverage its capability as an environmentally friendly brand, making environmental sustainability its core management priority. This helped Toyota rebuild its brand image and regain investor and consumer confidence, ranking it number one in Interbrand's *2012 Best Global Green Brands Report*.

11 The Committee Encouraging Corporate Philanthropy (CECP), in association with The Conference Board, in its annual *Giving in Numbers: 2012 Edition*. Survey based on 214 corporations, including 62 of the top 100 companies in the Fortune 500.



Most firms have realized that it is not enough to act as a better community member – you have to communicate it well, too.

Opportunity: leveraging CSR and public confidence

Volker Barth, Head of Compliance, Daimler, Germany



Impact

From my point of view, over the last 12 to 18 months, the world has dramatically changed in terms

of governance models and the levels of transparency the public demands around governance failures. Looking at the bank scandal across countries, everything is published and everything is transparent. The new media make everything transparent; there's great interest from both the public and investors in companies, and Daimler is one of those companies that is always focused on in the newspapers.

If we have a failure, the press jumps in immediately and can harm your reputation. This is how the world has changed: the customer will now ask that good corporates practice good governance. They will invest only in good corporates in the future, and they

will only use products from companies that practice good governance. You must always be compliant as a consequence, and you must always challenge yourself: "When I think about the steps I have taken, would I be happy to read them tomorrow in the newspaper? Can I stand up for them and defend them?" That's the challenge.

Mitigation

I think you should avoid working on the compliance issues, and increase the steps you're taking in integrity issues. You must have buy-in from people within the firm; they have to understand why we are doing this. If you create only controls in the process, it's a waste of time and money. You can only lead a company with a good culture; that's my experience over the last few years as Chief Compliance Officer. I put less emphasis on controls and more on the leadership. We tell the people in the company: "we trust you;

sometimes we control you – there's no doubt about that – but we trust you." But that means you can only work with such a model if you act on failures. If there is real misconduct, you have to send a signal in the organization; you have to fire the leaders, and you have to cancel agreements with suppliers or distribution partners if they are involved in misconduct. Otherwise, it's only window-dressing.

Next 2 years?

I think the level of regulation will dramatically increase as regulators become much more aggressive – that's what's expected from the public. This will also be the case in countries where you don't expect it, particularly rapid-growth markets. A big downside risk here is that authorities in rapid-growth markets are not as well prepared as those in developed markets.





Investing in cleantech: green from the bottom up

Table 11
Ranking from 2011 to 2015

Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Investing in cleantech	6	9	9

Regulation on climate change will come from the politicians, but the most effective solutions will be bottom-up. Generally, the emphasis is on using cleantech, or environmental technologies, as part of wider economic and industrial policy so that national interests, social goals and the environment all benefit from increased focus on new, greener technologies.

Local stakeholders are keeping a close eye on how the businesses they support address cleantech. Today's instant communication and active stakeholders mean that business reputations can be seriously hurt by news of poor environmental stewardship. Conversely, investment in cleantech, along with openness and proactive management of environmental issues, can boost corporate image.

Organizations increasingly encourage "good behavior" throughout their supply chain links and their businesses by including environmental criteria in their practices and tenders. And consumers are forming advocacy groups that incentivize companies to make cleantech investments. For example, CarrotMob – an organization where consumers use a "buy-cott" instead of a boycott to reward companies that make sustainability improvements – has recently partnered with Unilever to scale up the concept.

Slipping down

However, cleantech tends to slip down the list of corporate priorities when the economy is challenging: the opportunities seem less vibrant when subsidies for clean energy are being scaled back and the carbon trading market is uncertain. In mature markets, new financial investment in renewable energy dipped below US\$70 billion in 2009, from over US\$80 billion in 2008.¹²

Unsurprisingly, cleantech investment has fallen in this year's rankings, but it remains in the top 10 opportunities. Companies, especially in sectors relying heavily on energy inputs such as transport and manufacturing, know that they face resource scarcity along with stakeholder expectations about efficient resource use. The cost of carbon emissions will rise, too. Efficient energy use will increasingly be a cost, as well as a green, issue (see "**Cost competitiveness**"). Of all opportunities in the top 10, organizations – in both mature and rapid-growth markets – consider cleantech investment the opportunity likely to increase importance the most by 2015.

12 Bloomberg, UNEP (United Nations Environment Programme)

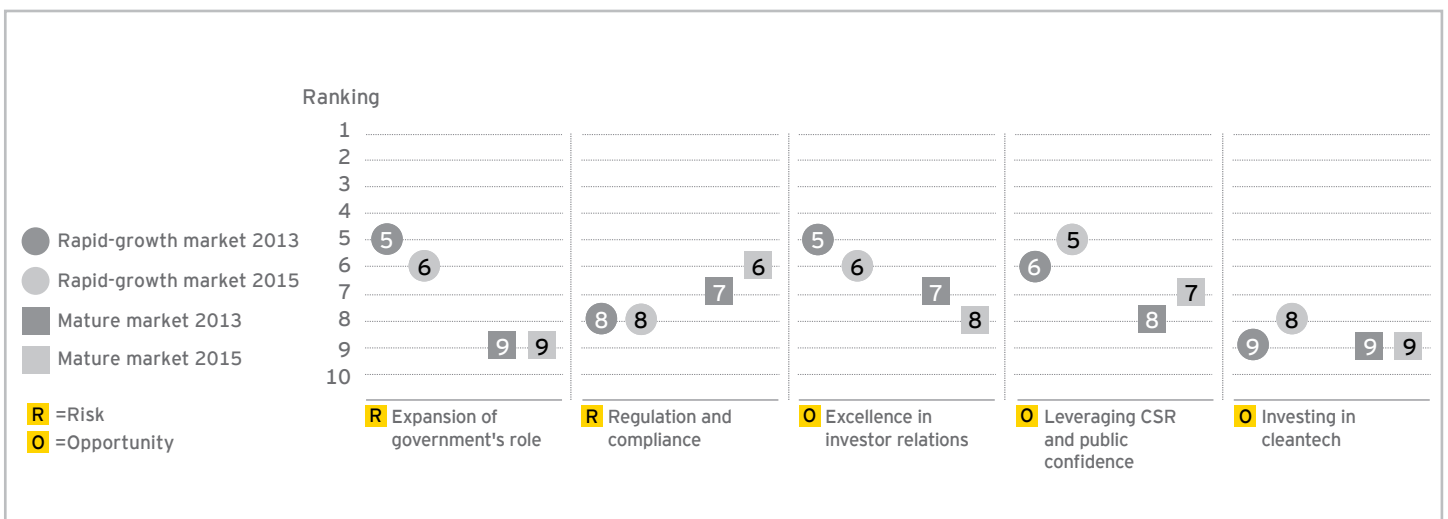


“The responsibility of a company’s leadership in this area is much higher than it used to be. It isn’t only to do with court proceedings now; with social media, the public will penetrate the company.”

Volker Barth, Head of Compliance, Daimler, Germany

Chart 3

Ranking in 2013 and expected ranking in 2015 – comparison rapid-growth – mature markets



“We regularly engage regulators in conversation primarily on the topics of sustainability and safety.”

Mark Robins, Senior Vice President: Group Risk AngloGold Ashanti

What it all means for businesses

Government involvement in business, particularly with regard to regulation and compliance, is expanding. Organizations must be seen to comply with increasingly onerous regulation and take interest in social and environmental issues, not only to avoid penalties from regulators but to accrue crucial advantages in stakeholder and public perception.

To mitigate the risks and enable opportunities companies could:

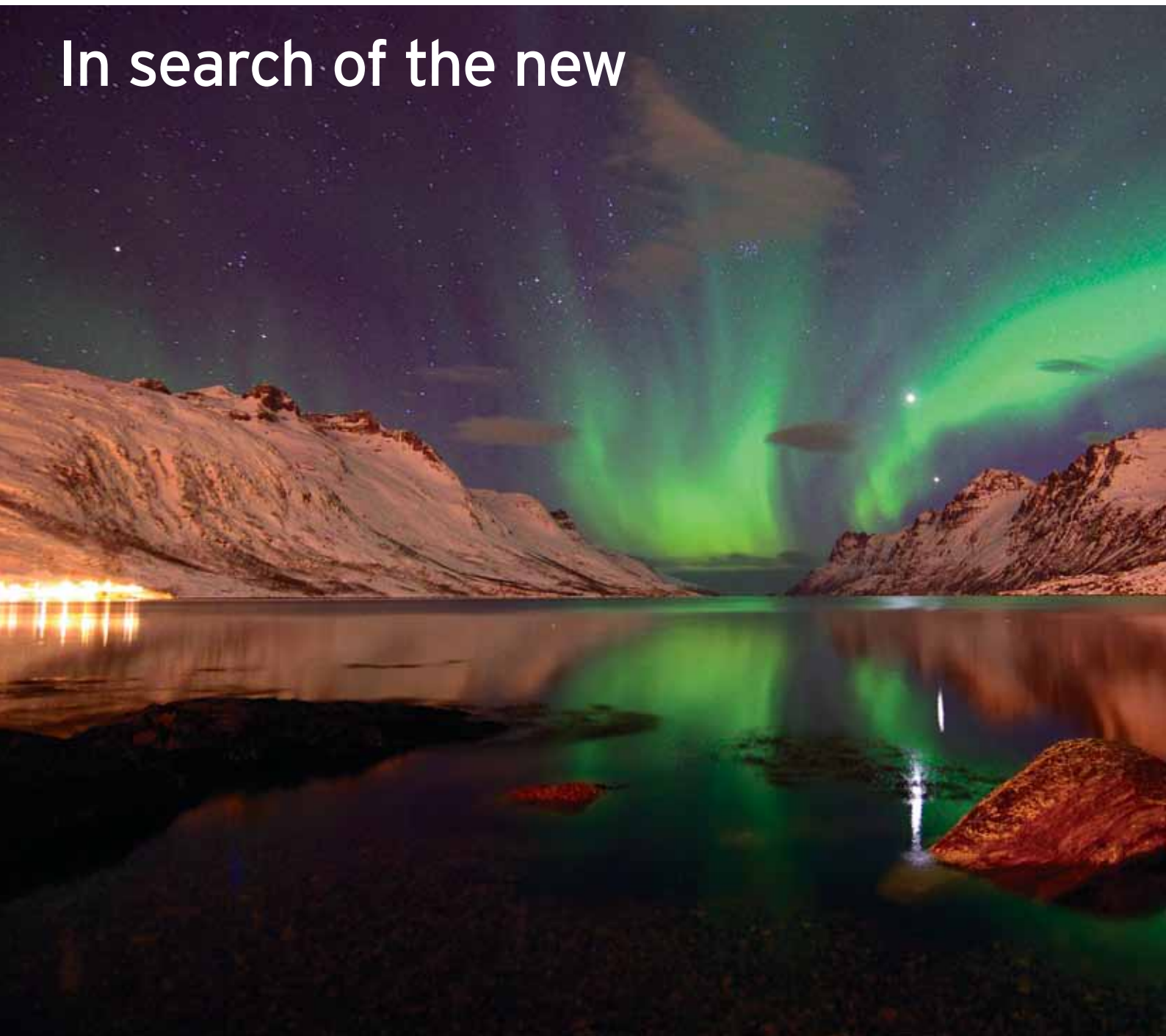
Areas	Actions
Performance	<ol style="list-style-type: none">1. Assess the effectiveness of the current regulatory compliance system, and consider the ability to manage the anticipated future regulatory environment.2. Assess the risks and costs in entering a new market from an operational perspective.3. Identify opportunities for using environmental and ethical requirements to their advantage for new product and market opportunities.4. Assess the effectiveness of the current regulatory compliance system, and consider the ability to manage the anticipated future regulatory environment.
Risk	<ol style="list-style-type: none">1. Execute enterprise risk management frameworks focused on credit risk, market risk, operational risk and regulatory compliance.2. Integrate and centralize system for efficiently monitoring and promoting compliance to government regulations.3. Identify the most significant individuals at shareholder and target shareholder institutions and make best use of time spent on investor relations.4. Identify optimal level of funding based on short-term cost of technology deployment and long-term cash flows and liabilities.
IT and information security risks	<ol style="list-style-type: none">1. Make public communication about their risks, control measures (including information security) and compliance an integral part of their risk strategy.2. Put a regulatory intelligence and reporting system in place to monitor compliance with all applicable requirements.3. Make IT and information security a regular agenda item in the boardroom and make it part of all their transformation efforts.4. Make sure their compliance function is aligned with their risk functions to avoid overlap.5. Make sure that they are focused on the right controls and implement continuous controls monitoring to reduce costs of compliance further.

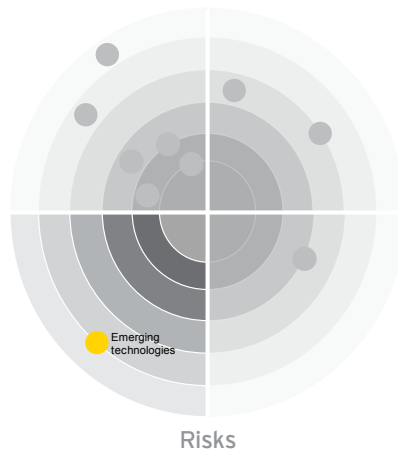
Self-assessment questions

1. How do you develop insights on the possible impacts of shifts in government regulations on business strategy and performance?
2. How do you evaluate the way in which new regulations or laws can create new markets for specialized products or services?
3. What capability do you have in scenario analysis and taking pre-emptive action to offset any impact of changes in government role?
4. With whom do you collaborate to track changing regulations and seek compliance assistance?
5. How do you reduce your exposure to share-price volatility?
6. How do you identify cleantech investment opportunities that are supported by proprietary technologies and multiple partnerships to minimize risk?
7. In what ways can you better communicate your compliance program as part of your go-to-market strategy and so build customer confidence?
8. How can you benefit from a regulatory intelligence and reporting system that protects you from unnecessary fines and other legal impacts?
9. What kinds of discussions on IT and information security take place in the board room and in relation to large transformation projects?
10. How effective and efficient is your compliance monitoring system?

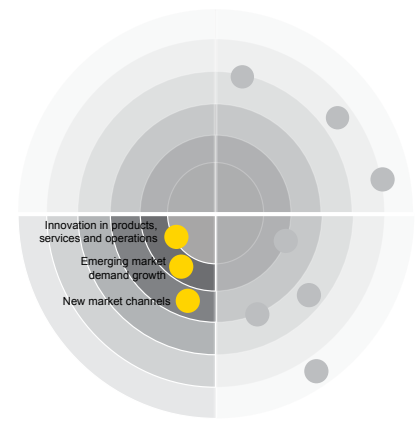
Customer reach

In search of the new





Risks



Opportunities



What do they want?

Reaching your customers depends on knowing who they are, where they are and what they want. But customers are increasingly “chameleon consumers,” defying traditional market segmentation. They shop online but want the human touch. They insist on personalization but communicate in packs.¹³ That is especially true of the emerging middle classes in rapid-growth markets, which often lie outside traditional distribution frameworks. You can no longer simply guess what the average consumer wants. Rather, the answer lies in filtering the mass of information now available on individual people to target them directly.

Better understood

Recent developments in cloud computing, big data and mobile devices are creating new channels to identify, understand and reach customers. Innovation – of services, operations and products – has become the biggest opportunity for companies as they look for new ways to reach customers, with emerging-market growth and the use of new marketing channels both seen as significantly greater opportunities this year. Much of the technology is becoming more established, and better understood. Therefore, while companies remain wary of the dangers they could pose; emerging-technology risk has slid to ninth place, from fifth in 2011.

¹³ Ernst & Young *This time it's personal: from consumers to co-creator*.



Innovation in products, services and operations: messy, unpredictable and vital

Table 12 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Innovation in products, services and operations	4	1	1

The Great Depression showed that technological change is particularly rapid during and just after major economic crises.¹⁴ As the cost of innovation is driven down, incentives for innovation go up. Innovation has become even more important after the more recent credit crunch, with company performance less easily fueled by debt and investors, particularly in mature countries, more cautious.

“Often innovation is most effective when it is simplification, certainly in terms of products,” says Steve Watson, Ernst & Young’s Global Performance Improvement Leader. This is especially true in banking, where highly complex financial products have confounded both consumers and regulators.

However, innovation is not always a managed process, with the flow of new products and services commanded from the top. The innovation process needs to be fluid and flexible. It also tends to be messy, unpredictable and spontaneous; “one size fits all” is rarely a productive approach. Organization culture and the ability to do things bottom-up as well as top-down make a huge difference to success.

Watson observes that innovative organizations drive a culture and set up policies to promote and reward innovation systematically. Having a clear vision of what this means for your business is key. External contributions such as commercial and academic partnerships can help, too. Innovation often occurs through networking and critical mass. Companies exist close to one another and compete, collaborate and learn together.

The gap is closing

Rapid-growth markets offer a range of opportunities for new product innovation, too. “Many markets are evolving quickly,” says Vijay Subramaniam of Marico India (see box), “so mapping consumer needs to identify the right bouquet of offerings to consumers is very important.” Historically, innovation has flowed from mature markets to rapid-growth markets, but the gap is closing. R&D spend in China and India increased by over 8% in 2010-11, compared with just 2% in the US and UK.¹⁵

Innovations in services and operations are as important as product innovations. In the pharmaceutical sector, the traditional approach to innovation needs some reinvention, for example. The growing regulatory costs of bringing drugs to market, alongside the “patent cliff” (the predicted drop in revenues as patents run out and generic competition increases) and a lack of R&D productivity, has necessitated a shift toward a diversified portfolio. Research-driven companies have had to become outcome-based and patient-centered to survive the hit. Personalized medicine, using genetic testing to analyze an individual’s genetic material, is also gaining momentum globally.

Protecting innovations is as crucial as producing them, but it is getting trickier. Innovation is increasingly cumulative as new products expand on earlier inventions, for example in electronics and biotechnology where a single product often incorporates hundreds of patented elements. The previously clear lines around what could be patented are diffusing, too. More companies may soon be able to patent novel business methods and service innovations among their products.

14 Alexander J. Field, “The Most Technologically Progressive Decade of the Century,” *The American Economic Review*, Vol. 93, No. 4 (November 2003), pp. 1,399-1,413.
15 IMF (International Monetary Fund).



“One size fits all” is rarely a productive approach.

Opportunity: innovation in products, services and operations

Vijay Subramaniam, CEO of International Business, Marico, India



What's the opportunity?

Some of the markets we are in are evolving, so mapping consumer needs to identify the right bouquet of offerings that fulfill

those needs ahead of the competition is very important. The opportunities in this area far outweigh the risks.

How are you taking advantage of the opportunities presented?

This is linked to the war for talent in that a lot of our measures to drive this opportunity are contingent on growing

our talent base from within. The first thing we can do is to ask what innovation means in the context of the business. We have to create a common understanding so everyone is on the same page. Secondly, it's very important to understand how to spend time with consumers, to understand them and gain insight from them. We have developed structured training mechanisms for this. Thirdly, we generate idea funnels to act as a mechanism for acting on specific opportunities. Fourthly, we make sure we have the right IT tools for cross-border management. Fifthly, we have a taskforce approach: each specific project will have a taskforce and a

taskforce leader, which cuts across functions and cuts across markets. Sixthly, we review all of our innovation projects through the idea stage, the feasibility stage, the capability stage and finally the launch stage.

At the leadership level, we debate the innovation challenges that face us as an organization, to prioritize and make good choices over which ideas to pursue. We have clearly defined matrices, so when we set objectives for ourselves (whether annually or over three years), we will set our innovation and core budgets against those objectives.





Emerging market demand growth: the future lies here

Table 13 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Emerging market demand growth	5	2	2

With anemic mature market growth, the world has long looked to new markets for expansion opportunities. For 2013-14, the International Monetary Fund (IMF) expects growth of 5%-6% across rapid-growth economies, far ahead of mature economies. Slowing growth in China remains a big danger (see “**Emerging challenges**”) but few other options remain. But to exploit these rapid-growth markets, companies must relate the opportunity directly to their degree of risk tolerance, according to Ernst & Young’s Global Risk Leader, Randall J. Miller: “It is not a question of them getting in,” he says. “It is a question of how they win.”

Global opportunity, local challenges

Corporate operations must fit with local regulatory, operational and cultural issues. L’Oreal is seeking to attract one billion new consumers over the next decade and is expanding in several major rapid-growth markets where long-term demographic trends are in its favor. This requires a thorough understanding of each markets’ consumers (see “**Cost competitiveness**”).

The prize is worth the effort. Already, two-thirds of global consumer spending comes from rapid-growth markets. And the number of middle class people in developing countries is growing fast, meaning that consumer-goods demand should rise sharply over the next 25 years. The number of rapid-growth market households earning above US\$30,000 will more than double to 149 million by 2020, overtaking both the US (120 million) and the Eurozone (116 million).¹⁶ Past patterns will offer some clues to what they want to buy, but intimate knowledge of the individual countries and creative thinking will also be essential.

Emerging technologies: the opportunity overtakes the risk

Table 14 Ranking from 2011 to 2015			
Risk	2011 ranking	2013 ranking	2015 expected ranking
Emerging technologies	5	9	8

Innovative companies are not only adapting themselves to rapid-growth markets, but also to emerging technologies. In fact, the most acute risks – along with the ripest opportunities – may lie in the overlap between the two.

The crucial emerging technologies include cloud computing, mobile applications and big data that all help companies in promoting better efficient and more effective use of resources. Properly designed and implemented new technologies provide incredible opportunities to help a company with better cost control, branding promotion and strategic management. “However, increasing reliance on technologies also usher a level of vulnerability that makes companies wary of their fundamental IT governance and protection challenges, from better data quality measures to stronger cyber-security management”, says Ernst & Young’s, Asia Pacific IT Risk and Assurance, Jenny S. Chan.

This risk has dropped in ranking from our 2011 survey as some emerging technologies become more mainstream, with companies for example more comfortable with tackling “big data” to find new business insights. As a result, emerging technologies are increasingly seen as opportunities rather than threats.

16 Oxford Analytica research.



“While we develop specific metrics, we still have a lot to learn. Many companies recognize that social media is important, but tapping into social media’s commercial potential remains a challenge.”

Christophe Babule, Head of Internal Audit, L’Oreal Group, France

Missing the boat

Of course, this presents a danger to companies that fail to keep up. “When all companies are thinking about emerging technologies, there’s a danger that you will miss the boat without sufficient investment,” says Ernst & Young’s Global IT Risk and Assurance Leader, Paul van Kessel. By the end of 2012, the number of mobile-connected devices will exceed the number of people on earth.¹⁷ How will this square with strategies set as recently as 2010, when average smartphone usage was one-third of what it is today?¹⁸

In the background, cyber security remains a key concern. As the internet has grown, so has the number of potential online threats.¹⁹ And the use of emerging technologies in business has created growing concerns over attribution, collateral damage and future technological developments. Finding a single way to mitigate this risk is challenging, given the complexity of technology and speed at which it is developing. Traditional security models focused on keeping external threats out of the organization are no longer effective. The new security model is predictive and enterprise-wide.²⁰

Paul van Kessel, Ernst & Young Global IT Risk and Assurance Leader says: “For all the steps that companies have taken in virtualization, cloud computing, social media, mobile and other emerging technologies, they continue to fall behind, creating an information security gap that grows ever larger.” According to the Ernst & Young 2012 *Global information security survey*,²¹ only 42% of organizations say that their information security strategy is aligned with their business strategy. Information security continues to be IT-led rather than focused on the overall business strategy.

In North America, emerging technologies were seen as being a considerable risk – the fifth-most important – in 2015. West Europeans agreed that this risk would rise up the rankings over the next two years.

New marketing channels: game changer

Table 15
Ranking from 2011 to 2015

Opportunity	2011 ranking	2013 ranking	2015 expected ranking
New marketing channels	8	4	4

Cloud computing and data insights hold tremendous promise to engage with, and market to, consumers better. And the potential to segment and target customers based on their data could be game changing for companies: opportunities from new marketing channels are cited as the fourth-biggest opportunity, up from eighth in 2011. We expect them to rise in importance through 2015.

Cloud computing could develop as a business-to-business industry with people buying, selling, analyzing and creating universal standards for the data that is captured. Storing data in a cloud is good for customers as it saves space and money, and is accessible in multiple places and on multiple platforms. Companies, in their turn, can build vivid pictures of their customers and target them based upon their previous purchasing patterns and recorded behavior. This is already being done by Amazon, Google and Facebook. Going forward, advertising is likely to be based on people’s future requirements, rather than simply on their past purchases.

Social media is becoming core to marketing strategy as it explodes in size, too. Facebook added 400 million users between 2010 and 2012; LinkedIn has grown to almost 200 million users, while Twitter exceeds 340 million tweets daily. “The next generation of e-banking will be more about how we can create a relationship electronically with customers,” says Swedbank’s Hakan Berg. As the growth of new users slows (especially in mature markets), social media providers will start to look at ways of increasing the use of their platform, working with other companies to create ways of further integrating people’s lives with social media.

17 Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2011-16.

18 Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2011-16.

19 For more information, please visit [http://www.ey.com/Publication/vwLUAssets/Countering_cyber_attacks/\\$FILE/Countering_cyber_attacks_March2011.pdf](http://www.ey.com/Publication/vwLUAssets/Countering_cyber_attacks/$FILE/Countering_cyber_attacks_March2011.pdf)

20 For more information, please visit [http://www.ey.com/Publication/vwLUAssets/Information_Security_Services/\\$FILE/Building_trust_borderless_world.pdf](http://www.ey.com/Publication/vwLUAssets/Information_Security_Services/$FILE/Building_trust_borderless_world.pdf)

21 For more information, please visit <http://www.ey.com/GL/en/Services/Advisory/2012-GISS---Fighting-to-close-the-gap---Overview>



A lot to learn

Companies remain keen to find a return on their investment in social media, and they are increasingly gathering more precise metrics of how these channels have resulted in business.

“While we develop specific metrics, we still have a lot to learn,” says Christophe Babule of L’Oreal. Many companies recognize that social media is important, but tapping into social media’s commercial potential remains a challenge.

This is apparent externally: only 15% of social media users think companies use it well, according to an Ernst & Young report²² (*This time it’s personal: from consumers to co-creator*, conducted with YouGov). In particular, firms need to understand how specific innovations can be applied to the everyday needs of individual organizations and consumers. Not only that, but firms must be able to absorb the information flowing back through communication channels. Blogs, Twitter and Facebook have all emerged as powerful influences. According to Edelman’s 2012 TrustBarometer, trust in social media has risen 75% since 2011. Bloggers and tweeters have become society’s new spokespeople.²³

Respondents in rapid-growth markets place this opportunity third, compared with sixth in mature markets where internet penetration is already very deep. In part, this reflects the rapid growth in new users coming online, as well as the striking opportunities to bypass traditional channels. One example comes from Kenya, where mobile payments have far surpassed traditional banking channels.



²² For more information, please visit www.ey.com/consumerbarometer

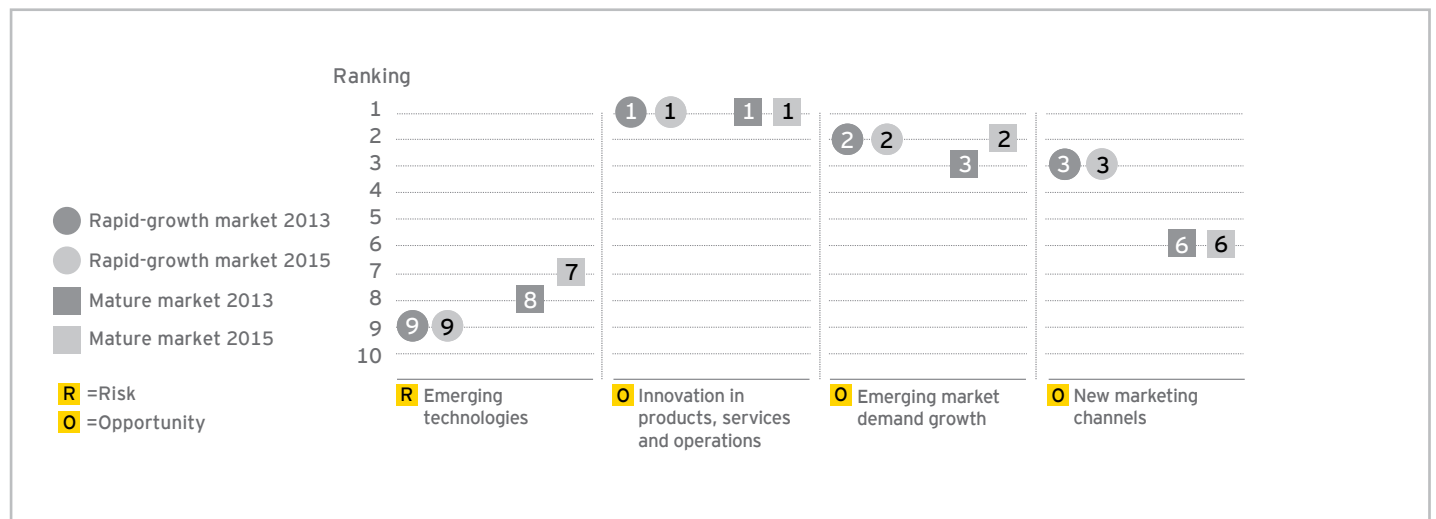
²³ For more information, please visit www.ey.com/consumerbarometer



Already, two-thirds of global consumer spending comes from rapid-growth markets.

Chart 4

Ranking in 2013 and expected ranking in 2015 – comparison rapid-growth – mature markets



“The next generation of e-banking will be more about how we can create a relationship electronically with customers.”

Hakan Berg, Chief Risk Officer, Swedbank

What it all means for businesses

Organizations need to prioritize technology and innovation in order to improve their overall customer reach, as new markets and technologies emerge in the aftermath of the global financial crisis. Opportunities exist for those able to understand the imperatives in this area and integrate their processes and operations accordingly.

To mitigate the risks and enable opportunities companies could:

Areas	Actions
Performance	<ol style="list-style-type: none">1. Identify potential rapid-growth markets to expand operations.2. Define a channel-selection strategy aligned with the business strategy and focused on customer needs and market demand.3. Design coherent organization-wide strategy for innovation and well established processes for managing products and services.
Risk	<ol style="list-style-type: none">1. Set up an effective channel management to ensure use of the right channels that apply to the business strategy.2. Develop a consistent framework to assess the value created by investment in IT operations.3. Undertake targeted IT investments aimed at inefficiencies in current business practices.4. Gather a deep understanding of critical cost categories, such as cross-border taxes and tariffs, and supply chain performance to identify the true costs and benefits of sourcing to rapid-growth markets.
IT and information security risks	<ol style="list-style-type: none">1. Evaluate the potential benefits and risks of integrating throughout the value chain and how IT can enable additional value generation across it.2. Align their IT investment strategy with the company's strategic goals.3. Enhance communication and transparency around technology and information security requirements and efforts.4. Perform a risk assessment on the various distribution channels per geography and enhance technology and information security measures where necessary.5. Develop a policy for using social media by their employees when that relates to their organization; monitor what social media report about their organization and take appropriate actions.

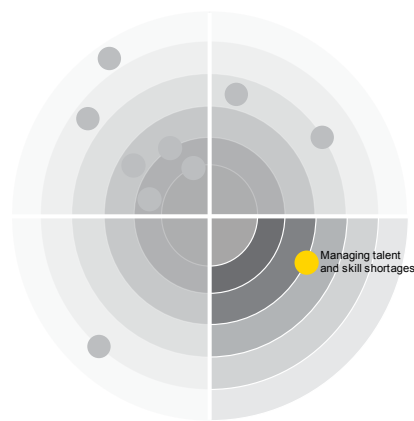
Self-assessment questions

1. How do you effectively evaluate rapid-growth markets to ensure that they fit with your competencies and strategic objectives?
2. How is innovation embedded in your business model?
3. How can you work more effectively with channel partners to ensure the value proposition is easy for the market to understand?
4. How are you tracking the risk and adoption rates of emerging technologies? Which ones are likely to have limited value or high deployment risk?
5. How do you assess changes in factors such as adoption of IT, workforce demographics and the rise of social media in order to identify which emerging technologies are having the most impact?
6. What financial analysis do you conduct to ascertain the true costs and benefits of sourcing from rapid-growth markets?
7. How do you connect with your customers, suppliers and employees to drive innovation in your business?
8. How extensively do you use technology to accelerate and drive the adoption of new ideas and programs?
9. How do you consider technology and information security while launching a new product or entering a new geographical market?
10. How secure are your new go-to-market strategies (e.g., websites, mobile apps, social media), including digital payment systems, to ensure customer confidence and maintain brand reputation?

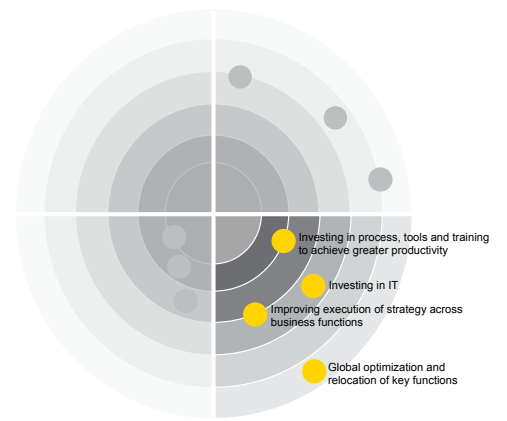
Operational agility

Tuning for greater performance





Risks



Opportunities



Crucial to survival

The simplest solutions to the operational challenges arising from a difficult economy have, for the most part, already been tried. But firms are still struggling with profit pressures and skill shortages, as well as a limited ability to invest. That makes operational agility crucial to surviving today's volatile business environment and it is heavily represented in this year's global top 10. It includes one of this year's top 10 risks and four of this year's top 10 opportunities.

The search for talent

Talent management and coping with skill shortages remain key risks as companies expand into new markets, and education systems sometimes struggle to keep up with firms' demands. However, they have moved down from third place in 2011 to fifth in this year's report. They have been overtaken by investment to improve productivity, essential in today's tight-margin markets (although in absolute terms this has fallen one place to third spot). A new entrant to the top 10 opportunities is global optimization, increasingly important both to minimize costs and to unlock rapid-growth markets' potential.

Companies in highly competitive mature markets regard operational challenges as far more significant than those in rapid-growth markets. That is especially true of IT investment, the fourth-greatest opportunity in mature markets but only eighth for rapid-growth ones.



Investing in process, tools and training to achieve greater productivity: cheaper and better

Table 16 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Investing in process, tools and training to achieve greater productivity	2	3	3

The first step toward maintaining a flexible operating model is to recognize where internal investment will help the organization. Productivity is an area where many companies feel there is much room for improvement. That is especially true of mature markets, such as North America and the EU, where companies place this opportunity second. Rapid-growth markets place it fourth.

Remote potential

However, some of the best examples of innovation to cut costs and create better service can be found in rapid-growth markets. Some private hospital groups in India are lowering treatment costs through remote diagnosis and surgical specialization – an example likely to be followed by some African countries. In rapid-growth markets like this, authorities can experiment with new models of provision, and exploit technologies to develop telemedicine and eHealth systems. These can leapfrog some elements of expensive Western healthcare systems to achieve better outcomes at lower cost. Awareness of this potential is spreading fast. The question remains, however: will cheaper really mean better services?²³

More generally, that is the question assuming ever greater importance in light of the current climate; companies that can improve productivity while cutting costs will have a major competitive advantage (see “Cost competitiveness”).

Improving execution of strategy across business functions: practical criticism

Table 17 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Improving execution of strategy across business functions	1	5	5


Clever investment strategies can be set at the top, but they must be put into practice. When an overall strategy has been decided, all available resources must be geared toward its implementation. This means ensuring communication lines are open and processes are consistent across markets. “The difference between a good strategy and a bad strategy is often simply in the execution,” says Marico India’s Vijay Subramaniam.

This means dealing with a range of challenges, most of which are organizational in nature. They include the quality of leadership, the culture and values within an organization, and the improvement of key business processes. Major change will not happen without these three things being aligned and tackled effectively. They are then reinforced by other levers. Good talent management is vital. Reward and engagement policies must align incentives and effort with the right performance measures. And organizational design and management processes (especially planning and performance management) must be up to scratch, with job roles that give clarity and accountability.

Forget a “one-off” fix

Many organizations seize on one or two of these as the answer, but significant change always demands more. Particular situations must be diagnosed, and several of these levers must be pulled in a coordinated way. Change is not amenable to a one-off fix-firms that excel in this area work over time to embed best practice in what they do and how they do it, but rather consider this an ongoing process that is continuously adapted to the needs and demands of the business.

24 For more information, please visit www.ey.com/rapidgrowthmarkets



“The difference between a good strategy and a bad strategy is often simply in the execution.”

Vijay Subramaniam, CEO of International Business, Marico India

DHL Express

Challenge

In the past 10 years, the logistics industry has undergone a transitory phase. Disappearing trade barriers and political borders; advancement of technology; increasing complexity of businesses; and fastidious consumers have led to an increase in the demand of logistics services.

Opportunity

DHL²⁵ realized the dynamic need of customers and promptly responded by working rigorously to enhance its operations by investing in IT leading to optimization of resources. The company transports about 1.8 million parcels annually. To reduce the human effort spent on transshipping the parcels manually, DHL incorporated technology in its daily operations to optimize resources. DHL undertook the following key initiatives to enhance operational efficiency through IT investment:

- ▶ Launched “parcel robot,” which automatically unloads containers and swaps bodies in a few minutes
- ▶ Introduced automated “Pick-Up points and Drop-Off points” (PUDOs), which are equipped with bar code scanners and are connected via electronic data interchange to avoid wrong deliveries
- ▶ Incorporated the use of “telematics” software, which helps optimize the routes; saves traveling time and avoids traffic jams
- ▶ Launched “DHL Smartsensor” which safeguards the quality of sensitive goods with temperature-sensitive sensor technology
- ▶ Commenced “SmartTruck” – a pickup and delivery vehicle, which combines a number of technologies, including a route planner. This helps optimize the route traveled.

Going ahead, DHL plans to launch “mobile Transaction Number” (mTAN) to offer high-level security to its customers by replacing Personal Identification Number (PIN), its older technology.

Outcome

By incorporating technology in its daily operations, DHL has been able to manage its operations efficiently and effectively, by providing value to its customers. In 2009, the company received 20 awards in 10 countries, which has increased to 62 awards in 24 countries in the year 2012, for customer service excellence. The DHL “SmartTruck” concept has helped DHL reduce the number of miles traveled by 15% and the length of average route by 8%. DHL early adoption to technology has made them today one of the world’s leading logistics companies.

25 DHL Launches Smart Sentry Tracking Technology,” Kevin Scarpati, Supplychain Digital, 4 December 2011, http://www.supplychaindigital.com/global_logistics/dhl-launches-smart-sentry-tracking-technology accessed 13 October 2012; “Expanding offers - Improving Service” Deutsche Post DHL website, <http://www.dp-dhl.com/reports/2011/annualreport/further-information/expanding-offers-improving-service-2.html> accessed 12 October 2012.



Strategy execution was highly ranked in North America (as the fourth-greatest opportunity) but rapid-growth markets put it in eighth spot.

Investing in IT: the right tools

Table 18 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Investing in IT	3	6	6

Executing a strategy successfully often depends upon the tools required to implement it. Many firms now invest in IT to drive both their analytical and administrative processes. DHL's investments in IT systems have helped it to become one of the top players in logistics, for example. Indeed, integrating IT systems was a common theme among those mentioning operational challenges and productivity as relevant. "We're implementing IT systems globally, we're designing our processes globally," says Bunge's Flavia Landsberg. "Everything has pointed toward integration of how information is stored and how we do things."

Cloud computing will have a significant role in this over the next two years. "Cloud computing has changed a lot," says Ernst & Young's EMEA IT Risk and Assurance Leader Manuel Giralte Herrero. "In the past, outsourcing was more defined into one tangible, physical location." With the move to the cloud you do not often know where, or in how many locations, your data is housed. Companies are still figuring out how best to incorporate cloud into business models, innovation networks and core services. They are also grappling with how to deal with the cloud transition risks like privacy, vendor risk management, user provisioning and providing assurance to customers. "It's a real challenge, but necessary if companies want to stay on top of their game," says Ernst & Young's Americas IT Risk and Assurance Leader Bernard Wedge.

Staying on top

Staying on top of the game means monitoring and evaluating new tech advancements that might boost company growth and efficiency. And increasingly, that means keeping on top of advancements made by private firms as well as public bodies. Google invests far more in ICT research than the EU spent on ICT in its Seventh Framework Program for Research (FP7), for example – approximately €2 billion versus €1.3 billion.

By a large margin, organizations in mature markets consider this opportunity more important than do those in rapid-growth markets. It ranks in the top five opportunities for North America, the EU and South Central America, but in the bottom two for the BRICs and other rapid-growth markets.

Managing talent and skill shortages: mind the gaps

Table 19 Ranking from 2011 to 2015			
Risk	2011 ranking	2013 ranking	2015 expected ranking
Managing talent and skill shortages	3	5	5

While IT is critical to business efficiency, organizations must also have the right people to implement and maintain changes. A globalized environment has increased competition for staff. Despite an overall increase in global talent, demand is increasing more quickly.

In some rapid-growth markets, educational attainment and technical qualifications lag behind the needs of businesses, meaning that companies experience difficulty in sourcing skilled staff. "Many companies have reasonable talent in mature markets but have significant gaps in rapid-growth markets," says Ernst & Young's Global Risk Leader, Randall J. Miller.

There are still major gaps in a number of talent areas in rapid-growth markets, notably accounting. "In some markets, you can't buy experience," L'Oreal's Christophe Babule explains. "You just have to develop it as fast as you can. The experience of your people will not necessarily grow as quickly as the market."



“You can’t buy experience. You just have to wait. The experience of your people will not necessarily grow as quickly as the market.”

Christophe Babule, Head of Internal Audit, L’Oreal Group, France

Succession planning

Companies skilled at talent management have a robust set of operating-model principles, including the processes, systems, competencies and profiles necessary. This allows them to use a baseline model to cut the overall risk of an acquisition or joint venture. However, many companies do not have this in place, something especially true of manufacturing and automotive firms.

This is not a rapid-growth market problem alone, however. North America and Southeast Asia ranked it higher than any other regions, indicating fierce wars for talent there.

Global optimization and relocation of key function: everything can be moved

Table 20 Ranking from 2011 to 2015			
Opportunity	2011 ranking	2013 ranking	2015 expected ranking
Global optimization and relocation of key functions	–	10	10

Global optimization and relocation of key functions is a new entry to this year’s top 10. “The geographical dispersion of manufacturing, along with other activities such as call centers, is not new. However, what is now emerging is the ability to move a range of functions – such as IT, marketing, finance and R&D – to wherever is most cost-effective,” says Ernst & Young’s EMEA Performance Improvement Leader Sabine Bechelani.

Building on this, the world’s biggest global companies are now also exploring how they can combine various back-office processes into specialist multi-functional shared service centers. For example, whole individual firms might have shifted their finance capabilities into a regional center of excellence, and outsourced their human resources function altogether, there is now a trend toward consolidating these and other back-office functions into a single shared resource.

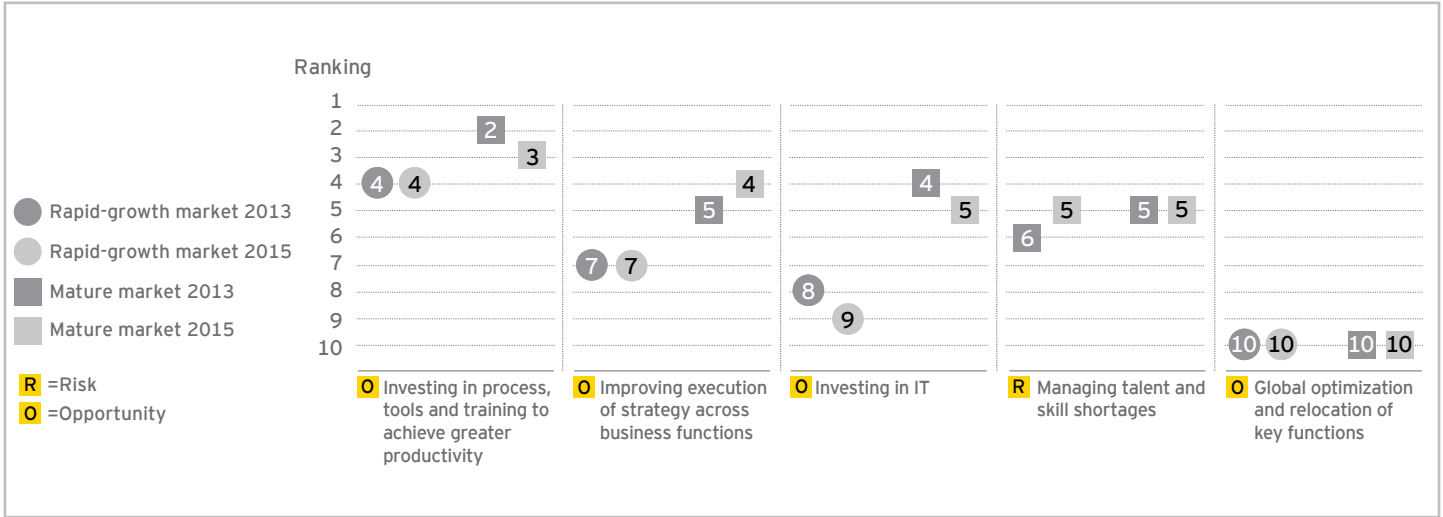
An Ernst & Young’s report (*Driving improved supply chain results*) found that 64% of executives expected the majority of growth to come from rapid-growth markets within three years. Some 67% said that they are developing their supply chains to support this growth. Most expected to move toward a more global approach within three years to realize critical benefits of scale or process across their organizations. This includes a third who said that they were likely or very likely to move their global headquarters to a rapid-growth market in that same time period.

In praise of integration

Where to place the global headquarters is a more complicated decision, involving political risks and the preferences of senior directors among other things. “The biggest thing is integration,” says Bunge’s Flavia Landsberg. “Having companies in over 40 countries, we’re moving toward integrating it all while retaining localized decision-making processes.” For multinationals, particularly those with interests across mature and rapid-growth markets, standardizing and integrating operations is crucial. Structuring the company so that the right people make the relevant decisions, and to avoid redundancies, is also vital.



Chart 5
Ranking in 2013 and expected ranking in 2015 – comparison rapid-growth – mature markets





“The biggest thing is integration. Having companies in over 40 countries, we’re moving toward integrating it all while retaining localized decision-making processes.”

Flavia Landsberg, Director of Risk, Bunge

What it all means for businesses

Operational agility can be achieved by those managers who can drive a net increase in productivity, either within process, tools and training or through supply chain flexibility. “Companies cannot afford to wait for a return to 'normal times' ... they're not coming back; in periods of sustained and even accelerating volatility, firms must proactively reconfigure – not only to take advantage of productivity opportunities that currently exist (whether in talent, advanced technology or structural changes), but to aggressively innovate their operating models to take advantage of that very volatility versus their slower-moving competitors,” says Ernst & Young’s Americas Performance Improvement Leader Greg C. Cudahy.

To mitigate risks and enable opportunities, companies could:

Areas	Actions
Performance	<ol style="list-style-type: none">1. Evaluate the end-to-end supply chain for potential risk hotspots and create a risk mitigation plan as part of the supply chain strategy.2. Create a driver-based planning process to identify the key economic drivers for the business.3. Evaluate the current cost structure against comparables and look for opportunities to streamline back office functions.4. Define the roles and responsibilities to help guide staffing appropriately.5. Build development plans and succession plans to ensure that the right people are in the right role.6. Assess the systems and processes that are in place to support business.
Risk	<ol style="list-style-type: none">1. Undertake workforce planning driven by long-term strategic talent needs at their organization.2. Understand if the organization has any prevalent barriers to innovation in products, services or operations.3. Optimize workforce management by analyzing labor costs, scheduling, productivity and turnover, and recommending actions to improve workforce flexibility.
IT and information security risks	<ol style="list-style-type: none">1. Enhance information security by assessing the information security technology market and implement – if applicable – the newer technologies.2. Evaluate the current analytics systems against available options.3. Assess the information security functions (as well as their risk management and compliance functions) and enhance the effectiveness and efficiency of these functions (enhance maturity level, risk convergence).4. Integrate IT services with the company's business operations, make it a part of the business organization, align KPIs (key performance indicators) and SLA (service level agreement) of their IT operations with the departments that IT supports.

Most expected to move toward a more global approach within three years to realize critical benefits of scale or process across their organizations.

Self-assessment questions

1. How do you minimize variability in your supply chain while introducing more cost-effective processes and solutions?
2. How do you plan and prepare for the increased volatility of the market you operate in?
3. Have you effectively consolidated and standardized global activities - including using a shared service center?
4. How do you ensure you have the right people with the right skills in the right roles?
5. How do you ensure you have the right solutions, and integrated systems and processes in place to increase collaboration?
6. What risk-assessment measures for innovations do you undertake?
7. How do you regularly conduct market technology scans to identify new tools to protect critical systems and data?
8. What does analysis of your business processes reveal about optimal performance (i.e., analyses of marketing spend and supplier spend, etc.)?
9. How well do your information security and compliance functions perform and efficiently integrate with other risk functions?
10. How do you continuously improve service levels and meet ever-greater business demands while optimizing IT service costs?



Emerging challenges

Preparing for uncertainty





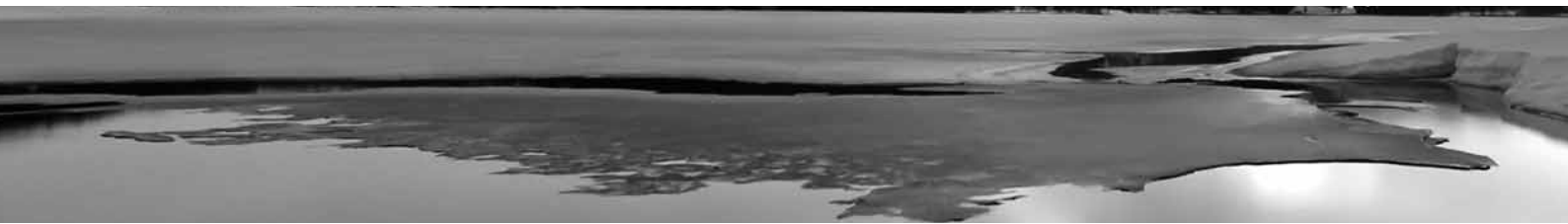
Rethinking the risk radar

In years gone by, unexpected risks in another region or economy didn't necessarily have serious consequences elsewhere. But in an increasingly globalized and interconnected world, this is less often the case. Instead, factors outside of a given firm's control can pose a pressing challenge to its strategy, operations and profitability. In turn, this demands a wider view of the potential risks that are rarely on the corporate risk radar.

For example, what if the US economy enters a Japan-style "lost decade"? Or what if conflict in the Middle East draws in the region's major powers, and cuts off oil and gas supply chains? Most importantly, how would such issues reshape the business environment? And what can companies do to anticipate and manage such risks?

Each of these emerging challenges – developed with input from an expert panel, and Oxford Analytica's Global Risk Monitor – has an impact on the key risks and opportunities detailed in this report so far. And as each carries consequences for a wide range of markets and sectors, we consider plausible scenarios for how each may evolve over the next three years. Rather than considering these challenges as general concepts, we believe it is most useful to identify specific contingencies. The top five we've identified are as follows:

- ▶ The US enters a deflationary trap
- ▶ Deep recession in the Eurozone
- ▶ The end of rapid growth in the BRICS
- ▶ A full-scale inter-state war in the Middle East
- ▶ Cyber conflict that disrupts infrastructure and business operations



The US economy: stepping into the deflationary trap?

Within the US economy, our chief concern is the possibility that the US may enter a “deflationary trap,” formally defined as four straight years of falling headline CPI inflation. Japan experienced this between 1992 and 1995; should the US experience something similar, the consequences would be devastating for the global economy. With the US representing more than half of the value of global equity and bond markets, there would be significant negative consequences for investors and financial institutions around the world.

What would result? The US would likely experience at least one year of real GDP decline, perhaps on the order of -1.5% or -2.0%. And instead of a normal economic rebound, growth might remain flat or negative for a couple of years. Unemployment would rise to 10%-12%, while all measures of economic output or sales (such as auto sales or housing starts) would likely decline sharply, perhaps by 30% or more. Investment spending would drop by at least 15%, as is normal in recessionary periods, while consumer confidence would tumble.

This would create an array of challenges. Equity prices would plummet, potentially by as much as 50%. Volatility is expected within bond markets; low-performing bond markets have a precedent in Japan's case, but should markets focus on the increase in the ratio of net debt to GDP, the costs of US borrowing may rise significantly. Accordingly, the dollar would lose value on international markets, potentially threatening its status as the global reserve currency (**see “Market risks”**).

Deep recession in the Eurozone: testing the limits of austerity

How long can EU leaders avoid a truly sustainable solution to the continent's fiscal crises? When and how can growth in Europe be restored again? For businesses, the key risk is that Europe's path of austerity will perpetuate a vicious cycle of low (or no) growth, and thus a worsening of debt-to-GDP ratios. These have already led to public protests and political upheaval, although they have also given a degree of calm to volatile markets.

But as public spending represents a sizeable part of many EU economies, austerity packages often lead to increased unemployment, which in turn threatens to drive these countries into a deeper recession and further erode public finances (**see “Sovereign debt”**). As we are witnessing in Italy, the drive toward austerity also carries profound political consequences for the technocratic governments that seek to rein in past profligacy.

With anemic growth over the last three years, Europe's fall into a deeper recession is a significant possibility. In this scenario, severe austerity packages implemented by indebted states cause Eurozone unemployment – already at record highs – to rise even further. This reduces aggregate demand and further erodes public finances, which hurts business activity and increases both borrowing costs and the risk of disorderly defaults. The result is a deep recession across the Eurozone.

The consequences are wide-ranging. The combination of weak growth and poor budget outcomes creates contradictory policy pressures, with the result that further stimulus packages are unviable, as they may financially exhaust Member States. Exports to Europe from rapid-growth economies suffer, significantly slowing the global economy as a result. Further pressure piles on European financial markets, with radical steps (such as large-scale European Central Bank intervention, requiring an EU treaty change) needing to be taken to avoid sovereign default in major countries. As an institution, the European Monetary Union (EMU) is existentially threatened, with creeping erosion of the single market and continuing disagreements over key policies causing major divisions.



Crumbling BRICS? The growth party's hangover

Once hailed as the engines of growth, the outlook for the BRICS now looks more modest. Policy-makers in India, Russia and South Africa may remain trapped between slowing growth and higher inflation; in Brazil, it is highly uncertain whether domestic demand will remain a robust driver of growth.

But the key concern is China, precisely because its scale and growth rate are so important to other rapidly growing markets, and the global economy. While the Chinese Communist Party (CCP) is keen to portray any slowdown as a necessary adjustment from lower exports, a sharp deceleration or recession could derail the Chinese development dream. More crucially, the subsequent softening of commodity demand would have ripple effects across the globe.

While the November 2012 leadership transition provided some reassurance to the wider business community, China's performance is also highly dependent on external factors. If the world economy implodes for a second time in a decade, China may be unable to patch over this new shockwave with yet another fiscal and monetary stimulus package. Its financial resources may become strained, even to the extent of an outright recession.

Even if China avoids this extreme scenario and Beijing succeeds in rebalancing the economy toward consumption-driven growth, the volatility of the economy may then increase as it starts to generate internal boom-bust cycles. These cycles would have far-reaching implications for markets that depend heavily on Chinese demand – notably, Brazil and South Africa, for which China is now the largest export market. Russia and India are somewhat more insulated, but would in no way be immune. The effects on consumer-oriented sectors may be particularly acute, as the expansion of middle-class spending patterns in the BRICS had been a key source of buoyancy amid slackening mature market demand (see **“Emerging market demand growth”**).

The Middle East: boiling over?

After uprisings in Tunisia, Egypt, Libya and beyond, can the Middle East reach a new political equilibrium? Perceptions of government stability have been overturned, and new fault lines are emerging in one of the world's most dynamic and resource-rich regions. The Egyptian military's apparent re-entry into politics has raised questions about the independence of new, popularly elected governments – and about whether regional governments will reposition their policies toward global businesses.

Over the last two years, Libya has experienced revolution, Syria civil war, Yemen a significant change in government, and Bahrain large-scale demonstrations. At the same time, many governments have promised political and economic reforms. There are reasons for optimism about regional powers' economic policy trajectories, but there are also significant downside risks associated with the possible escalation of ongoing disputes – and the implications this would have for global energy markets (see **“Political shocks”**).

Any intensification of regional conflict would carry a high risk of spillover; direct or indirect interference with Gulf shipping would disrupt supply chains and raise risk perceptions across the region. Given the US's still-substantial military presence in the Middle East, the risk of Western entanglement in a regional conflict represents a significant challenge for companies operating there. A broader military conflict involving attacks on US military facilities would raise operational risks for Western firms in the Middle East, where instances of terrorism may become more frequent and the prospect of infrastructure damage may increase. Electricity grids and key lines of communication may be targeted, and instances of cyberterrorism are also possible. The price of oil is likely to spike dramatically in such a situation, possibly above US\$150 – pushing up inflation and denting the growth outlook across mature and rapid-growth markets alike.

Cyber conflict: the shape of warfare to come?

A fundamental shift in the nature of conflict – from the battlefield to cyberspace – is the final emerging challenge potentially faced. Organized state and non-state cyberattacks may focus heavily on commercial assets and civilian infrastructure. Rather than inflicting physical damage on utilities or telecommunications networks, key infrastructure could be shut down without a single shot being fired.

“The likelihood and potential costs of such cyber conflicts are growing, with prominent examples witnessed within the oil and gas sector during 2012. An ongoing increase in technology dependency has created a far more complex, interconnected and networked world,” says Ernst & Young’s Japan IT Risk and Assurance Leader Haruyoshi Yokokawa (see **“Emerging technologies”**).

Cyber-conflict engagements profoundly favor the attacker due to a combination of limited attribution, no requirement for geographic proximity, low cost of entry, and rapid operational pace. Technological advances relating to defenses are always likely to lag behind.

The growth of organized cyber attacks, either with or without the backing of nation states, has as its precedent the 2010 Stuxnet virus. As the first example of “weaponized” malware engineered to identify and attack a physical target, it marked a new benchmark for sophistication in this area. An attack of a similar sophistication, but on a larger scale, may lead to a considerably more severe outcome. In 2008, the World Economic Forum put the cost of a major “critical information infrastructure” failure at US\$250 billion – this will only have escalated since then as more critical functions have moved online. Further, cyber-terrorist cells may be able to seize control of infrastructure, compromising national security, potentially triggering major diplomatic repercussions – and incurring massive costs for the companies that own and operate these infrastructure assets.

Conclusion

By highlighting these emerging challenges, we aim to invite readers to reconsider their assumptions about the wider geopolitical and economic context, as part of efforts to stress test their company’s strategy. Each of these issues has direct business implications, from considering which markets represent the most promising growth opportunities, to developing proactive strategies and technologies to engage in cyber defense.

Anticipating and adapting to these possible emerging challenges fosters a culture of flexibility and nimbleness – putting companies in a better position to respond to inevitable global uncertainties, even if some or any of these risks do not come to pass.





Methodology

Risk and opportunity identification

The initial stage of the process involved identifying key risks and opportunities, both for global businesses across sectors and within each sector itself.

For each sector, as well as for the global report, we spoke to at least five experts in each field, asking them to identify what they thought were the leading risks and opportunities for the 2013-15 period.

We asked the interviewees to focus particularly on risks and opportunities for multinational, global organizations within their sector. We narrowed the final list down to 15 risks and 15 opportunities per sector, which then were used as a basis for ranking in the next stage of the process.

Ranking the top 10

This stage involved a large-scale survey of 641 companies across the world. For the survey, we asked whether individual risks and opportunities within the report were important for their organization both now and in two years' time.

Respondents to the survey rated each risk and opportunity between 1 (not important) and 10 (extremely important). The results were then aggregated; the 10 risks and opportunities with the highest mean score then became the top 10 risks and opportunities.

During the survey, we also asked executives who, in terms of job title and function, was responsible for individual risks and opportunities within their firm.

Understanding the impact of and firms' response to the top 10

We then interviewed a number of senior executives at major organizations within their field to understand how individual firms see these risks and opportunities impacting them, and how they go about responding to individual risks and opportunities.

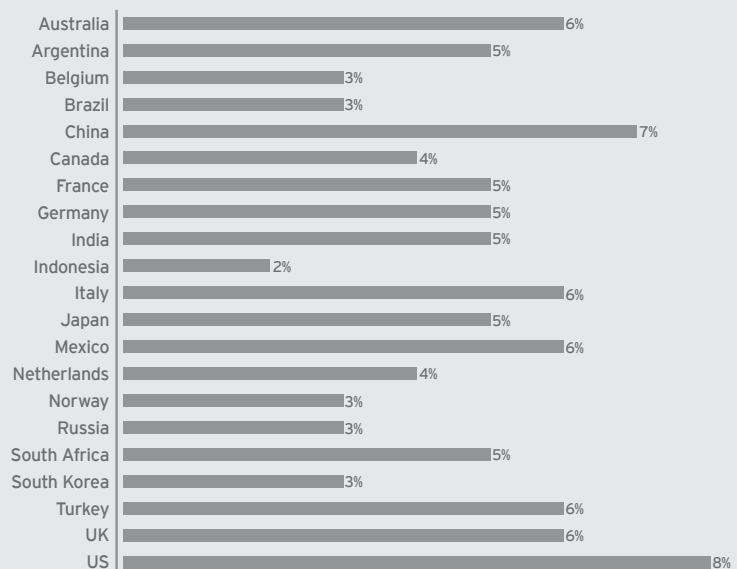
The interviewees were asked to identify three risks and opportunities particularly relevant to them. They were asked five questions for each of those they identified:

- ▶ What has been the impact of these risks and opportunities on your organization?
- ▶ Have they increased in importance over the last two years? If so, why?
- ▶ How has your organization dealt with these risks and opportunities? What approach have they taken?
- ▶ What would your advice be to others facing these risks and opportunities?
- ▶ Are these risks and opportunities likely to become greater between now and 2015?

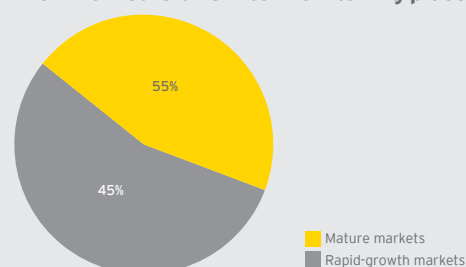
We also asked firms about the nature and structure of their risk management functions, and whether or not this had recently changed.

Additionally, we interviewed our own Ernst & Young practice professionals to get their take on the impact of these risks and opportunities, and how they see firms responding to them.

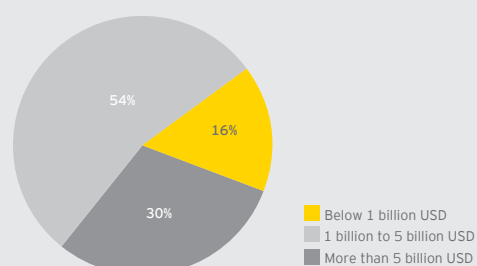
In which country is this interview taking place?



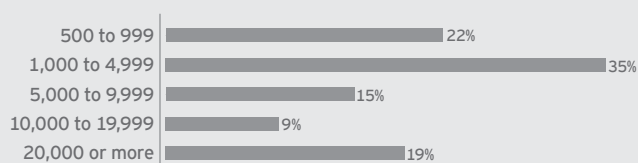
In which market is this interview taking place?



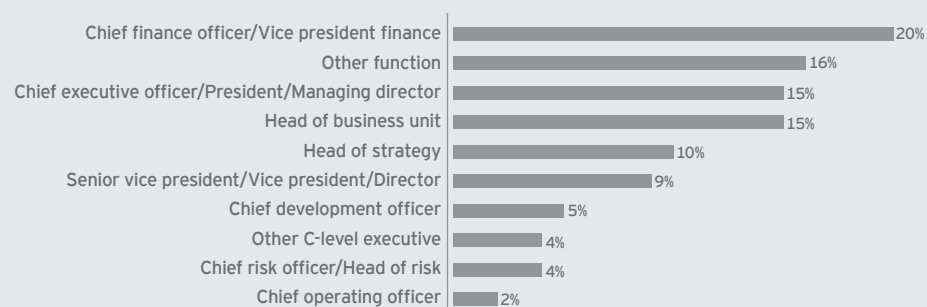
What was the sales revenue (roughly) worldwide?



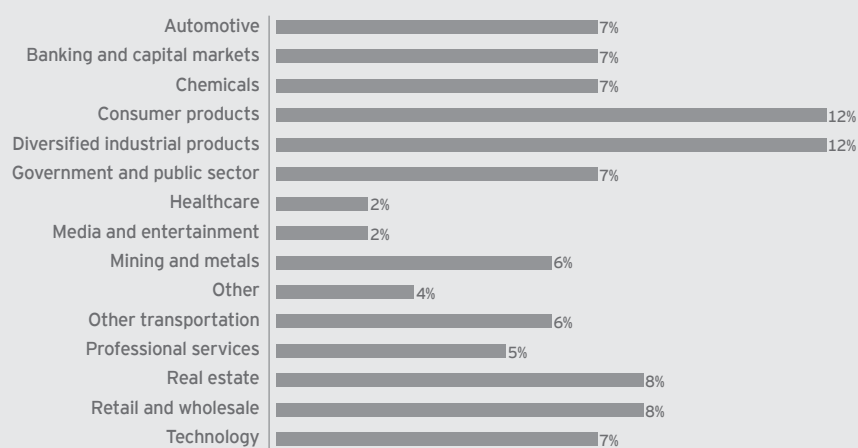
How many employees does your organization have?



In which function do you work professionally at the moment?



Which industry or sector does your organization primarily belong to?



Appendix

Risks and opportunities below the radar

The risks and opportunities that formed part of our top 15, but did not make it into the top 10 following our large-scale survey, are listed below.

Risks

11. Access to credit
12. Business model redundancy
13. Inability to innovate
14. Taxation risk
15. Social acceptance risk and CSR

Opportunities

11. Building regulator confidence
12. Mergers and acquisitions
13. Restructuring of business and disposals: corporate activity
14. Cross-sector cooperation and alliances
15. Public-private partnerships



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