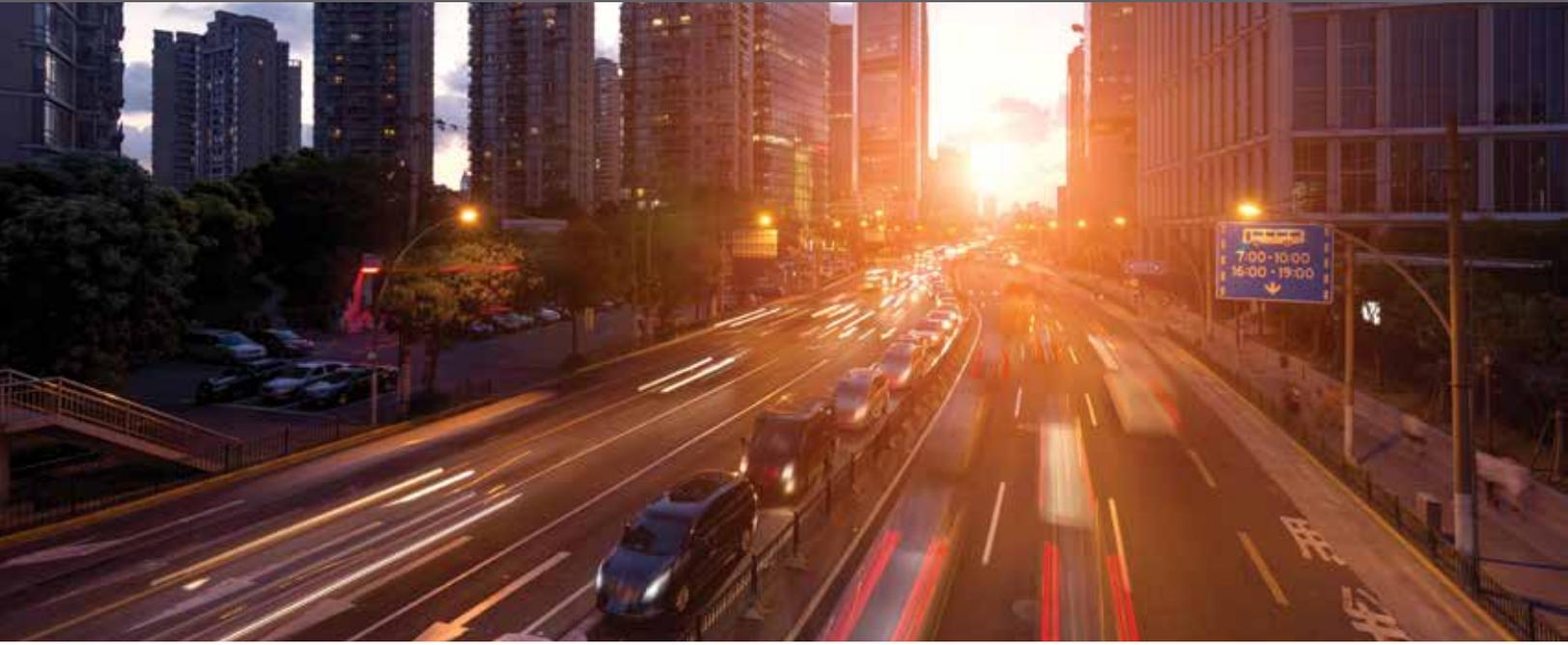


THE LAUDER GLOBAL BUSINESS INSIGHT REPORT 2017

# CHANGE ON A GLOBAL SCALE



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## CHANGE ON A GLOBAL SCALE

Irish playwright and avant-garde thinker George Bernard Shaw, who was awarded the Nobel Prize for literature in 1925, once wrote that, “Progress is impossible without change, and those who cannot change their minds cannot change anything.” Nearly a century later, his words couldn’t ring more true. Across the globe, nations continue to struggle with change. The effort to shed steadfast traditions, entrenched processes and institutionalized thought in order to embrace the new is far more difficult than even a visionary like Shaw could have imagined.

Yet nations persevere in the face of daunting challenges, knowing that progress is the only path to rebuilding and strengthening their economies. Business leaders, policy makers and ordinary citizens are coming together to effect change and create a better tomorrow. As they look to what worked in the past, they face the future knowing that growing pains are inevitable. In this special report, students from the Joseph H. Lauder Institute of Management & International Studies traveled the globe to offer unique perspectives gleaned from interviews, observation and research into the struggle for self-improvement.

In Kenya, leaders are experimenting with new ideas to push past the business-as-usual tactics that have historically stymied growth. The private sector is stepping up to fill the void left by the public sector, and organizations are using social enterprise to generate employment. Markets around the world are also keeping up with changing consumer tastes. In Latin America, for example, a burgeoning middle class is willing to pay a little more for specialty coffee, while beer aficionados are falling in love with pricey craft beers. Meanwhile in China, leaders are taking elements from Western economic policies in the effort to stimulate growth at home.

From a small shift to a sea change, transformation is taking place around the world. Some countries will win; others won’t be so successful. The road is undoubtedly long and fraught with hardships. But for those who persist, the payoff will be immeasurable.

## **THE IMPACT OF TECHNOLOGY ON EMERGING MARKETS**

- 2 Chasing China's Changing Consumers: The Race for Millennial Wallets
- 6 E-Commerce in Colombia: The Future in a Click
- 10 Trust-based Consumer Recommendations: A Case Study in Kenyan Entrepreneurship
- 14 Cultivating a Startup Ecosystem in France

## **TRENDS IN CONSUMER BEHAVIOR**

- 18 Beer in Latin America: A David and Goliath Story
- 22 The Delicate Balance Between Economic Progress and Environmental Impact
- 25 Gauging the Possibility of Change in Japan's Economic Future
- 28 A Village Changed: How Policy and Conservation Impact Urbanization in India
- 31 Germany's Shifting Consumer Behavior
- 35 Waking Up to Growth: The Emergence of Third-wave Coffee in South America

## **EXPLORING NEW MODELS FOR GROWTH**

- 38 Fostering Economic Growth in Sub-Saharan Africa Through Social Enterprise
- 42 Brazil's Labor Market: Weathering the Unemployment Storm
- 46 Understanding Brazil's Economic Crisis: A Lost Opportunity or a New Beginning?
- 50 Supply-side Economics, with Chinese Characteristics
- 53 Uniting a Nation: Colombia's Ambitious Infrastructure Program
- 56 Kenya's Startup Scene: How Private-sector Innovations Are Filling Gaps in Public-sector Services

## **BACK TO THE FUTURE: HOW HISTORY SHAPES PROGRESS**

- 60 Cameroon's Colonial Legacy: Lessons for the Modern Day
- 63 The Effects of China's Population Policies
- 66 Venture Capital in Europe and the United States: Differences in Economy and Culture
- 69 How Cameroon's Informal Sector Powers Its Economy
- 73 Commercial Real Estate in Russia in a Time of Crisis



## Chasing China's Changing Consumers: The Race for Millennial Wallets

China is simultaneously old and young, rich and poor, developing and developed. The diversity of the country's economy, demography and urban income distribution presents a major challenge for firms seeking to win customers in this critical market. One key step to success involves understanding and adapting to China's millennials, a coveted taste-making group with growing spending power. Yet the generations born after the 1978 marketization reforms are themselves rapidly changing. Keeping up with their evolving mindsets and purchasing behaviors is a race that continues to determine which consumer companies lead in the country.

### Young Consumers Take Center Stage

Discussions about China's economy over the past year have focused rightly on rising macro headwinds. Structural rebalancing and an aging population indeed promise lower GDP growth now and into the future. Yet at the same

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As government and party officials now acknowledge, China's economy is entering a 'new normal,' an era of slower but ideally more sustainable growth.

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time, excitement about China's young consumers is not misplaced: The country may be slowing down and getting

older, but its millennials are primed to become a driving force behind new growth.

As government and party officials now acknowledge, China's economy is entering a "new normal," an era of slower but ideally more sustainable growth. Thus, annual GDP growth targets have been lowered to 5%-6%. Behind the expected slowdown in headline growth, the government is also attempting to move the domestic economy away from exports and investment and toward private consumption. This rebalancing imperative signals an opportunity for consumers to enjoy a larger share of any gains.

Similarly, demographic trends certainly indicate that China is graying. According to Euromonitor, a market research firm, the country's 65-and-older population is projected to total 247 million by 2030, increasing by 85.3% from 133 million in 2015, and rising from 9.7% of the total population in 2015 to 17% in 2030. This rapidly aging population will present

significant implications for the government's social spending and the health care system.

But from a global perspective, China's millennial generation remains a remarkably large segment of the population with massive growth potential. With 410 million people ages 16-35, the country has nearly five times more millennials than the United States (87 million). In fact, its millennials outnumber the combined total working-age population of the U.S. and Western Europe. Equally important, they comprise a group with growing spending power. Its aggregate income is forecasted to grow by \$3 trillion between 2015 and 2025, with average income in dollar terms rising from \$5,900 to \$13,000, according to Goldman Sachs. Similarly, Boston Consulting Group notes in a 2015 report that millennials are now driving consumption in China, with their "consumption growing at a 14% annual rate — twice the pace of consumers older than 35." The firm predicts that their consumption will amount to 53% of the total rate in China by 2020.

## Understanding Millennials' Changing Preferences

As millennials continue to emerge as a critically important consumer demographic in China, companies need to adjust their local strategies accordingly, tailoring both their product mix and distribution channels. Targeting millennials, however, requires a change in mindset for companies as the group's preferences/needs strongly diverge from those of older consumer segments. A 2011 consumer research study conducted by the MSL group, a communications company, highlights how the Chinese consumer has moved "from the collective to the individual." Compared to older generations who focus on family needs first, millennials — those born in the 1980s and 1990s — focus on their own needs and those of their friends. Instead of fearing change, they are adapting to a globalized, changing world. They are more likely to create trends than follow them. They're on the internet and on their mobile devices. They are more willing to upgrade their consumer experience, looking to trade up from their current lifestyle. Often, they're looking to have new experiences, rather than just products alone. In a 2014 study, Zenithoptimedia, a media-planning company, classifies China's millennials as a "unique, independent group seeking new experiences and interesting products; [they're] obsessed with the mobile, digital lifestyle."

To understand and target millennials on an even deeper level, the distinctions between those born in the 1980s and those born in the 1990s must also be examined. These two groups differ in their priorities, how they use the internet and also how they see themselves. The former is focused on their friends and social group, while the latter is focused on themselves. The former is the first internet generation. They're comfortable with finding information online and have used social media from an early age, making the internet a social platform for them. The latter are the pampered generation. They want to be unique and concentrate on their individualism. Accordingly, they see the internet as a place to shape their own image. To truly understand millennials and capture their preferences, companies need to understand both of these dynamics. As David Chu, an associate account director at DigitasLBI, a major advertising company, states, "Understanding the different types of millennial mindsets is key for companies [that] want to be successful in China. What they want, how to reach them, it's all constantly evolving. They're quite a departure from millennials in other regions, and it is difficult for companies to adapt to how fast Chinese millennials are changing."

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From a global perspective, China's millennial generation remains a remarkably large segment of the population with massive growth potential.

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## Business Challenges Presented by Millennials

Unlocking demand from China's discerning millennials requires meeting a series of new challenges across functional domains. Businesses competing for these consumers need to adapt product, marketing, channel and logistics operations to an environment where speed and flexibility are necessary capabilities. Creating a broad, constantly updated range of products and experiences — increasingly with customized options to satisfy "upgraders" and customers demanding originality — is a basic requirement for staying relevant. If choice is the keyword on the product side, reach is a defining

need for marketing and channel. Chinese millennials spend even more time on mobile devices than their Western counterparts, frequently learning about, researching and purchasing a product all on the go. Curating a differentiated brand experience through WeChat, the leading messaging client, and Weibo, a Twitter-like service, demands full-time attention to offense and defense as consumers offer constant feedback. Finally, backend logistics need to live up to the expectations of rapid delivery and seamless service to complete the customer-experience loop in a country that has more than 300 cities with a population of over one million. The combination of these concerns poses a complex issue for companies hoping to win over Chinese millennials.

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Chinese millennials spend even more time on mobile devices than their Western counterparts.

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### **Alibaba Learns How to Capture Millennials**

Alibaba Group, China's largest e-commerce operator, has become a household name in global business circles since its \$25 billion initial public offering in 2014, but it is perhaps still underappreciated for its strategic approach to serving the millennial demographic. Western financial media present Alibaba's access to a large consumer population with rapidly growing incomes as a driver for almost inevitable success. Yet the company's evolving strategy, which has kept young online shoppers loyal, deserves more attention as a case study in staying ahead of shifting demand.

Frequently described as China's Amazon.com, Alibaba benefitted from starting its consumer business nearly a decade after the introduction of the American e-commerce giant. But targeting a developing country lacking sophisticated payment and logistics infrastructure, Alibaba opted to create a platform for third-party merchants to reach consumers, rather than a direct-sales model. Sacrificing control over product inventory and fulfillment, it focused instead on creating a consistent user experience and developing a cash-on-delivery system to serve customers without credit cards. The resulting Taobao marketplace introduced shoppers on low budgets to a

large variety of cheap apparel and household goods from independent merchants.

This platform — which today features over eight million sellers transacting approximately \$250 billion in annual sales, according to recent investor releases — offers selection and convenience that brick-and-mortar retailers struggle to match in a market where many retailers have yet to create distribution networks extensive enough to open physical locations in smaller cities. These sellers remain with Taobao because Alibaba charges no sales commissions, choosing instead to take fees only for storefront and keyword-marketing services that feed back into improved customer experiences. As the group's CEO, Daniel Zhang, explains, "We started Taobao in 2003 when online shopping in China was virtually nonexistent. For five years, we didn't generate any revenues ... we [just] focused on acquiring users and building an ecosystem." This vision helped to grow a platform that now has more than 400 million annual buyers, over 80% of whom hail from China's millennial generation, which has come to view shopping on Taobao as a way of life. Jessica Geng, an avid user, said, "I love that Taobao is so convenient. I buy everything on there from groceries to clothing. I barely go into stores anymore."

Alibaba continues to respond to this demographic's changing preferences by introducing new marketplaces. Tmall, a platform launched in 2010 for branded stores, connects brands from Adidas to Samsung with Chinese customers who are eager to trade up while still enjoying online convenience. According to iResearch, an analytics firm, Tmall saw more than \$180 billion in 2015 sales and accounts for nearly 60% of the B2C e-commerce market in China, which has grown explosively as consumers search for name-brand clothing, cosmetics and electronics.

While the upgrading trend remains powerful, consumers are also increasingly looking for individualized products. Thus, the latest addition to Alibaba's marketplace is Tmall Global, a platform for buying directly from overseas merchants. The outlet is a response to the increasing demand for foreign brands not available in China that has been created by the rapid growth in outbound tourism. Similarly, in 2016 the company announced a reshaping of Taobao to cater to growing demand for handcrafted, original items. It hosted its first "T(echnology)A(rts)O(riginality)" Maker's

Day convention in Shanghai in July 2016 to promote this concept, attracting over 30,000 attendees.

Alibaba also has adapted its marketing and channel strategy to the emerging mobile and social media environment in which millennial consumers make purchasing decisions. While its marketplaces began firmly in the desktop era, the company used the IPO as a chance to reinvent these platforms. Growing from just 1.4% of revenue in 2013, mobile accounted for 63% of sales in its most recent fiscal year to March 2016. Alibaba also recognizes that younger shoppers learn about and promote favored brands through social media platforms. As in Western countries, China's video-sharing and social-networking apps now serve as vital influencers for e-commerce. Since 2014, Alibaba has acquired outright the largest video site in China, along with a 30% stake in Weibo, China's version of Twitter. Controlling these assets gives the company the power to offer advertisers data from a complete sequence of marketing interactions, from initial awareness through final purchase. These transactions enable Alibaba to live up to the title that Forrester Research, a technology consultancy, gave the company in a 2016 report: "the world's largest digital ecosystem."

Nevertheless, even Alibaba has not been perfect. For example, the company's recent forays into online travel and group deals have proven to be challenging. These sectors are experience-based rather than product-based, and Alibaba entered them to capitalize on the trend of consumers' growing preferences for experiences. Unfortunately, Alibaba was a late entry and has yet to challenge the existing leaders. Identifying another large market opportunity is one thing, but delivering a service that requires managing a more integrated offering is new territory.

Clearly, Alibaba has demonstrated that a platform model offers significant benefits for adapting to rapidly changing consumer tastes in China. Its flexible, asset-light approach has continually provided the company with the cash to keep developing new segments that capture the attention of key millennial customers. Regardless of its success in new trends, it continuously tries to capitalize on them because the company has learned that the one constant in chasing the young Chinese consumer is change.

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*This article was written by Roy Eriksen, Matthew Phillips and Lillian Young, members of the Lauder Class of 2018.*

# E-commerce in Colombia: The Future in a Click

Business is booming in Colombia. With over \$3 billion in online transactions in 2015, its e-commerce market is the fifth-largest in Latin America. This figure is expected to grow at a compounded annual rate of 18%, reaching nearly \$5 billion in 2018. It is enormous growth for a country whose internet penetration was a mere 59% of the population in July 2015. Even more surprising is the fact that only 16% of Colombia's internet users have made purchases online, compared with the global average of 41.3%. In a place that is increasingly safer, more connected and more visible from a commerce point of view, a number of issues still need to be resolved to guarantee long-term stable growth within the sector. Despite significant development in the investment landscape, the continued lack of funding solutions for startups, the complicated payment system and inefficient infrastructure have stalled growth.

## Financial Challenges for Budding Entrepreneurs

Interest in private equity and venture capital began in Colombia in 2007 with a new federal regulation that allowed for the creation of a government-backed venture capital fund. However, the first large private investments, the majority of which were designated for Brazil, did not enter the continent until 2009. At the same time in Colombia, the national government, a number of city councils and international funds joined forces to develop the first pillars of the country's innovative landscape. According to the Latin American Private Equity and Venture Capital Association (LAVCA), while the amount of capital available increased markedly between 2011 and 2015, Colombia still lags behind some of its more developed counterparts.

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Entrepreneurs have ridden the wave of growth but have also felt the societal limitations of a still-underdeveloped ecosystem.

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During this same period, total private equity and venture capital funding in the region equaled \$2 billion that was divided among 667 investments. But the number of successful exits represented just \$496 million spread among 60 companies. In 2015, Colombia closed five venture capital funds with a total invested capital of \$82 million, compared with 19 funds in Mexico and 36 funds in Brazil. Nevertheless, in analyzing Colombia's trajectory over this period, its

growth rate since raising the first fund in 2013 has greatly surpassed that of its neighbors.

Turning specifically to the e-commerce space, according to LAVCA, between 2011 and 2015 investment in Latin America reached \$112.7 million, the second-highest of all sectors after financial technology. In addition, the region has led the world in smartphone adoption. Colombia alone had 14.4 million smartphone users as of 2014 and was second only to China in terms of e-commerce growth.

Medellín's rapid growth as an innovation hub has been nothing short of impressive. Following years of violence and drug trafficking, the city has effectively rebranded itself as a center for startups. It is not surprising that Citi and the *Wall Street Journal* in 2013 jointly named the city the most innovative of the year. This led to a number of prestigious honors for Medellín, including hosting the 2016 Global Entrepreneurship Congress and the 2016 Latin American World Fair, which both provided international exposure. The mayor's office has supported a plan for the city to become the innovation capital of Latin America by 2021.

Entrepreneurs have ridden the wave of growth but have also felt the societal limitations of a still-underdeveloped ecosystem. Kenneth Mendiwelson, founder and chief executive officer of Refinancia, a specialty loan provider in Bogotá, notes the need for entrepreneurial role models and successful exits in order to incentivize new founders and attract capital to grow the Colombian market. At the same time, Esteban Mancuso, founder of Velum Ventures, cites the need for favorable regulations, market transparency and educational resources for the new wave of entrepreneurs.

## The Real Cost of Payments

Like many developing markets around the world, Colombia has a burgeoning system of payment methods that poses many challenges for new and existing e-commerce businesses — primarily the prevalence of credit cards, the variety of payment methods and fraud. Fortunately, each of these areas is moving toward a more efficient system that should help ease the process and increase the number of transactions in the e-commerce market in the near term.

While payment card (credit, debit, store, etc.) spending in Latin America is expected to reach \$2 trillion in 2018, Colombia's share of that total remains small behind Chile, Argentina, Venezuela, Mexico and Brazil (Brazil alone represents about 50% of the total). Less than half of the country's population owns a credit card, amounting to 0.7 cards per resident. Brazilians hold 2.6 cards per inhabitant, a figure similar to that found in the U.S.

However, there has been a push to increase payment card usage across Colombia. Many more stores and locations are implementing point-of-sale (POS) terminals to accept cards issued by the country's main processors: CredibanCo and Redeban. This initiative is expected to add more than 100,000 POS terminals in many industries, including some that never had them previously (e.g., taxi companies). It is also likely to improve the supporting POS technology. This will allow for more Colombians in a typically cash-centered environment to become more card friendly. This trend will also directly impact e-commerce purchases; more people will be accustomed to using payment cards and more likely to purchase online.

Currently, online transactions in Colombia are paid through a variety of methods, including credit cards (39%), cash (25%), debit cards/bank deposits (23%), PayPal (7%, although the company closed its operations there in 2016) and bank transfers (6%). Prepaid cards are omitted because they comprise a negligible share of the market. However, they hold huge potential for the tens of millions of Colombians who don't have bank accounts (35% of the population in 2013). This segment of the population is not financially inept. In fact, many of them add credit to their phones, as is common in most of Latin America.

Managing payment methods can be complex as they directly impact the top line of e-commerce companies. This is critical, especially in the case of developing markets such as Colombia. These companies would like to ease the process for any consumer who is willing to buy their products. Thus, they must accommodate the range of payment methods that consumers are comfortable with. There are also more creative alternatives, such as including payment with a monthly utility bill. At the same time, payment methods can be employed to increase sales, as with credit card promotions. Most countries in Latin America also utilize a *cuota* system in which customers pay off credit card purchases in installments. This popular financing method incentivizes spending, and many e-commerce companies (e.g., Mercado Libre and Linio) work with banks or payment service providers to offer promotions.

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Online retailers face fierce competition from both traditional retailers and international e-commerce players.

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Cash continues to be a common payment method in Colombia, even though e-commerce companies would like to move away from it. This method can be separated into two distinct categories: prepaid and postpaid. The former comprises a smaller share of the sector and refers to bank transfers and online cash payment providers such as Baloto and Efecty. For example, customers who make a cash purchase on an e-commerce site receive a reference number. They then go to one of the POS locations for Baloto or Efecty to pay for their order in cash. The online provider signals the e-commerce site, and the order is processed. In the latter case, a customer orders online and pays the delivery person.

Cash payments are problematic for e-commerce companies for a number of reasons. Generally, they carry higher costs when compared with credit cards. In addition, if a customer decides to decline the product or the delivery company can't find the customer, then the originating company usually needs to cover the additional return costs. Finally, this payment method generally tends to tie up working capital

because the money is not deposited immediately into the companies' bank accounts, as occurs with most credit card payments. E-commerce companies could be waiting several weeks to receive the money for shipped inventory.

Even though credit cards are a sound solution for e-commerce companies, they are not without their flaws. Fraud remains a big problem in developing countries such as Colombia and has led many companies to implement prevention tools and techniques.

## A Culture of Distrust

In Colombian society today, "there is still a great distrust in online transactions," according to Alberto Samuel Yohai, president of the Chamber of Information Technology and Telecommunications in Colombia.

Consumers' level of distrust toward internet sellers in Colombia is indeed staggering. Over 90% of the respondents surveyed for this article flagged "internet fraud" as their greatest concern when shopping online. Other studies show that 80% of Colombia's potential online consumers will not make internet purchases until they see significant improvement in security in this sector.

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Cash continues to be a common payment method in Colombia, even though e-commerce companies would like to move away from it.

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On the surface, this sense of distrust seems to be justified given Latin America's underdeveloped online payment infrastructure and the frequency of internet fraud. However, studies have shown consistently that Colombian consumers' perceived security risk is significantly greater than the actual risk associated with online purchases. This may explain why Colombia's e-commerce adoption rate still lags behind that of other countries in the region such as Mexico and Brazil, whose security risks are similar.

According to Diego Navarro, managing director of online retailer Linio Colombia, this phenomenon stems from cultural norms. He notes that Colombians, in comparison

to Brazilians or Mexicans, are more conservative and risk-averse by nature. They are more cautious about virtual vendors and less willing to experiment with new technologies when making purchase decisions.

Mariana Lima, a Brazilian entrepreneur, expands on Navarro's theory by analyzing her customers' online payment habits. She offers three options: credit, debit or Boleto Bancario — a more secure but slightly more complicated payment process that offers a 5% discount. She has found that credit card payments are still the most popular method. An overwhelming 85% to 90% pay via credit card, and less than 5% pay via Boleto Bancario. These results effectively demonstrate that Brazilian consumers value convenience over price or security, in contrast to Colombian consumers who regularly rank security over price and price over convenience. Brazilian consumers are better-suited to the e-commerce model, whereas Colombian consumers' needs for now are better met by traditional brick-and-mortar stores. Only time will tell if they will adjust to the use of credit cards.

## The Colombian Supplier

The greatest challenges for Colombian e-commerce players are the scalability of their businesses, competition from traditional brick-and-mortar stores and dominant international players.

Unlike physical stores in the United States or Europe, whose sales have continued to decline steeply over the past decade due to uncompetitive prices and an increasingly unsustainable business model, brick-and-mortar stores in Colombia remain extremely competitive. The relatively inexpensive cost of commercial real estate and the presence of a large informal sector in the retail industry allow store owners to save a significant amount in overhead while reporting and paying less sales tax to the authorities.

This is bad news for online retailers because it significantly lowers their competitive advantage over traditional retailers, effectively eroding their value proposition to consumers. Online retailers face fierce competition from both traditional retailers and international e-commerce players. Nearly half of the Colombian population purchases from sites abroad, the two most popular being Amazon in the U.S. and Aliexpress in China, which offers free shipping.

China's extremely low production costs create intense price pressure for Colombian players. The price difference is often large enough that consumers are willing to wait up to three months for their purchases to arrive in order to take advantage of the lower costs that Aliexpress offers.

## **The Future in a Click**

Despite the challenges the e-commerce industry continues to face in Colombia, the next few years will become brighter

as the investment landscape improves and conditions for both buyers and sellers become more favorable. Infrastructure development should boost the long-term viability of e-commerce platforms. Thus, this is definitely an interesting time to be an entrepreneur in Colombia.

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*This article was written by Anne-Marie Firth, David Lobo and Rebecca Tse, members of the Lauder class of 2018.*

# Trust-based Consumer Recommendations: A Case Study in Kenyan Entrepreneurship

When locals, expatriates and tourists alike choose to hail a cab in Nairobi, Kenya, the most important consideration is often the driver. Fare, convenience and vehicle comfort are indeed factors. But in a city plagued with security concerns, the trust between the taxi driver and the rider is paramount. Consequently, passengers in Nairobi rely heavily on favorite taxi drivers and prefer referrals from reliable sources such as family and friends.

This issue of trust led Jason Eisen and Bastian Blankenburg to create Maramoja in 2015. It's a mobile and web application that allows users to choose from a selection of taxi drivers who are "trusted" by other members in the network. Once a user signs up, the app will request permission to scan the user's phone book to identify favorite drivers. These drivers make up Maramoja's taxi ecosystem. Each driver is then assigned an individual "trust score," which is calculated via an algorithm that assesses the degree of connection between the driver and the rider. When a user opens Maramoja to hail a cab, the app shows all the available drivers in the vicinity along with their assigned "trust scores." Once the user selects a driver, the app sets up the pickup location.

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Trust has yet to be applied within the context of technology.

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Like many entrepreneurial ventures originating in Africa, Maramoja is designed to solve a problem unique to the region: A Kenyan passenger must trust the driver before any services are rendered. Could this particular trust-based recommendation model have wider and more profound applications in the sharing economy and e-commerce space? How viable is this model outside the context of cab-hailing in Nairobi? Could an innovative solution developed in Kenya be adopted by the tech giants in the Silicon Valley?

## The Landscape of Online Consumer Recommendations

When it comes to consumer recommendations, the world is dominated by the five-star rating system. The main issue with this system is that a product or service's rating represents only the average of all the ratings given by users who are unknown to the customer. Unfortunately, this doesn't address the human concept of trust. "Trust is the main currency of the sharing economy," says Eisen. "Who do you trust? Not the people who have five-star ratings on Amazon and eBay. You trust the people you know."

In an experiment conducted by Maramoja, 96% of the time users selected a socially endorsed driver with less than a five-star rating over a socially unendorsed driver with a five-star rating. Trust has yet to be applied within the context of technology. The five-star rating system is very attractive for companies to employ for analysis because the data points represent transactional data. However, to assess trust properly, companies would need to collect relational rather than transactional data.

The five-star rating system also has an inconsistency issue. The threshold above which a product or service is deemed "good" varies by both company and user. As Eisen explains, "the five-star rating system means different things to different people. There is no consensus on what a four-star rating versus a five-star rating really means. You may be giving a four-star rating and thinking you're giving a good rating, but you are actually giving a failing grade." In the case of transportation service Uber, a rider who gives a driver

less than a five-star rating must provide feedback, meaning that anything below five stars represents poor customer service. Thus, it's virtually impossible to distinguish between "exceptional" and "nothing-to-complain-about" service because both get a five-star rating.

Other companies use this rating system but add a more personal twist. For example, e-commerce giants Amazon and eBay will not allow a customer to submit a rating without providing a supporting comment. This forces users to be more thoughtful when assigning a rating, which gets closer to a more trustworthy review system. However, unlike Uber's case, where a rider must review a previous driver before ordering a new ride, Amazon and eBay do not force their users to submit ratings. While the advantage is more thoughtful reviews, the drawback is there are fewer of them. Customer ratings are very important in the field of e-commerce, where even a 0.5% increase in conversion could have a huge impact on the bottom line, given the transaction volumes of companies like Amazon and eBay.

The App Store and Yelp both have review systems with the lowest barrier to entry for reviewers, which casts further doubt on how much these reviews can be trusted. The former's system gains more credibility as the app gains more users. When a new app is launched, it typically has a few five-star reviews, likely submitted by the app's designers and their families and friends to help get it off the ground. With the latter system, a new restaurant will first have a few five-star ratings from its owners and their families and friends. Adding to this bias, Yelp was recently involved in a public relations scandal over an alleged ploy to allow restaurants to pay for positive reviews.

The five-star rating system has the benefit of offering some level of insight into customers' experiences, but it also has significant drawbacks. The biggest one is that it doesn't address the issue of trust. It's also inconsistent across companies and users. Finally, it fails to account properly for extreme experiences.

## Innovation in Africa

Maramoja is one of many innovative startups in Nairobi. Observers are also familiar with the astonishing success

of mobile money transfer and financing service M-Pesa, which brought Kenya international recognition as an entrepreneurship and innovation hub in Africa. Other ventures, such as BRCK, a company that has developed a self-powered, mobile Wi-Fi and router device, also contribute to Nairobi's entrepreneurial ecosystem.

Maramoja exemplifies a shift away from the traditional epicenter of innovation and development. While much of the world's high-tech development originated from Silicon Valley, people in developing countries are now trying to replicate this ecosystem locally. Local companies performing product development and innovation in their home markets can better address the needs of their local consumers. Erik Hersman, chief executive officer of BRCK, asks: "Why are we using hardware developed in Silicon Valley if we are living in Kenya, where the conditions are completely different? Our goal is to develop products by Africans for Africans."

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While much of the world's high-tech development originated from Silicon Valley, people in developing countries are trying to replicate this ecosystem locally.

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This shift underlies a larger transition from a unilateral to a multilateral innovation paradigm. Supported by the infrastructure and skills provided by innovation hubs, hacker spaces and coding schools such as iHub and Moringa School, global innovation flows are gradually shifting. In the past, Western companies innovated and developed products at their headquarters, then exported them globally. Currently, local companies in developing countries innovate their own products to fit local market requirements. The natural next step will be a reversed flow, where innovations from developing countries are transferred to developed countries.

Maramoja exemplifies a company from Africa that developed a technology that could be transferred to more developed countries. While the innovation itself derived from the

necessity to provide security for the app's users, it has a wide range of potential applications across the world.

## Potential Applications of Trust-based Recommendations

How viable is this trust-based recommendation model outside the context of hailing cabs in Kenya? It has great potential, but several major issues and risks need to be addressed. First, companies trying to establish a two-way marketplace can succeed only if they reach critical mass. In the context of trust-based recommendations, only members of a user's tight network can provide this. To ensure that recommendations are trustworthy, customers need to be part of a community (e.g., family and friends). As Eisen points out, people "don't trust everyone equally."

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Second, trust-based recommendations are most helpful to those who use them for urgent, high-frequency products and services, such as the last-minute need for a baby-sitter. Consumers can afford to spend more time on research when they have sufficient lead time, but when that's not the case, trust-based recommendations are especially critical.

Third, trust-based recommendations are important for high-stakes services. Finding a safe and reliable driver may not be as much of a concern in the developed world, but it is of great concern in Kenya. In developed countries, critical industries could be services with access to people's homes (e.g., house cleaning or lawn care) or health and family (e.g., child care). Currently, consumers commonly rely on word-of-mouth recommendations from personal networks, and it is unlikely they would trust traditional five-star ratings in these high-stakes environments. Trust-based recommendations, however, could solve this issue.

Although e-commerce is not considered a high-stakes environment, it is another area that could benefit from trust-based recommendations in developing countries. Increasing consumer trust could lead to greater online sales as well as customer satisfaction.

Nevertheless, significant risks remain. First, potential users might not want to share their favorite service for fear of missing out in a future overbooking situation. In the case of Maramoja, a user might be unwilling to recommend a favorite driver in order to increase his or her chances of using the driver's services at any time. Consumers may also argue that they have no time to provide recommendations or write reviews. Ultimately, a shift from a mindset of scarcity to one of building a broad and beneficial database of great products and services for someone's network is needed and should be promoted. One possible solution is setting up a ranking structure that rewards users who proactively share their favorite service providers and reviews.

Second, even though recommendations remain within a user's network, that person might prefer to share their recommendations with only a specific set of family and friends. Companies could address this concern by, as Eisen suggests, "giving the user very granular control in his or her decision about what, when and with whom to share information." Personalized, restricted lists of family and friends, as observed currently with Facebook, would be one option to address this.

Third, companies need to address a lack of tech experience and adaptability. While digital natives adapt easily to new technologies, older generations might struggle. However, many of the relevant industries mentioned above (e.g., home services and childcare) revolve around older demographics. Companies can address this issue directly through increased marketing to the targeted generations or indirectly by incentivizing tech-savvy millennials to encourage their parent generations to use their services. The fact that tech adoption in the 35+ age demographic has been increasing by 25% over the past three years is reason to be optimistic that the new trust-based economy will not leave anyone behind.

Finally, the trust-based recommendation model can limit companies in their ability to influence consumers' buying choices — i.e., targeted marketing efforts might become less effective. The model relies solely on users' individual preferences. In this case, reliable and fast customer service is crucial. As seen today in the social media sector, this is a risk that many firms already manage well through dedicated teams that listen and react quickly to customers' feedback.

Eisen and Blankenburg posed the question of trust. The answer was something they already knew: Consumers

trust their families and friends. The universality of this issue offers Maramoja the chance to leverage its recommendation system for a wide variety of geographies and industries. It also presents an opportunity for Kenya to lead the way in the new multilateral paradigm of innovation.

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*This paper was written by Matei Dăian, Alexandra Dombrowski, Richard Koo and Dominik Pederzani, members of the Lauder Class of 2018.*

# Cultivating a Startup Ecosystem in France

An often-repeated joke about the French is that their national sport is going on strike — or as they would say, *faire la grève*. While delivered in jest, it speaks volumes about the particular French attitude toward work and how that attitude is perceived by outside observers. The stereotype of a French worker as one who enjoys an hourlong lunch, a 35-hour work week and monthlong vacations is not always representative of the working reality, but it can have serious ramifications for the country.

Workers' social benefits are a sacred subject in France, one of the first countries to guarantee comprehensive labor rights to its citizens. In 1864, French workers were given the right to strike, and over the ensuing years national labor regulations expanded as workers were granted such social rights as unionization, reduced work-week hours, remunerated vacations and a generous minimum salary. This history has led to the particularly labor-friendly working laws seen in France today. A 2015 Eurostat study notes that the French labor the least of all Europeans, spending on average 1,646 hours at work annually and on average 10.6 weeks absent each year (through a combination of paid vacation, sick days, holidays, maternity/paternity leave and compensation for overtime).

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Part of France's slow and cautious entry into the global startup scene can be attributed to its culture and work attitudes, which many consider to be extremely risk-averse.

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However, France's "work to live" ideal has come under debate as globalization and rapid technological changes are altering market dynamics and disrupting the old labor framework. While other countries have embraced these changes, and urban centers including San Francisco, Tel Aviv, Berlin and Dubai have benefited from fostering cultures of innovation and entrepreneurship, France has been overshadowed by its faster-growing peers. French business owners, policymakers and everyday workers alike are now grappling with if and how their country can adapt to the new global economic scenario and maintain both its globally competitive position and unique workers' rights.

The next few years could be a potential watershed moment for France. The combination of shifting domestic political attitudes, a gradual cultural embrace of entrepreneurship and a continental realignment following the United Kingdom's decision to leave the European Union (Brexit) presents a unique opportunity that the country must seize in order to grow and compete in the new global and technologically driven economy.

## Political Shift: Campaign Promises vs. Reality

Since the Great Recession of 2008, France's economy has remained largely stagnant with persistently high unemployment rates, particularly among the country's youth. In August 2016, the unemployment rate finally dropped below 10% for the first time in four years, and youth unemployment also dropped to a still-significant 24.3%. In comparison, unemployment rates in the U.K. and Germany are 4.9% and 4.2%, respectively.

This slow recovery has motivated French President François Hollande to adopt a more welcoming attitude toward businesses by attracting outside investments and encouraging home-grown startups. In contrast to many of his key campaign promises — such as raising the corporate tax rate, increasing taxes on bank profits and imposing a 75% top-income tax rate, which he has failed to deliver — he has successfully introduced many tax incentives to attract and retain entrepreneurs and investors. The government promoted not only the creation of a national community, La French Tech, to unite, organize and boost the French startup ecosystem, but also introduced tax cuts for every startup's first eight years and lower tax rates on venture capitalist investments and capital gains rates. These pro-business moves put France's policies closer to those of the U.K. and Germany. Such incentives resulted in 1,000 to 1,500 startups being created in France in 2015, according to French Minister of the Economy Emmanuel Macron.

A cornerstone of Hollande's efforts to revitalize French growth has been a reform of the country's labor laws. A bill referred to as the El Khomri Law (after Labor Minister Myriam El Khomri) or the *Loi Travail* aims to implement "new freedoms and protections for businesses and workers" and to reform France's generous labor laws to be more in line with those of other countries. Although the law was greeted with significant outcry, including protests and strikes in the summer of 2016, Hollande and Prime Minister Manuel Valls forced its approval by bypassing a skeptical French senate through rarely used executive power. This reform will have far-reaching implications for nearly every aspect of French work life. Proposed key updates to the legal code include an increase in the maximum number of working hours per week from 35 to 39, an easing of hiring and firing policies (particularly in times of economic distress) and a limit on the length and value of social services available in the event of layoffs.

Despite the significant economic difficulties and stagnating growth France has experienced in recent years, it remains the sixth-largest economy in the world. By recognizing the importance of tech entrepreneurship and incentivizing its growth, the French government is helping to create outlets for large numbers of well-educated youth and to stop the brain drain that has been plaguing the country.

## **A Cultural Shift From Failing to Flourishing**

Part of France's slow and cautious entry into the global startup scene can be attributed to its culture and work attitudes, which many consider to be extremely risk-averse. While Silicon Valley and the startup culture at large place a premium on failing fast and learning from the failure, in school and at work the French prefer to ignore misses and learn only from successes. Rachel Vanier, head of communications at Paris's soon-to-launch startup campus Station F, believes this attitude develops from a young age. "Historically in France, we do not have a culture that promotes taking risks. In school, the French learn that failure is forbidden," she said. The rejection of failure hinders France's entry into the startup market as a hub for entrepreneurs.

This national avoidance of failure also manifests itself in France's venture capital culture, where investors have higher expectations of early profitability than their American counterparts do. The demand for early returns has two key

outcomes. First, raising second or third rounds of funding becomes exceedingly difficult for French entrepreneurs as expectations for rapid success increase. Second, French entrepreneurs often focus on small, niche markets for their businesses, favoring more immediate profitability from a small-scale enterprise than potentially greater earnings and growth from an organization with more ambitious target markets and goals. As Katie Ilharreborde, product and marketing lead at ridesharing service BlaBlaCar, explains, "the big issue in France is its rapid readiness to downsize and specialize in a given industry for a small, addressable market." Notably, this niche mindset compels French entrepreneurs to focus solely on the domestic market.

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The rejection of failure hinders France's entry into the startup market as a hub for entrepreneurs.

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However, there is evidence to show that this culture is slowly changing and that the French startup scene shows growth and promise. Ilharreborde points to France's *crédit d'impôt recherche* (CIR), a research and development tax credit for French businesses investing in technology and innovation efforts, as a potential means for French startups to overcome the traditional culture against failure. Moreover, the sheer volume of startups in France indicates that young people are experimenting with technology and innovation despite the traditional education system. In fact, almost as many French companies attended the 2016 Consumer Electronics Show (CES), the largest trade show in the world for consumer electronics and technology, as American startups did.

While government investments, such as the aforementioned La French Tech, demonstrate a move toward more overt state-sponsored support of entrepreneurship, initiatives by private individuals have also helped the cultural conversation and support advance quickly. Xavier Niel, founder of French telecom Free and one of France's most successful entrepreneurs, in 2011 established the tuition-free coding school 42 and led development of Station F, "the world's biggest startup campus" in central Paris. According to its website, this campus is "dedicated to entrepreneurs and

creators, with an unprecedented scale and ambition.” The building, a former freight station located in the heart of Paris, is set to open in April 2017 and is funded almost entirely by Niel himself to encourage collaboration and co-location of entrepreneurs, with the goal of growing the startup ecosystem in Paris. Vanier comments that “the French culture of rebellion is now being applied to entrepreneurship.”

## Investments and Post-Brexit Opportunities

While San Francisco and the Silicon Valley area remain the global hub for technology startups and innovation due to a favorable fundraising environment, market size and a propensity to adopt new technologies, several European cities have quickly grown and emerged in their own right, particularly following the recession. Today, London, Berlin, Stockholm and Amsterdam are among the major players on the European scene, attracting and nurturing young entrepreneurial talent at higher rates than found in Paris. The reasons behind these cities’ successes are varied. Berlin and London make financial sense for young entrepreneurs seeking inexpensive office space and housing along with more favorable tax rates for early-stage companies. Stockholm and Amsterdam benefit from their history as open, innovative and design-oriented cities that appeal to young entrepreneurs. Furthermore, these cities all benefit from a marked halo effect, as talent follows talent and investors follow investors to established entrepreneurial hotbeds.

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Although building a startup ecosystem may take time, France is at an advantageous moment right now both politically and economically.

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The European Digital City Index of 2015 provides valuable insight by highlighting some of the primary structural issues and opportunities France must address. In the index’s comparison of digital entrepreneurship support across 35 European cities, Paris placed an impressive fifth — just ahead of Berlin but behind London, Stockholm, Amsterdam and Helsinki. While Paris scores high on “accessibility to skills” and

“knowledge spillovers” due to France’s high-quality research institutions and graduates, it falls in the bottom 40% for English language skills and labor costs. In addition, Paris ranks incredibly low for access to mentors, cost of living, availability and cost of fiber internet and office space. Finally, Paris ranks last in the growth of local online transactions, which might be interpreted as a resistance to adopt new technologies, a key factor in a startup environment.

One useful lens through which to compare the tech climate across European cities is in terms of venture capital investments. In 2015, the U.K. attracted €3.3 billion (US\$3.5 billion) in VC, followed by Germany with €2.7 billion (US\$2.9 billion), France with €960 million (US\$1 billion) and Sweden with €900 million (US\$967 million). On an investment per capita basis, however, France clearly lags behind its European neighbors. In addition, investments in France’s most successful startups, SigFox and BlaBlaCar, accounted for roughly one-third of the total in the country in 2015. While recent reports in the French Tech Funding Report and The Rude Baguette (a blog covering the French startup industry) reveal that French investments are growing, albeit at a slower pace than in neighboring countries, the question remains whether overall investments are increasing or big players are simply raising ever-larger amounts of capital.

France has begun making the necessary changes to the startup funding landscape. An important growing player in this sector is BPIFrance, a public investment bank that has been increasing its investments in early-stage French companies and startup accelerators. According to the French Tech Funding Report, BPIFrance in 2015 invested €200 million (US\$215 million) in private startup accelerators through the French Tech Acceleration Fund and an additional €600 million (US\$645 million) directly into startups through the Large Venture Fund, thereby establishing itself as one of the most active investors in Europe. With average investments ranging from €1 million (US\$1.1 million) to €5 million (US\$5.4 million), BPIFrance has addressed an historic weakness of the French startup scene: raising money for Seed and Series A rounds across a diverse set of companies. While raising money in subsequent funding rounds remains difficult, BPIFrance is a significant first step in ameliorating the domestic funding environment. Now it is up to private investors and banks to increase investments across rounds in order to maintain this momentum.

Following the U.K.'s referendum decision to leave the EU, the European business landscape is preparing for a major economic realignment from which France may be poised to benefit. Indeed, France has already started to offer tax breaks to U.K. businesses in the financial services industry, but it remains to be seen whether the country will take additional steps to attract startups. In neighboring Germany, Berlin has already started to target post-Brexit British entrepreneurs. It's an attractive city for young startups due to low living and working expenses, many incubators and established startups and funding sources. With cheeky ads on buses and billboards that read "Dear startups, keep calm and move to Berlin," Berlin is capitalizing on a unique opportunity. With its central geographic presence in Europe and highly educated workforce, Paris has an opportunity to attract these same startups if it moves quickly and thoughtfully

## Conclusion

As younger generations display an eagerness to innovate technologically and the government recognizes the importance of adapting to a new economic framework, France's startup scene is growing stronger and gaining prominence on the global stage. Emmanuel Schalit, chief executive officer of the French password manager and digital wallet startup Dashlane, noted, "A startup ecosystem is like a forest. A forest takes years to be developed. First the seeds develop trees, that eventually will grow leaves that will serve as fertilizer for the soil, and fruits that will release more seeds, to continue the cycle. In the startup ecosystem, the

first generation of entrepreneurs who made successful exits will become investors who will invest in the next generation of entrepreneurs and so on. When this ecosystem becomes robust enough, all the secondary synergies start to happen."

Although building a startup ecosystem may take time, France is at an advantageous moment right now both politically and economically. The French government has demonstrated its dedication to passing and reforming laws to stimulate business, private individuals are dedicated to helping grow the country's startup culture and the Brexit vote presents a unique opportunity to attract outside entrepreneurs and companies looking to relocate or expand into the European market. In order to leverage this momentum, France must address lingering weaknesses by establishing an infrastructure to support entrepreneurial growth and attract French and foreign investors who will give liquidity to the market and build the startup "forest" that Schalit describes.

The sustainability and long-term growth of the French startup scene are by no means guaranteed. In order to seize the opportunity, France must maintain the current political and cultural shift. The spring 2017 presidential elections will reveal whether the French people have accepted the change imperative for competing in the new global economy or whether the country will contribute to prolonging the negative stereotype of the French worker.

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*This article was written by Amelia Bell, Ana Luiza Mokodsi, Filipe Nunes and Sana Samnani, members of the Lauder Class of 2018.*



## Beer in Latin America: A David and Goliath Story

In bars, restaurants and grocery stores across much of the globe, a cold beer is easy to find. After all, most reports list it as the world's most favorite beverage after water, coffee and tea. In 2015, beer consumption totaled nearly 200 billion liters globally, following consistent growth since 2010, according to market research from Euromonitor Passport. The beer market in Latin America, which comprises about 17% of the global industry, has developed more rapidly than those in the Asia Pacific, North America and Europe during this period. And the growth of the craft segment of this market has been soaring even faster despite major challenges including extreme market concentration, import struggles and uninformed consumers.

From far back in history, humans have consumed beer. Over time, the frothy, alcoholic beverage has become entrenched in cultural traditions, and a large, dynamic market has developed to cater to its ever-changing consumers. Recently, craft beer has emerged as the newest segment of the market.

Craft brewers use traditional brewing methods to produce very flavorful, customized and unique beverages that have turned the industry on its head.

While a few European brewers had been using artisanal methods for hundreds of years, the style was popularized in the United Kingdom in the 1970s. Soon after, the craft trend spread to the United States, where microbreweries —

breweries that produce less than 1.8 million liters annually — began to influence the market. Today, craft beer represents a small but influential segment of the market that emphasizes quality over price. Craft brewers use traditional brewing methods to produce very flavorful, customized and unique beverages that have turned the industry on its head. These small, independent brands are growing at break-neck speeds in comparison with their traditional competitors. In America, where these brands are most popular, this segment grew to represent 12% of the overall beer market in 2015, according to the U.S. Brewers Association. That's a meteoric rise from just 4% in 2008. Similar consumer trends toward preferred flavors and higher-quality products are now appearing in developing countries, particularly in Latin America.

### **Out With the Old, In With the New**

The Latin American beer market is dominated by the bigger players. Between 2008 and 2013, craft beer represented a mere 3.1% of the overall market there. However, this

figure varies significantly by country, with Argentina the highest at 4.6% and Colombia the lowest at .3%. The 97% market-share owners, such as Ambev and SABMiller, would be daunting competitors to even the fiercest new entrants. These companies have established brands, seemingly infinite resources and highly efficient processes. Not only can they easily recruit top talent, but they also boast some of the most powerful executives in Latin America. In addition, these quasi-monopolies often own the distribution channels of the products they manufacture. Yet against the odds, the Latin American craft beer market is taking a more significant share each year.

Three key factors are driving this growth. First, globalization has increased consumer awareness of this product. Countries such as the U.S. and the U.K. have had a swift and significant impact on Latin America's beer tastes. Second, the emerging Latin American middle class can afford to experiment with new preferences in beer. Third, on the supply side, entrepreneurship is growing rapidly, and beer production is one of the most popular areas of innovation.

## Challenges in the Latin American Craft-beer Market

Many dream of brewing beer for a living, but turning that dream into a reality in Latin America involves more challenges than one may initially foresee. The cultural and historical backgrounds are serious obstacles as most countries in the region already enjoy traditional, well-established alcoholic beverages. Cachaça in Brazil, tequila in Mexico, aguardiente in Colombia and pisco in Peru and Chile are a few examples. Even if large beer companies have reduced initial cultural prejudices against beer, they have also contributed to building a different taste challenge: the pilsner monopolistic offer. Latin American beer consumers are accustomed to drinking beers with lighter flavors, milder aromas and lower alcohol content. Compared with these characteristics of the ubiquitous pilsners, the high alcohol level, strong flavors and unique aromas of craft beers can be difficult for many Latino consumers to accept at first taste.

One of the greatest challenges Latin American craft beer producers face is educating consumers about this new product and encouraging them to try it. Marcelo Carneiro, chief executive officer of Cervejaria Colorado, the largest craft brewery in Brazil, notes that "ignorance is my biggest

competitor and inciting people's curiosity my biggest challenge." Roberto Lanz Pombo, marketing and sales director of Bogotá Beer Company, the largest craft brewery in Colombia, agrees: "Educating and explaining to people the characteristics of our product is our hardest trial, and it requires time and patience to overcome this."

One challenging aspect in the operation of any brewery in Latin America is the dependence on importing key ingredients. Two crops essential for beer production — hops and barley — are not native to Latin America and must be imported from other regions of the world, primarily Europe and the U.S., which collectively produce more than 80% of the global volume. Combined with the highly volatile currencies of many Latin American countries, these imports expose breweries directly to the risk of exchange rates, impact production costs unpredictably and demand a higher level of financial preparedness to hedge against these risks. All of this ultimately contributes to higher prices for consumers who, despite benefiting from increased incomes over the last decade, are not yet fully engaged with craft beers, so they are less willing to pay more for them.

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The emerging Latin American middle class can afford to experiment with new preferences in beer.

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Finally, to educate Latin American consumers and overcome the high and variable production costs, craft brewery entrepreneurs find themselves in a lonely position. With little to no institutional support, 48% to 64% of small breweries in the key Latin American markets cease operations after just one year, according to data from the Economic Commission of Latin America and the Caribbean. Marcelo Regino, former owner of Karavelle, a Brazilian craft brewery, noted, "there is much more involved in running a brewery business than just the passion for beer. Entrepreneurs are not aware of this complexity." The notoriously complicated tax system and corrupt government environment also add layers of complexity to any business operation in the region. For example, a number of craft brewery owners lament that the highly bureaucratic and opaque process of getting local food and drink regulators

to approve a new beer recipe can delay a product's launch by up to four months in Brazil and up to a year in Colombia. Because continuous product innovation is a key characteristic of the craft beer market and the main draw for attracting consumers, this creates a significant hindrance to growth for craft breweries in Latin America.

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In the face of obstacles to growth that the craft beer market faces in Latin America, a number of breweries have achieved great success.

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## Successful Growth Strategies for Latin American Craft Breweries

In the face of obstacles to growth that the craft beer market faces in Latin America, a number of breweries have achieved great success. The vanguard entrepreneurs leading these companies are paving the way for others in Latin America. Bogotá Beer Company in Colombia is a strong example of how craft breweries there can take advantage of current opportunities and trends in the region to grow successful companies, all while expanding the craft beer market.

Despite pertinent political, socioeconomic and cultural differences across countries within Latin America, executives at a number of breweries note two common trends across consumer markets that influence craft breweries' strategies for market penetration and business growth. First, as mentioned above, there is increased awareness among Latin American consumers of the booming craft beer market in other countries around the world, namely the U.S. and the U.K. The second trend, which helps to facilitate the first, is the rise of social media, which increases consumers' access to information about specific craft breweries as well as craft beer in general. Both trends are important for breweries because consumers' interest in and demand for craft beer will grow as they become more educated about this previously unfamiliar market.

Capitalizing on these trends, leading Latin American craft breweries are employing three successful strategies. First, they're actively educating the public about their products.

While increasing consumer awareness about this market is occurring organically as a result of the larger global trends mentioned above, the most successful craft breweries still recognize that they must integrate education into their marketing and outreach efforts to attract new customers to this niche. For example, Bogotá Beer Company includes extensive descriptions about its products and brewing methods in its menus across all of its bars and pubs. It also provides intensive training to its staff so that all are well prepared to answer questions and make recommendations, especially for customers who are new to craft beer.

The second strategy targets middle-class customers through both marketing efforts and location decisions. To gain traction, many new craft breweries rely initially on well-educated and globally minded upper-class consumers with larger disposable incomes. However, to continue to expand their growth opportunities, they must tap into the burgeoning middle-class consumer market as well. Bogotá Beer Company has done this very deliberately by launching a new type of bar that specifically targets this demographic. While its original pubs are located in affluent urban areas and are primarily destinations for higher-end clientele on weekends, its new concept is inspired by the corner store bodegas that are fixtures in middle-class residential areas of Latin American cities. These bodegas, which are more informal than pubs, attract nearby residents to stop in for a beer after work. Because they are located in lower-rent areas, they can offer products at slightly lower prices.

The third strategy is forming alliances not only with each other, but also with the bigger brands in their respective countries. As noted above, the Latin American beer market is dominated by a small number of very large companies, which presents a challenge for small craft breweries trying to enter the beer market. Given the tough regulations these breweries face, many have found that they must coordinate and collaborate to influence policy and regulations more effectively. However, the craft beer market is still so small in Latin America that sometimes even this is not enough. Several breweries have recognized that they need to form alliances with these larger brands rather than try to compete with them. Some have accomplished this through distribution deals while others have succeeded in being acquired by larger companies. But it can be difficult for these breweries to maintain their identities as artisanal products

while taking advantage of the shared resources of the larger companies. Bogotá Beer Company is a successful example. In its 2015 acquisition by Ambev, it ensured that it would maintain complete control over the development of new recipes, continue experimenting with innovative ingredients and continue sourcing from local producers, thus allowing it to retain its identity while also giving it access to resources that enabled it to expand much more rapidly.

## **Final Thoughts**

A relative lack of consumer awareness of craft beer in Latin America, combined with the dominance of a handful of long-standing industry players, is reminiscent of the U.S. market in

the late 1990s and early 2000s. Given these similarities and the boom that has occurred in the U.S. craft beer market in recent years, it's easy to envision a promising future for this market in Latin America. However, Latin American craft beer entrepreneurs face certain unique cultural, economic and institutional obstacles to their success. Fortunately, several pioneers, such as Bogotá Beer Company, are paving the way and can serve as models for how other entrepreneurs can tackle these obstacles creatively and develop successful businesses.

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*This article was written by Mariana Burjato, Mark Kane and Genevieve O'Mara, members of the Lauder Class of 2018.*

# The Delicate Balance Between Economic Progress and Environmental Impact

The past decade has produced increased global awareness and concern for the environment. The inconvenient truth of climate change and its potential consequences are slowly driving policymakers, business executives and many others to become more environmentally friendly. Following the 2015 United Nations Climate Change Conference in Paris, nearly 180 countries signed an agreement resolving to set goals to reduce greenhouse gas emissions. Commitments such as the Paris Agreement are inspiring steps toward taking responsibility for sustaining the planet. However, greenhouse gases are only one part of the equation.

For developed economies such as the United States, this ecological problem often triggers conversations about the pollution generated by the enormous number of large cars driven daily or the amount of plastic used in packaging. For developing economies, however, the increasing push for environmental sustainability often competes with efforts to drive economic growth. China is often mentioned as an example, primarily with regard to the environmental impact of manufacturing plants that produce toxic water waste or fumes that cause smog. Simultaneously, those same factories have contributed in large part to China's economic growth, lifting millions of Chinese citizens out of poverty.

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Rural life is a vital part of Kenyan society and culture, and one can only hope that its ability to thrive remains a priority in the years to come.

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China's situation represents the dilemma that many developing countries face. The African continent is no exception. Many of its countries rely heavily on natural resources, especially oil, in addition to a growing manufacturing industry. Becoming environmentally friendly may require cutting back significantly on these sources of income or introducing more expensive "green" processes, thereby losing much of the low-cost competitive advantage. Is it fair to require such stringent environmental policies from developing countries when most developed countries

experienced economic growth from the exploitation of natural resources and "dirty" manufacturing during the Industrial Revolution? What right do developed countries have to ask developing countries to make this trade-off between faster economic progress and environmental sustainability?

Reality is even more complex. Large segments of the populations in many sub-Saharan countries still rely heavily on agriculture, an industry that would benefit in many ways from environmental sustainability. How should policymakers strike a balance between this complex set of priorities? Interviews with stakeholders in Kenya — rural farmers, executives at financial institutions and environmentalists — provide various points of view.

## One Country's Experience

Kenya has a rich and vast rural heritage. Its economic dependence on agriculture is demonstrated by the fact that nearly 80% of its workforce engages in agriculture or food processing, with almost 25% of the annual gross domestic product coming from agriculture-related activities. While only 20% of the land is fertile, the production of cash crops such as tea, coffee, cabbage and onions is substantial. In addition, livestock and poultry are significant sources of food in a country that is aiming to become food secure.

Kenya's agricultural needs and output were not met effectively during its early years, when nepotistic land distribution and poor management led to a dearth in both fertile soil and trees that were needed for both fire and water retention. This all changed when political activist

Wangari Maathai introduced the Green Belt Movement. The goal was simple: plant as many indigenous trees as possible, both by putting them in new areas and by replacing colonial-era, non-native trees that damaged arable land in the region. Her movement also focused on preserving existing forests. Slowly, this movement, which is still active today, began to yield effective results. “All these trees you see here — they were all planted due to the Green Belt Movement,” rural farmer Granville Nduhiu Kieru says, referring to the forests in the Nyeri region. “We use these trees for firewood, we use the land for grazing, and the fertility of our soil is now retained.” His neighbor, a wealthy coffee farmer, adds, “My soil now produces so much coffee that my main priority is to find exporters and markets to sell it. Growing the crop is no longer a problem.”

Abundant food security and economic benefits are now available to local farmers in rural Kenya. Nduhiu’s daughter explains, “We sell milk from our cows every day for 50 Kenyan shillings per kilogram (about US\$.50). Our cows produce around 15 kilograms a day. We sell tea for 14 Kenyan shillings per kilogram.” The government pays for both of these agricultural outputs. Nduhiu also has planted potatoes, sweet potatoes, cabbage, spinach, maize, avocados, bananas and other crops on his farm of 1.5 acres, so he and his family are producing more and healthier food. Rural life is a vital part of Kenyan society and culture, and one can only hope that its ability to thrive remains a priority in the years to come.

In a May 2016 interview with *African Business Magazine*, Jeff Immelt, chief executive officer of General Electric, said, “Without electricity, there will be no prosperity. It’s as simple as that.” Not surprisingly, prominent business leaders on the African continent share this sentiment. Jimnah Mbaru, former chair of the Nairobi Stock Exchange, notes that energy sources such as hydroelectric, geothermal, wind and solar are critical for Kenya to bridge the gap between where its economy is today and where it wants to be tomorrow. According to the World Bank, Kenya is one of 38 sub-Saharan African countries with more than 50% of the population living without access to electricity. This gap, Mbaru explains, is a major barrier to Kenya’s industrial development and hinders its economic growth potential. Much has been done to improve Kenya’s electricity

infrastructure. However, this progress is not without criticism and controversy.

Simon Thomsett, a nature conservationist, notes the impact that geothermal wells built in Hell’s Gate National Park, northwest of Nairobi, have had on the animals there. First, the drilling and noise pollution during construction of the Olkaria II Geothermal Power Station seriously disturbed birds of prey, including raptors and eagles, which play an important role in the ecosystem. Feeding on dead carcasses, they are the “cleaners” of the park. Thomsett adds that the birds’ nests were no longer considered safe as a result of their distress, which resulted in a decline in their population. Second, months after construction was completed and the birds began to return, Thomsett observed that some seemed to be dying after inhaling fumes as they flew directly over the wells.

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For developing economies, the increasing push for environmental sustainability often competes with efforts to drive economic growth.

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According to Aida Kimemia, a senior manager at the International Finance Corporation, geothermal is considered green energy and isn’t supposed to be toxic in any way. She notes that before the World Bank funds a project, environmental specialists complete a comprehensive analysis of potential environmental impacts. If the group’s report concludes that a given project is viable and won’t impact negatively on the environment, then it’s implemented. Finally, because the wells are in the park, animals naturally wander in and around the buildings. A photo of giraffes walking confusedly around the industrial above-ground pipes clearly represents the delicate balance between economic progress and environmental impact.

## Rehabilitating Raptors

Thomsett, a born-and-bred Kenyan, has dedicated his life and career to rehabilitating and conserving birds of prey. He is Kenya’s leading expert on raptors and runs the Raptor Camp in Soysambu. He has scaled 300-meter cliffs to search

for bearded vulture chicks for a reintroduction program in Kenya. He works alongside Sarah Higgins, who runs a rescue center for owls and raptors along the shores of Lake Naivasha, and Shiv Kapila, co-founder of the Kenya Bird of Prey Trust.

In 1996, Higgins found a fish eagle with a dislocated wing, which was the first raptor she brought to the rescue. In 2003, one of her friends called her after coming across an owl with a broken wing — an owl for which she built an overly large bird sanctuary. Currently, the Naivasha Owl Center hosts 23 owls, 18 raptors, a vulture and two marabu storks. The center cares for the birds and looks after them until they recover and are ready to fly again. It keeps the birds with permanent damage.

Higgins has an educational vision and wishes to partner with institutions to make the Naivasha Owl Center a focal point for those interested in conducting research on birds of prey. She envisions a place where students come from all over the world to learn about conservation and contribute their research findings to enhance the conservation-knowledge economy.

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Simultaneously ensuring sustainable growth for a developing country and protecting the existing ecology is certainly a delicate balancing act.

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While the Naivasha Owl Center has been supported by the Kenya Wildlife Service, it has been built and sustained by private funding. Higgins also hopes to raise funds to expand the clinic, which is in need of X-ray machines, ultrasound units and tools for surgeons.

Simultaneously ensuring sustainable growth for a developing country and protecting the existing ecology is certainly a delicate balancing act. It will require brave policymakers who are imbued with wisdom and are able to merge short- and long-term interests, serving both current and future generations of their own citizens.

Recognizing the need for an increased electricity supply on the one hand and the necessity to preserve the environment on the other is crucial for implementing this sustainable-growth model. Kenya aims to generate 5,530 megawatts of geothermal power, or 26% of its total capacity, by 2030. This will then make geothermal power the country's largest source of electricity. Research has shown that geothermal power has the potential to provide reliable and cost-competitive power with a small carbon footprint. At the same time, it can reduce vulnerability to the climate by diversifying the power supply away from hydropower, which currently provides most of Kenya's electricity. Nevertheless, it's disturbing to see one of these giant plants operating within a national park.

According to IFC representatives, comprehensive policies have been in place to mitigate environmental harm and weigh potential risk factors against the long-term developmental and social impacts of these projects. But pictures sometimes speak a thousand words, and a geothermal power station in Hell's Gate National Park remains a controversial matter. Officials need to ensure that policies are strictly followed and frequently updated to the newest technology standards. This requires that the Kenyan government take on an important role by ensuring that a balance of interest is maintained as policies are enforced.

If governments themselves are challenged while enacting viable policies for the sake of their countries' future society and environment, responsibility lies with organizations such as the IFC that often provide the governments with planning and funding for those projects. The work of nonprofit organizations such as Kenya's Green Belt Movement has been important in raising awareness for environmental causes, which has ultimately led to more comprehensive policies. Embracing an open public dialogue will further support efforts to create the right balance between economic progress and nature conservation for the benefit of Kenya and its citizen for years to come.

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*This article was written by Itai Abelski, Mona Kadouh, Natasha Maas, Zeehan Rauf and Yolanda Walker, members of the Lauder Class of 2018.*

# Gauging the Possibility of Change in Japan's Economic Future

Using words such as “gloom,” “lukewarm” and “negative spiral,” articles about Japan in the international media last year seemed to indicate the country is falling apart. Yet is an economic and social catastrophe actually looming in Japan's near future? How are business leaders approaching this possible crisis? As 2017 brings new hope for Japan, business leaders weigh in on the situation.

Of specific interest are their opinions on the effectiveness of Abenomics, a common reference to the economic policy of Prime Minister Shinzo Abe that focuses on productivity and growth as measured by the Organisation for Economic Co-operation and Development (OECD). If its “three arrows” of fiscal stimulus, monetary easing and structural reforms don't accurately reflect the changes needed, what must Japan focus on going forward?

Not surprisingly, there has been some skepticism about the crisis language and Japan's corresponding ability to make meaningful changes. Richard Folsom, representative partner of Advantage Partners, a large private equity firm in Japan, challenges the notion that Japan should be or can be compared with developing countries focused on growth. As a mature economy, the country is part of a new era of global economics in which progress is assessed differently. Folsom points out that even by purely economic measures, using real gross domestic product per capita, Japan led the United States and Germany even during the period known as Japan's lost decade, from 1991 to 2000.

Standard measures of macroeconomic health, such as GDP growth rates, stock market indices or real estate prices, do not consider deflation or population decrease. But because personal consumption and government spending are part of GDP, deflation and population decrease need to be considered when judging economic health. The general public, including foreign media, isn't used to measuring the economic health of post-industrialized countries with shrinking populations, so the foreign perception of Japan becomes skewed by incomplete analysis.

Folsom also notes that changes are needed, but in small, manageable bites, such as tackling corporate governance reform or the corporate tax structure. He subscribes to the

“1,000-needles” model (many careful incremental reforms) as opposed to the three Abenomics arrows, even as he appreciates the stability that a coherent plan provides.

Masanori Mochida, president and representative director of Goldman Sachs Japan, echoes a similar idea — that Japan's abundant wealth prevents the population, and the politicians in particular, from taking change seriously. When a true crisis materializes, he's confident the Japanese people will meet the challenge vigorously. Masatoshi Matsuo, chief executive officer of Genkai Capital, a real estate investment firm, points out how much hope Japan's business and consumer savings provide and is excited about the possibilities.

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With Japan's population having peaked in 2004, the populace is no longer facing an impending demographic crisis; it's in one.

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Yuichi Hiromoto, executive vice president of Mitsubishi Corp., questions whether Japan's businesses are willing to change and assume any leadership roles in moving the country forward. After a lifetime of business experience in Japan, he doesn't see Japanese executives as being willing to change the status quo.

If leaders from either the business or political worlds are unwilling to change, then mobilized support from the general population is also unlikely. Even though Japan's younger generation may be willing to implement changes, the population is aging and important structural decisions are made by the older generation at the top. This doesn't bode

well in a seniority-based, top-down system such as Japan. Many of the reasons for its low productivity are built into the society and lead to positive outcomes, such as the country's low Gini coefficient, which is a measure of poverty and income distribution.

The upper house election in July 2016 was a critical watershed for both economic and possibly constitutional reform. Since the inception of Abenomics in 2011, both its critics and its proponents have argued vehemently about which direction Japan must turn to regain its pre-bubble glory days. But, again, which metrics are truly important to determine the country's economic success? This election ushered in a new era of power for the Abe administration as his ruling coalition gained a two-thirds majority in the legislature, effectively according it the power to implement and bring to a national referendum whatever changes it desires.

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Entrepreneurs who aren't willing to play along with the establishment or who strive to disrupt too much are quickly stomped out.

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While the Japanese people for the most part remain skeptical about Abe's ability to affect real change for the economy, key political moves such as the delay in the consumption tax hike has taken the focus away from other serious implications of his coalition's monumental success. Japan is now facing the possibility of constitutional reform as Abe seeks changes to Article 9, which prohibits Japan from waging war to settle disputes.

With the recent uncertainty surrounding the passage and effects of the Trans-Pacific Partnership and Brexit, the Japanese people, in the face of this anxiety and uncertainty, crave stability and consistency. The Japanese media discuss the implications of these major economic episodes with apocalyptic flair, citing catastrophic consequences for long-protected Japanese agriculture, the Japanese automotive industry abroad and the impact on food and other imported goods.

Productivity is a primary concern for most Japanese business leaders. With Japan's population having peaked in 2004, the populace is no longer facing an impending demographic crisis; it's in one, according to Matsuo. The shrinking population and dwindling labor force are exacerbated by Japan's strict immigration policies and unaccommodating female labor market. Isao Okubo, managing director of GCA Savvian Corporation, a mergers and acquisitions firm, notes that important improvements and accessibility are needed in child care policies, maternity leave and state-sponsored nurseries.

Lingering problems with poor corporate governance and diversity among senior management in top companies pose significant problems for growth and change in major Japanese companies, according to Hiromoto. He argues that immigration is a significant area in which Japan could quickly increase its labor force and resolve some of its homogeneity problems. This comes with the typical risks of allowing low-skilled workers to disrupt low-paying job markets, of potential increases in crime and of increased pressure on social welfare systems. However, if managed effectively, immigration reform could increase the country's potential attractiveness to highly skilled foreign workers. A relatively high standard of living and a high level of safety allow for a very attractive socio-economic environment. Japanese cultural foundations, such as hospitality and politeness, could create a warm and welcoming environment for foreigners and their families.

In addition to increasing the human capital available to the Japanese labor market, entrepreneurship is a key driver of growth in all stages of economic development. Japan's entrepreneurship rate is quite low. Both the Japanese and foreigners recognize a culturally low risk tolerance. Tomohiko Yamasaki, director of business development at Softbank, sees his countrymen as being unable to tolerate risk or try new things. He is concerned that people are unwilling to move away from the accepted societal norms. The concepts of self permeate all aspects of a Japanese citizen's upbringing. While this gives rise to the humble hospitality for which Japan is so well known, it also leads to a strong desire to fit in.

According to Yamasaki, Japanese firms and the economy as a whole "need to promote innovation not only at the

individual level but also within organizations.” One key deterrent is that disruption is culturally taboo. A ride on the Japanese rail system illustrates this key norm. The almost-oppressive silence, juxtaposed with a train packed so tightly that special attendants must push people in before the doors close, emphasizes that thinking small and minimizing one’s own individuality are critical for living within Japan’s sociocultural norms. This is readily apparent in the glaring and shaming eyes aimed at a person who violates the silent sanctity of a train ride by, for example, talking on their phone or even speaking too loudly.

## Blocking Competition

In addition to a low risk tolerance, major Japanese businesses that have remained part of the “establishment” across the post-war economic system stand as significant barriers to entry into any market. Entrepreneurs who are not willing to play along with the establishment or who strive to disrupt too much are quickly stomped out, according to Tomoyuki Akiyama, global public relations representative for DeNA, a large mobile gaming firm. The low tolerance for risk, sociocultural change and diversity is exacerbated by the homogeneity of Japanese society.

Ethnic nationalism breeds an environment where no one who looks or sounds different can be accepted as truly Japanese. A lack of diversity in the labor force stifles any impetus for change. This is exemplified by the fact that a traveler from abroad quickly sees that the novelty of foreigners has still not worn off. This uniqueness creates a mentality among many Japanese people that foreigners or expat workers are too different to integrate effectively into Japanese society or even the Japanese business world. Expat workers are given few opportunities for true integration or long-term growth within the country’s economy. A large number of highly

skilled foreign workers would be willing to work and live in Japan; however, their long-term job prospects are poor. Hiromoto emphasizes that diversity, the most important factor in business and economic development, must expand. Without an increase in diversity in the workplace and in the thinking of those involved in the Japanese economy, true change will be nearly impossible to achieve.

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Diversity, the most important factor in business and economic development, must expand.

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While significant socio-economic change might be difficult to attain anywhere, Japan is handling its current demographic and economic problems quite well. The general consensus from top Japanese business leaders is skepticism of Abenomics and its ability to inspire real change along with optimism about the strength of the Japanese economy.

The pessimistic themes among Western media about the country’s future seem overblown and exaggerated. Japan is creating the groundwork for other major countries facing similar demographic shifts and displaying just how effectively they can adapt. It’s the first country to reach this demographic shift and the first to demonstrate what a mature post-industrial economy with an aging society might look like. While Japan faces many challenges, the relative stability and high standard of living supported by a high GDP per capita provide a promising outlook for its transition.

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*This article was written by Thomas Cavett and Noah Thomas, members of the Lauder Class of 2018.*

# A Village Changed: How Policy and Conservation Impact Urbanization in India

Majority urbanization is one of the defining factors of the early 21st century, encapsulating political, social and economic changes. This is most evident in India, where the economic and political systems struggle to keep pace with the migration of millions of Indians from rural villages to urban areas. In particular, this majority urbanization is an issue that threatens the country's rich heritage. Many of its cities have histories that can be traced back hundreds or thousands of years. The urbanization of these cities is influenced by the modern policies put into place by national and local governments alongside the social and political nature of conservation. For example, a small neighborhood called Hauz Khas Village in the middle of Delhi clearly manifests these conflicts. It's a modern, economically and culturally vibrant center situated alongside the ruins of a 700-year-old university and a reservoir. Thus, it serves well as an analogy for a discussion of urban spaces in growing historic cities.

## Urbanization and Its Policies

India and its people are in the midst of a huge economic transformation, one that has been well documented and discussed. One of the greatest changes has been in mass and rapid urbanization, which will dramatically alter the economy, culture and politics of the country and its people. According to a 2010 McKinsey & Co. report, "Urban

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India and its people are in the midst of a huge economic transformation.

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expansion in India will happen at a speed quite unlike anything the country or the world has seen before. It took nearly 40 years (from 1971 to 2008) for India's urban population to rise by nearly 230 million; it will take only half that time to add the next 250 million." India is in the process of becoming a majority urban country, with the last census in 2011 reporting an urban population of 31%. For large cities, national and local policies affect the nature and process of urbanization and urban change.

India's national urban and land-reform policies since economic liberalization began have influenced the path of this urbanization. Changing perceptions about urbanization have led to the onset of economic prosperity. Private-sector participation in urban development was permitted and encouraged. The National Commission on Urbanisation led the charge by recommending where and how to focus

urban development, detailing 329 key cities for development and recommending 78 actions to facilitate urbanization. A range of policies were aimed at improving the economic and housing conditions of the urban poor, including slum- and employment-focused policies. In the early 2000s, the Urban Reform Incentive Fund aimed to speed up liberalization through reductions in regulation and taxation and removing limits on land ownership and rent. Many investment incentives were introduced to combat the huge gap between infrastructure and the chronic lack of investment. Combined with the booming Indian economy, all of this led to an increase in private investment in urban commercial and residential properties.

There were also major changes within Delhi. The largest and most prominent was the creation of the National Capital Region (NCR). Growth on the outskirts of Delhi was constrained by its boundary with other states, and its population density was limited by greenfield and government sites. As such, the NCR planning board created a policy whereby growth could be spread evenly among Delhi's bordering developments, the result of which is now a metropolis with a population of over 45 million citizens. Delhi is an urban sprawl unlike any other in the world, with each area having a unique identity dictated by its locals, new residents and patrons, all of whom speak different languages and represent cultures from all over India. There are also strict restrictions imposed by the Delhi Development Authority (DDA), especially regarding the floor-area ratio (FAR), which effectively limits the height of buildings. This limit was raised several years ago, leading to redevelopment

in Old Delhi, which historically had not been a densely populated area. Future planned amendments to the FAR, especially for commercial properties, will continue to drive this redevelopment.

One final factor is a lack of uniform enforcement for any policy guidelines. While certain policies are adhered to, such as FAR restrictions, others are not, such as sanitation or safety restrictions for commercial properties. In addition, as infrastructure spending in Delhi and other urban areas continues to lag behind demand, private investment has stepped in to fill the gap. However, this is not the archetypal public-private partnership type of investment. Rather, in many places individual or company investors build on top of existing services — in India’s classic *jugaad* fashion of innovation. For example, the lack of electrical power infrastructure in Hauz Khas Village has led local businesses to install their own live wires from the nearest poles, creating a maze of fire hazards. This is clearly not a sustainable solution; it harms local residents and risks both lives and livelihoods. As a 2013 article in *Governance Now* noted, “the *jugaad* infrastructure of Delhi creates its brittleness. Any significant shock could quickly reduce the entire thing to an unmanageable chaos.”

## Conservation in an Urban Climate

Rapid urbanization has had a significant impact on the conservation of heritage sites in India’s metropolitan cities. In Delhi alone, one can often see new, major developments surrounding old heritage sites. It’s abundantly clear that conservation efforts are not distributed equally or methodically. Some areas, such as Lutyen’s Bungalow Zone, inhabited by Delhi’s political elite, remain untouched and well maintained, while others, such as Hauz Khas Village, can be found surrounded by modern development.

Conservation efforts in Delhi also vary greatly, depending on the political party in power. Comparing heritage sites that are well maintained with those that aren’t leads to the conclusion that conservation is, in fact, politically driven in Delhi. The previous Central Government, in collaboration with Delhi’s state government, had submitted a nomination to include Delhi in the list of UNESCO World Heritage Cities. However, once the new Central Government was elected to power, this nomination was withdrawn, without the knowledge or consideration of Delhi’s state government,

simply because the new Central Government viewed this nomination as “anti-development.” It supports a shift toward development of Delhi, which compromises protection of the heritage sites.

This leads to a most natural question: Who, in fact, is in charge of conservation in India? The answer is the Archaeological Survey of India (ASI), which falls under the umbrella of the Ministry of Culture and is responsible for the conservation of cultural and heritage sites throughout the country. Until very recently this agency operated by means of a manual implemented in the early 1920s. The Ministry of Culture finally approved an updated set of policies in 2014, incorporating new developments and technologies in the field of conservation.

Nevertheless, the ASI focuses only on the structural conservation of monuments and does not involve itself in any form of restoration work or protection of heritage sites. As a result, sites such as Hauz Khas Village find themselves impacted by the city.

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Delhi is an urban sprawl unlike any other in the world, with each area having a unique identity dictated by its locals, new residents and patrons.

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For example, Delhi maintains its own laws regarding development around monuments and, as reported in the *Times of India*, these are believed to be vague: “Unlike ASI, the rules for development around Delhi government protected heritage monuments are hardly known.”

In addition, “These include mostly those smaller monuments overlooked by ASI for protection. Many of these are in danger of vanishing or have been encroached upon so badly that their original character has been completely disfigured.”

Delhi is one of the most polluted cities in the world, which has had a significant impact on the state of its monuments. The results of this pollution could not have been predicted by the 1920s manual, so there is a public outcry for ASI to update its mandates and re-evaluate the future of these sites. In addition, Hauz Khas Village is open to the public and not heavily guarded. As a result, it is subjected to desecration

by visitors. Walls and pillars are covered in inscriptions left in chalk or sometimes even carved into the stone by visitors. This demonstrates that conservation is not a key consideration in India. The public takes monuments such as these for granted and is unaware of the consequences of the detrimental actions.

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As infrastructure spending in Delhi and other urban areas continues to lag behind demand, private investment has stepped in to fill the gap.

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### **The Story of Hauz Khas Village**

Hauz Khas Village, like the rest of India, has undergone its own transformation over the past two decades. Its gentrification has turned it from a sleepy neighborhood in central Delhi to a bohemian artist hub and then to an over-commercialized party street. All the while, the nearby 700-year-old ruins remain unchanged. The urbanization of Hauz Khas Village began around the 1980s, when it was an out-of-the-way place where designers opened stores frequented mainly by foreign customers. Cultural activity began to grow there around the 2000s as art galleries, restaurants and bars began to pop up due to the low rent at the time. Since then, it has been plagued by unstoppable, uncontrolled urbanization.

The reasons for the fast-paced massive transformation are an amalgamation of the trends discussed above. Urbanization rapidly increased Delhi's population and economic liberalization, and the ensuing boom resulted in a rapid increase in demand for real estate in Delhi. India's, and especially Delhi's, young and urban population demanded a new type of entertainment. The city's updated real-estate policies and investments meant that private individuals could step forward to meet that demand, updating their wares and services as tastes changed. Yet all this change often conflicts with the need and desire to conserve the surrounding history. Conservation efforts have struggled to keep pace.

This growth has led to some unfortunate incidents in the past few years. In 2013, the National Green Tribunal

decreed that 34 restaurants be shut down for not following protocol that mandates the proper treatment of wastewater. The restaurants were dumping polluted water into the centuries-old lake that was central to the initial development of Hauz Khas Village. However, because the government did not provide the tribunal with appropriate support for enforcement, the restaurants re-opened within a weekend, without being fined and still continuing their harmful practices. Conduct such as this allows businesses to grow unchecked, endangering not only the historic sites but also the environment and consumers.

In 2016, a fire broke out in the residential area of Hauz Khas Village, leaving one person dead and another seriously injured. It was caused by a short circuit in wiring, and the site's density caused the fire to spread rapidly. The haphazard and unplanned construction of the area meant there was no dedicated fire exit for the building's residents. In addition, emergency fire services were unable to access the site quickly because the roads were congested with parked cars. Every factor that contributed to this fire and its consequences resulted from poor urban planning and lax construction regulations.

### **Conclusion**

Jan Morris, a noted historian, author and travel writer, said it best: "Certainly Delhi is unimaginably antique, and age is a metaphysic, I suppose. Illustrations of mortality are inescapable there, and do give the place a sort of nagging symbolism. Tombs of emperors stand beside traffic junctions, forgotten fortresses command suburbs, the titles of lost dynasties are woven into the vernacular, if only as street names." India, more specifically Delhi, is a historically rich and relevant place. On the other hand, it's also a metropolis that is urbanizing at a rapid pace. Thus, it is imperative to consider how to conserve history in this story of development and modernization. Hauz Khas Village serves as an example of the impact of this rapid urbanization on monuments in Delhi and demonstrates that Delhi and other urbanizing modern cities must make a concerted effort to conserve a place for their past in their present and their future, or else they risk losing it forever.

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*This article was written by Zeenia Kateli and Gautam Mittal, members of the Lauder Class of 2018.*

# Germany's Shifting Consumer Behavior

Germany has a reputation for being a country of savers, so German consumerism has long been perceived as being highly conservative. With more life insurance policies than citizens, the country comes across as risk-averse and unlikely to be associated with the startup culture or booming e-commerce. But could this impression prevent outside investors from entering particular markets?

To fully understand Germany's economic potential, outsiders need to understand the growing startup scene, the existing consumer culture, the effects of the environmental culture and some surprising trends in the German retail market.

## The Growth of Startups

Germany's startup culture carries an undertone of irony, as the German people generally don't participate in risky business ventures. However, investments in German businesses are at an all-time high. According to the United Nations Conference on Trade and Development's *World Investment Report 2015*, the country led Europe in terms of having the highest level of outside investment. As outsiders are investing heavily in Germany, the general business environment has begun to change, and the economic environment is shifting to facilitate the growth of new businesses, in particular the rise of digital startups. This has very interesting implications for Germany's consumer culture.

According to Startup-Berlin.com, a German website dedicated to connecting startup organizations and providing necessary resources, every 20 minutes a startup is founded in Berlin. One may ask how a city once divided by the iron curtain of the Cold War rises to become the greatest startup city in Germany, with hundreds of companies to date. Many believe this is due primarily to the spirit of re-invention that has driven Berlin during its struggle to reconstruct itself into a city worthy of being Germany's capital. The idea that a city is willing to risk investing in itself has led entrepreneurs to adopt a similar approach to risk management. In addition, the abundance of affordable housing has encouraged predominantly young, poor and creative artists and entrepreneurs to flock to Berlin, especially to its eastern sector.

The real estate market has also played an invaluable role in the rise of startups. For example, an apartment in Berlin costs 66% less than a comparable one in London. The Berlin mayor is considering converting Tempelhof, the old airport, into office space for startups. Moreover, in recognizing the advantages of young businesses, the German government has adopted legislation that enables educated foreigners to live and work in Germany. Today, citizens of 180 different nationalities reside in Berlin, and half the residents are not originally from the city.

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The real estate market has played an invaluable role in the rise of startups.

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The German word for venture capital, *risikokapital*, itself implies the risk inherent in investing in new businesses. Nevertheless, companies such as Goldman Sachs, Microsoft and Google are among the many companies that have invested in Berlin. Google even founded Factory Berlin, which provides entrepreneurs with work space to develop their startups. In addition, organizations such as Berlin Partner and Tel Aviv Global joined forces to foster the development of startups in Berlin and Tel Aviv. These factors have all contributed to Berlin's growth and its ranking as No. 7 on [digitalcityindex.eu](http://digitalcityindex.eu), a list of cities that best support digital startups. Munich, with its wealth in both capital and academic institutions, is ranked 10th, and London tops the list at No. 1.

The digital startup scene in Germany is expected to generate more than 100,000 jobs in the near future. Will Germans begin to embrace the digital marketplace in response to the increase in digital businesses and employment

opportunities? It's reasonable to believe there's a correlation between the startup culture and Germany's consumer culture.

## Germany's Consumer Culture

While similar in many ways to the rest of the developed world, Germany's consumer culture is unique due to the strong influence of the country's history on its consumer behavior. The experience of three major wars, hyperinflation, and division and reunification over the course of the nearly 150 years since has left German consumers somewhat risk averse. With conservatism as the key driver for consumption behavior, some interesting trends have emerged in recent years.

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The digital startup scene in Germany is expected to generate more than 100,000 jobs in the near future.

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An examination of the data published for Germany in 2015 by the European Commission's Macroeconomic Imbalances Procedure shows that more than half of the gross domestic product is comprised by the services industry, which is not surprising for a developed country. Corinna Fernando, corporate communications director at Deutsche Bank in Frankfurt, notes that even though Germans tend to spend a lot on services, this does not include secondary services that accompany a product, such as delivery, installation, etc. Many of the companies emerging in this space — GrubHub, UberEATS and delivery giants like Amazon — are likely to encounter significant obstacles in trying to penetrate the German market.

Nevertheless, it's possible to stay ahead of the curve when targeting German consumers. Based on data from the Regional Planning Forecast 2030, published in 2013 by Germany's Federal Office for Building and Regional Planning, the number of families will decrease to 20% of the population, and there will be a greater number of older single people. Thus, there will be higher demand for goods and services targeted for the latter group. Furthermore, average household income will increase significantly, which

will drive stronger demand for luxury goods. Finally, the increasing diversification of the German population will require a transformational shift in marketing strategy for many local and international companies, generating a strong and long-term demand for professionals in the field of diversity marketing.

Another aspect is sustainability and its importance in German production and consumption patterns. Many developed countries have made enormous strides in promoting sustainable behavior, but Germany takes it to the next level on both the producer and consumer sides. According to representatives of Allianz AG, one of the oldest established German companies, the strategy is clearly steered toward short- and long-term sustainability over profit. For example, on the producer side, more and more German startups are focusing on healthy lifestyles and sustainable behavior. For instance, Cell Garden, a south German company, offers an appliance that allows anyone to grow premium-quality foods and pesticide-free microgreens at home. Its research shows that eliminating even a small portion of pesticides from everyday consumption will help support a healthier lifestyle. Thousands of German startups tackling issues of health and sustainability are emerging every year. On the consumer side, the demand for natural clothing — that is, clothing made from materials produced or grown in compliance with organic agricultural standards — has been increasing exponentially each year. German consumers continually look for healthier, more environmentally friendly alternatives in other fields, which creates enormous and worthwhile opportunities for exploration.

## An Exception to Germany's Austerity Rule

Interestingly, Germans are willing to spend much more than others in some aspects of their lives. Germany is one of the most environmentally oriented large economies, pioneering several ideas in the energy market that has made the country a leader in green-energy policies. These achievements came about through subsidies from taxpayers, energy-price increases and even investments from private households.

The transformation of Germany's energy market — or *energiewende* — began with the liberalization of this market in 1998, when the government approved a law prohibiting

companies from controlling both energy generation and distribution, permitting any player to generate and sell energy and allowing consumers to choose their energy providers. In 2000, the government passed its renewable-energy law, which guaranteed long-term stable prices (higher than the market) and sale priority for energy produced with renewable resources. Following the 2011 Fukushima nuclear disaster in Japan, the German government decided to shut down all nuclear power plants by 2022.

According to Ekkehard Will of the European Energy Exchange AG in Leipzig, the implementation of such countermeasures had the positive impact of reducing both Germany's carbon footprint and dependence on fossil fuels. However, he adds that the combination of the liberalization of the market, the state subsidies and the priority given to renewable energy created a market environment where no utility provider is willing to invest in cheaper, traditional energy sources. Thus, guaranteeing overall price competitiveness is no longer a priority.

The stability of the subsidies has incentivized German households to invest heavily in renewable energy. However, this apparently safe investment frenzy should be viewed with some skepticism because sunny days are not the norm in Germany. According to a report from the American Council on Renewable Energy, the sunniest region in Germany — the states of Bavaria and Baden-Württemberg — is comparable to the American city of Seattle, which is known for the prevalence of cloudy and rainy days. Even though the German government secured a modest long-term investment return, the cost of the necessary subsidies, combined with the energy price increases, contradicted the country's traditional austerity.

This unexpected German behavior leads to the conclusion that Germans are more willing than others to pay more to be green and sustainable.

## Emerging Trends in Retail

In assessing the German market for new opportunities, one may be tempted to test the country's appetite for new products in the retail market. However, given the *sparfuchs* — or “save rather than spend” — mindset for which Germans

are known, no one can be faulted for preferring a cautious approach toward consumer products. A review of the most recent data from the Statistisches Bundesamt (German Federal Statistical Office) shows that revenues in the retail market grew 2.9% year-over-year in 2015. This figure is particularly revealing considering that since 1994 (the first available data point), no other year had demonstrated growth of more than 2% year-over-year.

Because German companies are much more likely to be privately held, and thus do not have to comply with exchange requirements for financial reporting, it can be difficult to identify the conditions that drove up national retail revenues to a staggering €526 billion in 2015. However, close examination of publicly available data from several companies and the government illustrate three distinct shifts in German consumer behavior: discount, delivery and online.

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Many developed countries have made enormous strides in promoting sustainable behavior, but Germany takes it to the next level on both the producer and consumer sides.

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German producers and consumers alike are known around the globe for their emphasis on quality and a willingness to pay a premium price for it. But the German appetite for a good deal on products has been growing. In its most recent company performance statements, EDEKA, one of Germany's best-known food retailers, notes that revenues have grown above average at 2.8% in its discount stores. Metro AG, a German conglomerate of leading grocery, home appliance and electronics brands, highlighted in its 2015 annual report that revenues through delivery sales increased an impressive 10% over the previous year. Even more striking were the firm's online sales: a whopping 22% revenue increase, from €1.4 billion to €1.8 billion. Perhaps the most notable trend in retail sales across Germany is the pivot to online shopping and e-commerce. Data from the Statistisches Bundesamt show a huge 37% increase

in the retail sub-category “external sales,” which includes online sales.

Will the retail boom of 2015 continue, or was it just an aberration in the German consumer tradition? If interest rates in Europe remain low or even go negative, one could reasonably assume that consumers will choose to spend their euros rather than letting them sit idle or collect in saving accounts. If “spend first, save later” is the new behavioral norm in Germany, then eager investors or entrepreneurs should consider opportunities that take advantage of the growing appeal of discount, delivered and online products.

As entrepreneurs and investors scan the globe for the next market to invest in — from Silicon Valley to Beijing — they ought to plan a stop in Germany. From a diversifying demographic to changing consumption behavior in retail, a switch from saver to spender, a new energy market and a percolating startup scene in Berlin, Germany may not be as German as previously thought.

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*This article was written by David Burshtein, Patrick Feeney, Jefferson Ferronato and Tatiana Sheptock, members of the Lauder Class of 2018.*

# Waking Up to Growth: The Emergence of Third-wave Coffee in South America

A new culture focused on premium and specialty coffee has emerged around the world, one centered on the sourcing, preparation and appreciation of the ancient drink. Globally, Kenyan and Nicaraguan coffees are savored like the finest Spanish wines or Scotch whiskies. In this new dynamic, Colombian and Brazilian coffees have emerged as two of South America's most appreciated products.

This growth in demand for “third-wave coffee” has already had a significant global impact. It's estimated that the specialty coffee market in the United States grew from \$8 billion in 2000 to about \$16 billion in 2012, according to the Brazilian Journal of Marketing and the Specialty Coffee Association of America. After Starbucks closed 900 stores around the world in 2009, CEO Howard Schultz attributed part of this retreat to the growing threat of independent coffee shops. In other words, the market for third-wave coffee in countries such as Colombia and Brazil presents a new and potentially broad opportunity.

Third-wave coffee in Colombia and Brazil is a result of three factors: effective marketing techniques, the existence of strong coffee cultures in both countries and the significant expansion of the middle class. To clarify, the term “wave” is used by industry analysts to describe phases in the evolution of coffee production and consumption processes and the subculture these processes subsequently create. For example, the first wave of coffee was characterized by mass production and consumption, facilitated by bulk-packaged coffee such as Folger's that enabled consumers to make instant coffee at home. The second wave was marked by the emergence of coffee shops in cities, which enticed consumers to drink the beverage throughout the day.

These earlier waves set the stage for the third wave, distinguished by producer specialization and consumer connoisseurship. This new culture of coffee is defined by small-batch artisanal coffee roasters and independent coffeehouses that integrate vertically into a tight-knit and relationship-based supply chain beginning with direct-trade growers and extending to coffee brokers, roasters and café owners. These coffees have unique origins and use innovative preparation methods, which consumers seek and appreciate. In other words, third-wave coffees

exist in contrast to the second wave, that is, coffee (and a culture) sold by multinational companies such as Starbucks, whose beverages are aimed at a general audience for mass consumption.

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The growth of Colombia's middle class has created greater demand for specialty coffee.

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## Colombia: Riding a New Wave into the Future

The growth of this third wave is strong in Colombia, one of the region's historic leaders in coffee production and exportation. The country has been commercializing coffee, particularly the Arabica bean, since 1874.

However, the coffee quality — and the coffee culture — took significantly longer to develop. In 2002, the Colombian Coffee Growers Federation (a nonprofit organization established in 1927 and comprising 500,000 coffee-growing families) founded Juan Valdez Café in order to promote free-trade coffee. Over time, this innovative business model evolved into an iconic coffee chain within Colombia that developed the category and concept of third-wave coffee. Juan Valdez leveraged its relationship with the country's coffee growers and educated its consumers, thus establishing itself as a premium brand of Colombian coffee and simultaneously creating a new ecosystem for coffee consumption.

Juan Valdez invested in marketing campaigns with the intent of telling the story of Colombian coffee in an effort to change consumer habits. It has become commonplace to find advertisements highlighting different tasting notes

and regions and to attend coffee tastings explaining coffee origins and preparation methods. Juan Valdez's close relationships with coffee growers not only created a fairer and more sustainable economic model than traditional mass-market coffee, it also brought greater quality and thoughtfulness to each roasted cup.

This unique positioning of specialty coffee as a sophisticated product and experience, in contrast to everyday coffee, contributed to the growth of Juan Valdez's in-store sales. More importantly, it educated the consumer about the nuances of coffee and began developing a new coffee culture.

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Consumers have begun to enjoy coffee as an experience instead of just a drink.

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Now, Colombian coffee drinkers understand the specialty drink and seek out this luxury at a number of new specialty coffee shops in the country. Paola Laguna Becerra, co-founder of Bourbon Coffee Roasters in the capital city of Bogotá, explains Juan Valdez was the catalyst that "culturized the client" — in other words, prepared the market — for specialty shops like Bourbon to enter the space profitably. Just as Juan Valdez leveraged its close ties with coffee growers, so too does Bourbon develop permanent supplier relationships that yield better quality coffee. And the Colombian consumer is increasingly willing to pay for this product: Growing demand from more educated coffee drinkers has led to even more of these shops, which now account for 7% of coffee consumption in the country.

From a broader perspective, economic factors also facilitated the popularity of third-wave coffee in Colombia. The growth of the country's middle class has created greater demand for specialty coffee. "Colombian purchasing power has grown," says Juan Manuel Ortiz, restaurant manager and barista at Salvo Patria. "The consumer has more money to spend on coffee."

From August 2010 until the end of 2015, Bogotá's poverty rate fell by 12.5%, improving the lives of 4,600,000 people. As a result of economic growth, the middle class now

accounts for 70% of the nation's population, as reported by Colombian news agency Colprensa. "This growth has opened up opportunities for entrepreneurs and consumers," says Becerra.

The confluence of these factors is driving the rise of third-wave coffee in Bogotá. For example, in 2012, 69% of young Colombians ages 18-24 consumed coffee; in 2016, the figure is 78%. Concurrently, the share of sales of third-wave coffee in Colombia tripled between 2010 and 2016, reaching up to 5% of the market, according to El Espectador newspaper. Independent coffee shop owners confirm this, saying the market has grown very quickly, with several of them planning to expand their presence in the coming year.

## **Brazil: The Sleeping Giant Awakens**

Since the introduction of Arabica and robusta coffee in 1727, Brazil achieved success through large-scale production. Today, the country is the largest coffee producer in the world, growing 40% of the world's coffee, followed by Vietnam (16%), Indonesia (7%) and Colombia (4%), according to the U.S. Department of Agriculture. Although Brazil has vast expertise in production, Brazilians are still learning the best ways to brew and drink specialty coffee.

Brazil's trajectory in the last half-century provides an interesting case study in shifting consumer habits. The initial phase of mass coffee consumption in Brazil began in 1953 with Nescafé's introduction of instant coffee. During this period, sales were focused on supermarkets, and consumption occurred at home primarily for breakfast with the purpose of waking up.

Brazil entered the second wave of coffee consumption around 1980, with increasing urbanization and a greater need for quick-service food and beverages. Coffee began to be consumed in bakeries, restaurants and coffee shops. Stores such as Café do Ponto, Fran's Café and Casa do Pão de Queijo started franchising in large numbers throughout Brazil's cities. This expansion helped popularize coffee in Brazilian daily life.

While coffee can be readily purchased almost anywhere in the country, specialty coffee has reached Brazil only recently. Similar to Colombia, this is due to a deep coffee culture, the entry of specialty coffee shops and the rise of the Brazilian middle class.

Brazil's middle and upper classes grew from 57% in 2002 to 68% in 2014, increasing the consumer base from 96.7 million to 129.2 million people, according to government statistics. The growing demand and purchasing power of these classes have manifested themselves in a desire to know the coffee bean, its origin, the roasting techniques and the preparation methods that are influenced by external trends. As a result, Brazilian consumers have begun to enjoy coffee as an experience instead of just a drink.

In addition, it seems this growing consumer base has driven more coffee drinking. The Brazilian International Coffee Industry Association reported that coffee consumption in Brazil reached its highest point in 2015, with 20.5 million bags sold (with 132 pounds of coffee per bag). That's a 33% increase compared with 2005.

Consumption at specialty coffee shops and cafés also increased, as locally grown, high-quality beans that were previously exported began to be sold in the domestic market. Specialty coffee shops such as Café Suplicy and Santo Grão, both influenced by external trends, began to pop up in Brazil's metropolitan cities in the beginning of 2000. In a controversial move, Starbucks entered Brazil in 2006. Marco Antonio Suplicy, owner of Suplicy Cafés Especiais, notes, "The entry of Starbucks helped the specialty coffee market by popularizing the consumption of higher quality coffee and various forms of preparation. It has become easier to win over clients after they have already had an experience with Starbucks."

Starbucks' growth and expansion in Brazil are the result of increasing demand and the desire to experience coffees of diverse origins. Unlike in the U.S., where Starbucks' growth has begun to decline, in Brazil the company has shown much room for expansion. In the last five years, Starbucks has grown 28.7% in Brazil, while growing only 5.3% worldwide.

## **New Opportunities for South America**

The new specialty coffee market holds great potential for entrepreneurs in South America's coffee sector, which, with the expansion of demand for artisanal coffee, is no longer dominated by Juan Valdez and Starbucks. Felipe Sardi, co-founder of Colombian company La Palma y El Tucan, an international provider of high-end Colombian coffee, created Café Libertario in Bogotá's Zona G restaurant

district to share his love for specialty coffee with his fellow citizens.

Similarly, the emergence of specialty coffee is creating opportunities for workers in Brazil and Colombia. "I went to a middling school, but here they took a chance on me, and now I can pursue a promising career as a barista," says Freddie Pinto, a barista at Café Libertario. These opportunities extend through the value chain, to coffee farmers who have an opportunity to grow better coffee and gain higher prices and margins for their efforts.

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Perhaps the greatest opportunity emerging from this new trend is for consumers to enjoy a new and affordable luxury.

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The surge in interest in the product has also generated ideas for potential new business models in the existing coffee sector. For instance, a number of Colombian-based coffee roasters and cafés are entering the hospitality space by seizing on coffee tourism, giving consumers the opportunity to travel to and stay on coffee farms and learn about the production processes across the value chain. In this sense, the specialization of coffee, like that of wine or premium spirits, opens a broad set of avenues for innovation.

Yet perhaps the greatest opportunity emerging from this new trend is for consumers to enjoy a new and affordable luxury. Dropping in on any of the numerous bustling specialty coffee shops in Bogotá, Medellín, Rio de Janeiro, or São Paulo, one can see the growing sophistication and increasing demand of specialty coffee drinkers. Once an indulgence only for the high-priced palates in developed countries, specialty coffee is now a viable industry not only for exportation but for domestic consumption as well. In this sense, it's encouraging for South American economies to see so many people waking up to the smell of a great cup of coffee.

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*This article was written by Regina Escamilla, John Paz and Will Saborio, members of the Lauder Class of 2018.*



# Fostering Economic Growth in Sub-Saharan Africa Through Social Enterprise

The theme of social entrepreneurship in sub-Saharan Africa has become extremely popular and important in recent years. Strongly influenced by foreign actors, this model has emerged as a new way of tackling poverty and underdevelopment on the continent. Solutions deal with basic social problems that still exist in many African countries and target the provision of goods and services to underserved populations in both rural and urban poor communities. To understand the foundations of this movement and its importance to the continent, however, one must examine the history of foreign aid in Africa.

Before the rise of social enterprises, foreign actors had already played a significant role in Africa's development. Following Europe's post-World War II reconstruction period, both the World Bank (initially named the International Bank for Reconstruction and Development) and the International Monetary Fund (IMF) focused their efforts on poor countries, many of them on the African continent.

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The debate about the impact of foreign aid on Africa's development is still ongoing.

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The initial mission of these multilateral institutions was poverty alleviation and macroeconomic stabilization in these underserved regions. They pursued these goals by providing financial aid, which took the form of concessional

loans or grants. In addition, Structural Adjustment Policies (SAP) were designed as a condition for this type of aid to accelerate market-oriented reforms and thus foster economic growth on the continent. Africa has received over \$1 trillion in foreign aid in the last 50 years, mostly from the U.S. and Western Europe.

The debate about the impact of foreign aid on Africa's development is still ongoing. Some economists, such as Dambisa Moyo, a board member of Barclays Bank and former head of economic research and strategy for sub-Saharan Africa at Goldman Sachs, contend that foreign aid to corrupt African governments worsens economic inequality and creates more social problems. Others, including Jeffrey Sachs, professor of economics at Columbia University and a senior United Nations adviser, argue that aid has helped some countries break out of their poverty trap. There is no question, however, about the Western influence on the emergence of social enterprises in the region. In 1999,

authors Patrick Chabal and Jean-Pascal Daloz noted that international aid to the non-state sector was the main driver of the development of social enterprises in Africa.

As a consequence of the deregulation and privatization efforts led by the World Bank and the IMF's SAP, the non-state sector, which includes NGOs and social enterprises, has dramatically expanded its role in the African socioeconomic development model. Drawing on business tools and leveraging the inability of local governments to address social problems, entrepreneurs began to combine social interest and market efficiency, creating social enterprises to provide basic goods and services to groups that are underserved by regular businesses in underprivileged areas. This sector has also attracted an international audience, which has not only financed the sector's fast-paced growth in Africa but has also helped to develop the hybrid model of for-profit social enterprises. In recent years, Africa has experienced a strong inflow of social enterprises led primarily by entrepreneurs who have been educated abroad. The Awethu Project and Samasource are two such examples.

In short, the reduced participation of the state, driven in large part by the aid provided by foreign actors to African countries, and the active role of the international community, in terms of both funding and developing solutions, are the key elements that support the rise of social entrepreneurship on the African continent and address issues such as upskilling and unemployment.

## **Social Enterprise as a Solution to Unemployment**

The population boom in Africa and the related issues of unemployment present some of the greatest challenges for the continent's future. The United Nations estimates that Africa's population will double to 2.5 billion by 2050, accounting for more than half of global population growth. This demographic trend creates an urgent need for governments to implement sustainable programs that will create jobs and opportunities for African people.

The World Economic Forum consistently ranks unemployment and underemployment among the top five global risks of greatest concern. In Africa, unemployment

is one of the most pressing obstacles to stable economic growth. The state sector's inability to provide sufficient job opportunities and to satisfy basic needs only reinforces the vicious cycle of poverty, leading to higher rates of inequality. The continent's expected population explosion, coupled with high unemployment rates, creates a high potential for destabilization in the future. Young people are disproportionately affected. According to the International Labor Organization, they comprise the most impacted segment of those without jobs.

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Social entrepreneurship is an innovative way to create solutions that fit the communities it aims to serve.

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This backdrop has created a pressing need to solve Africa's unemployment problem, especially for the lowest socioeconomic segments of the population. Governments, in most cases, have been unable to address the issue successfully. On one hand, the adoption of a neo-liberal model of socioeconomic development has led to a diminished role for the state, decreasing its ability to be effective in solving problems. On the other hand, even if governments target lower unemployment rates explicitly, the solutions they implement are often either insufficient or ineffective. Government programs for upskilling, tax incentives and wage subsidies have the potential to increase employability, but only marginally.

Expansion of the non-state sector could offer a sustainable solution to Africa's socioeconomic challenges. In particular, entrepreneurship can have a significant impact on reducing unemployment by providing the necessary job opportunities and skills training for the continent's poorest people. In sub-Saharan Africa, social entrepreneurship has been an increasingly popular way to redress inequalities. Some countries, such as Kenya and South Africa, are quickly becoming social innovation hubs, with foreign and local entrepreneurs creating an entire ecosystem focused on sustainable solutions for the bottom of the pyramid.

Social entrepreneurship is an innovative way to create solutions that fit the communities it aims to serve. Successful models not only create employment, but also incorporate elements that generate lasting impact. Social enterprises develop permanent change by placing the community and its needs at the core of their business concepts. Successful social ventures in sub-Saharan Africa show that it is not enough to provide the underserved population with the opportunity to earn a living wage. The greatest impact is created when these enterprises invest in the people by conducting training programs to help them grow a small business or gain a competitive skillset that will serve them in the future.

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The population boom in Africa and the related issues of unemployment present some of the greatest challenges for the continent's future.

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The emerging leaders who create these social enterprises are often driven by a strong sense of purpose and a readiness to challenge the status quo. They have the potential to transform Africa's impoverished communities by helping to create jobs and spur the region's economic development.

## **The Awethu Project**

The Awethu Project in Johannesburg, South Africa, is a for-profit social enterprise that aims to provide opportunities for talented individuals who belong to historically disenfranchised communities. As the country with one of the highest Gini coefficients in the world, South Africa has extreme income inequality stemming from the legacy of apartheid and other factors. The Awethu Project hopes to ameliorate the high unemployment rates and grow the middle class by promoting entrepreneurship to create jobs.

Co-founder and CEO Yusuf Randerer-Rees and his partner and CIO Rob LeBlanc believe that talent follows a normal distribution in nature. But due to unequal nurture, people with talent and ambition in disadvantaged environments are unable to obtain the opportunities they

need. As a result, there is an underutilization of talent in emerging markets. The Awethu Project wants to identify and develop high-potential individuals to access and unlock their human capital. The company's premise is to democratize opportunities in order to help potential young entrepreneurs who live in Johannesburg's most marginalized neighborhoods. The organization operates as an incubator for entrepreneurs, teaching them necessary business knowledge and equipping them with basic skills to level the unequal playing field. It also serves as a venture capital firm, investing in the entrepreneurs' ideas while acting as both management consultants and fund managers to help the entrepreneurs move forward with their ideas and ensure profit generation for their investors.

Rather than being just a traditional incubator that helps new businesses grow, the Awethu Project also incubates the individuals. It trains, supports and mentors early-stage entrepreneurs who do not have the backgrounds or opportunities to build their businesses or to take them to the next level. There is a special focus on young entrepreneurs, and the enterprise hopes to alleviate the disproportionately high youth unemployment rate in the country, which is three times the average rate found in emerging markets. It judges the impact of the incubation program by looking at the number of jobs created. During the 22-week incubation program, entrepreneurs accepted into the program are given initial funding to build out their ideas and create jobs. Toward the end of the program, the top performers are provided with a seed-capital equity investment to grow their businesses further. By 2016, the Awethu Project had incubated 1,000 entrepreneurs and impacted the lives of thousands of other individuals as a result.

With the promise that the Awethu Project's model holds, it has received funding from a variety of sources — including corporate investors, direct foreign investors and development finance institutions — along with federal funds from the South African government. With the government spending R30 billion (over US\$2 billion) each year on youth unemployment, the Awethu Project provides an alternative for-profit investment option that generates quantifiable returns. LeBlanc hopes that within five to 10 years, the company will have R1 billion (over US\$70 million) in assets under management, while investing in 10,000 entrepreneurs

and their businesses and expanding to seven other countries on the continent.

## Using Microwork to Provide Living-wage Jobs

Considered the powerhouse of East Africa, Kenya still faces significant problems with its youth population. Despite being East Africa's largest economy, it has the highest number of unemployed youth in the region.

Samasource is a social venture that teaches women, youth and refugees in rural villages and slums how to perform digital-based work for top tech companies such as Google, Microsoft, Cisco, Getty Images, TripAdvisor and @WalmartLabs. It's part of the Sama Group, an organization based in San Francisco with offices and operations in Haiti, Uganda, Kenya, Ghana and India. The group was founded in 2008 by Leila Janah, who has a degree in African development studies and was a former consultant at Booz & Company and the World Bank. Her experience in development taught her that "the best way to end poverty is to simply give people work, which isn't considered 'sexy' among donors who want to fund a preschool or cure a disease," according to her profile on Fast Company.

The walls of Samasource's offices in Nairobi are constructed from corrugated tin, the same material used for housing in the city's slums. One of the directors notes that this serves to remind the employees that they are welcome in a professional environment despite society having marginalized them to the bottom of the economic ladder.

Providing low-skilled workers with dignified employment and a living wage is one component of Samasource's strategy to combat poverty. A living wage is defined as being above the poverty level. The company uses the concept of microwork — that is, breaking down large projects into smaller tasks that can be performed by anyone with basic computer skills. Employees are trained to perform these microwork tasks and thus earn a living wage to support themselves and their families. One example of this is geotagging for auto companies.

In addition to on-the-job training, the Sama Group provides educational opportunities through Samaschool to address concerns about job-readiness among new hires in Kenya.

Samaschool works with outside employers to provide students with a market-driven curriculum that changes every six months. It also provides a revolving fund for students to finance their studies. Loan repayments begin when students receive their first paycheck.

Samasource goes one step beyond many other social enterprises in quantifying its impact through quarterly reports. The company defines impact as breadth times depth. The number of employees and the number of dependents affected is the breadth. According to its third-quarter 2016 report, it has impacted 8,127 workers as well as 25,112 dependents. The depth of impact is measured through the 3.7-fold increase in its employees' income over four years. The company measures this by staying in touch with its employees even after they leave the company.

Is this a sustainable model? According to Samasource, its high-profile clients are very satisfied. The firm benefits from an output quality that is comparable to that of its competitors and has a unique social-impact plan.

## Conclusion

Social enterprises in sub-Saharan Africa have focused increasingly on targeting key problems, such as unemployment. The Awethu Project and Samasource are two ventures that offer different bottom-up solutions to the same problem. While the former encourages the development of entrepreneurs who will in turn create more jobs, the latter focuses on creating living-wage jobs for the lowest skilled. Yet each sees potential in individuals who have long been marginalized by society. As social enterprises, both complement their respective governments' actions to alleviate social problems. By creating replicable and expandable business models, both have the potential to impact hundreds of thousands of the most disadvantaged Africans. At the same time, the South African and Kenyan governments remain important actors in fostering a positive environment to support these types of social enterprises and scale up their impact.

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*This article was written by Vitor Agnello, Elena Gerasimova, Carolyn Han and Erinda Semanjaku, members of the Lauder Class of 2018.*

# Brazil's Labor Market: Weathering the Unemployment Storm

Brazil, once a star in the BRIC economies (Brazil, Russia, India and China), is undergoing a tumultuous period. Although the country weathered the 2008 financial crisis very well and even outperformed some economists' forecasts, since 2010 its success story has become a cautionary tale. Over the last two years, Brazil's gross domestic product has slumped, its president was impeached, several politicians were jailed and unemployment rose to 11%.

In the midst of this crisis, citizens are asking when things are going to get better. Renato Jansson Rosek, head of Banco Central do Brasil's investor relations and special studies department, believes that the Brazilian economy will worsen before it improves in 2017, provided the political situation remains stable. He expects the unemployment rate to rise to 13%; but even as the economic outlook improves, there's a delay before benefits trickle down to ordinary citizens. He believes that employment is unlikely to pick up until 2018.

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Monetary policymakers believe the best way to help the Brazilian economy recover is to increase the level of confidence by reducing inflation as much as possible.

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The Brazilian central bank's mandate is price stability and does not include maximizing the level of employment in the economy, in contrast to the dual goals of the U.S. Federal Reserve. Monetary policymakers believe the best way to help the Brazilian economy recover is to increase the level of confidence by reducing inflation as much as possible. Priscilla Burity, an economist at BTG Pactual, the largest investment bank in Latin America, expects the unemployment rate to reach 12.5% by the end of 2017 and projects GDP growth of 1%.

Until the economy begins to show stronger signs of recovery, Brazilians will need to keep searching for scarce job opportunities and try to make ends meet with the support of

nongovernmental organizations and innovative employment options such as Uber. Brazil's labor market is somewhat flexible because many people are self-employed and thus trained to look out for their own opportunities and well-being in general, unlike employees who may have a more difficult time sorting out their life situations if they are laid off.

However, even though a quarter of the Brazilian population is self-employed, this does not mean that the situation is easy. The local economy is depressed and has only recently started to recover a bit in the last few quarters. Given that employment is a variable that lags GDP growth, Brazilians continue to feel the crisis from an employment perspective.

According to the Instituto Brasileiro de Geografia e Estatística (IBGE), its national statistics institution, Brazil's unemployment rate was 11.2% in the February-April 2016 period, the highest since IBGE began its surveys in January 2012. This figure came in below market expectations of 11.4%. (A record low of 6.2% occurred in December 2013, and the average rate for 2012 through 2016 was 7.7%.)

With inflation rates hovering between 9% and 10%, Brazilians' average monthly income was estimated at R\$1,982 (US\$566) in May 2016, 2.7% lower than the year before. In addition, while the labor force, which includes workers as well as job seekers, is growing 2% year over year, the employment rate is declining 1.4% annually.

One of the direct consequences of this decoupling of the growth of the labor force and the growth in the employment rate is that employees are migrating from the formal to the informal private sector, where they encounter more precarious working conditions, significantly lower salaries

and fewer income-generating possibilities. The monthly formal job-creation rate currently hovers around -100,000, an improvement over 2015, when 200,000 jobs were lost each month — worse than any period since 1999. Thus, while private-sector formal employment is declining year over year at 4.2%, self-employment is growing at 4.3% and domestic work at 5.1%, according to IBGE data.

In such a difficult context, it is not surprising that people are finding it ever harder to secure jobs. According to Brazil's Ministry of Labor and Employment national consumer survey, in 2013 about 20% of the population considered it easy to find employment. Currently, the percentage of job seekers who feel as confident about their prospects is nearly negligible. Moreover, more than 90% consider job procurement difficult.

## Labor-market Regulation in Brazil

There are more than 1,700 labor laws in place in Brazil. Workers' rights are guaranteed by the *Consolidação das Leis do Trabalho (CLT)* — consolidated labor laws — and the Federal Constitution. According to the World Bank Group's *Doing Business 2015* report, the official minimum monthly salary was US\$435 in São Paulo and US\$451 in Rio de Janeiro. Workers cannot work more than 8 hours per day unless they are compensated accordingly and the salary for each extra hour worked over the permitted maximum is 50% over the regular hourly wage. The minimum length of maternity leave is 120 calendar days, the maximum length of the probation period is three months and the minimum annual paid leave is 26 days.

Today, 73 years after the creation of the CLT, which was instituted under President Getúlio Vargas, structural reforms are being discussed. The labor-market reforms currently under development aim to make the laws more flexible. The changes are expected to boost workers' productivity, reduce costs for businesses and investors and subsequently spur output.

Employee benefits being re-evaluated include vacation wages, pensions, payment of a bonus equal to a month's salary, maternity leave and the *Fundo de Garantia do Tempo de Serviço (FGTS)* or compensation fund for time of service, an employee-owned fund that amasses compensation for

the worker's time working in a formal organization. The Labor Commission has to negotiate with the unions to formalize the reform proposals. Upon mutual agreement, these proposals may be sent to the National Congress for final approval.

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One of the direct consequences of this decoupling of the growth of the labor force and the growth in the employment rate is that employees are migrating from the formal to the informal private sector.

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These new rules might specify, for example, that employees and employers could negotiate whether the former's bonuses are paid out in installments and whether the one-hour lunch break could be reduced to half an hour in exchange for a shorter workday. Currently, these negotiations are not allowed and, because they are outside the CLT framework, they result in restrictively regulated compensation to employees. In addition, the draft law related to business outsourcing, which allows companies to hire individuals registered as "unipersonal companies" without directly paying them social benefits, would be accelerated.

These labor-law reforms — and the pension-system reforms also under discussion — need to go through the National Forum on Pensions and Labor, where they risk being rejected by union members. Finally, the current administration is also studying measures to reduce informality and to address professional qualifications. It is worth noting that the areas outside the purview of the negotiations are related to employee health and security.

While Alessandro Molon, a federal deputy from the center-left political party *Rede Sustentabilidade*, agrees that the Brazilian labor market urgently needs reforms to make government intervention more efficient and to reduce the bureaucracy, he also stresses that these reforms should not enable entrepreneurs to reduce or abuse workers' rights. He notes that a labor market with fewer rules could

reduce unemployment but at the same time could easily increase instability in the economy. On the positive side, he adds that a majority of federal deputies back reforms that would reduce government intervention in the labor market (“tributos sobre a folha de pagamento”), and the new provisory government of President Michel Temer is likely to remain in power for two years. Because Temer is unlikely to run for office in the 2018 presidential elections, he will be able to take the lead on the unpopular reforms.

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Many NGOs are committed to helping those who are in the most precarious situations, but several are tied to religious organizations and depend on financial donations and voluntary contributions.

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## Emergency Measures for Emergency Times

One measure passed in November 2015 has already made the labor laws more flexible. It created the Programa de Proteção ao Emprego (PPE), or job protection program, a government-funded program that allows approved companies to cut their employees’ working hours and salaries up to 30% during times of crisis, after negotiating with the corresponding unions. In exchange, the government pays affected employees part of their salaries, up to 65% of the value of their unemployment insurance.

Since the beginning of the PPE, 97 companies have been approved and another 29 are awaiting confirmation of eligibility. This could ultimately result in 61,125 jobs being saved, at a cost to the national budget of R\$160 million (US\$48.5 million).

Separately, the minimum salary will be adjusted in 2017 in line with the country’s adverse economic environment. As BTG Pactual’s Burity explains, the minimum salary is adjusted each January by taking into account the previous year’s inflation level in conjunction with GDP growth for the year before that. If GDP growth is positive, it is included in determining the minimum wage. If it’s negative, it’s excluded.

Thus, 2016 reflects only the inflation level because GDP growth was close to 0% in 2014. It will be excluded again in 2017 because it was -3.8% in 2015, the relevant period for the calculation. As a result, the rule for calculating the minimum salary already incorporates an emergency mechanism for times of recession or crisis, such as the present one.

## Stories from São Paulo

São Paulo, the largest city in the country and the continent, is home to many of the newly unemployed. One needs only to take Uber rides to hear the stories of former engineers and accountants who have become drivers to make up for their lost income. João was a tax auditor in the auto industry before he was let go in early 2016. For him, the political scandal that resulted in President Dilma Rousseff’s impeachment mirrors the level of bribery and corruption he witnessed during his accounting career. He blames the current chaos on politicians who “have done nothing but steal” for years.

Another driver, Wallace, was a firefighter until he decided to retire early, fearing that impending reforms to the pension system would eliminate benefits for which he had worked his entire life. He recognizes that these benefits are unsustainable, but he left public service before it was too late and now drives passengers and reminisces about the years when Brazil was “one of the strongest economies in the world.” The stories go on, all with a common conclusion: The opportunity to work for a gig platform such as Uber has saved them in the midst of a bad economy.

Despite the social net Uber has brought to the Brazilian market, there are still many unemployed individuals for whom becoming a driver is not an option — owning a car is expensive and leasing one can be even more so. Many NGOs are committed to helping those who are in the most precarious situations, but several are tied to religious organizations and depend on financial donations and voluntary contributions. Obra Social Dom Bosco, for example, supports those seeking jobs by offering professional courses (for example, language and computer skills) and hosting workshops on effectively navigating the job hunt. It also helps individuals compose their resúmes and prepare for interviews. Another organization, Fundação

Mudes, which has been in operation for 49 years, helps low-income adolescents and young adults prepare to enter the labor market by offering paid internships and job training.

Of course, these initiatives are complements and not supplements for the state, but they play a key role in reaching individuals within their own communities and helping them navigate an increasingly complicated labor market. Moreover, because they are faith-based, they support job seekers emotionally and help them get through what can be a complex process.

## **Conclusion**

The crisis in Brazil is far from over. The unemployment rate is high and many analysts expect it to continue to increase in the short term. Efforts to control inflation, while stabilizing

for the macro economy, are likely to exacerbate this dynamic. Moreover, because several labor, retirement and possibly tax reforms may be enacted, popular unrest is likely and is already appearing in demands for acting President Temer, whose term has already been beset by a corruption scandal, to step down and for new elections to be called. It is vital, therefore, for the new government to build trust with constituents, explain that the measures it is taking are painful but necessary and demonstrate a commitment to eliminating the corruption that a large segment of the population cites as the root of the country's problems.

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*This article was written by Alberto Anton, Carla Benavides and Angela Londoño, members of the Lauder Class of 2018.*

# Understanding Brazil's Economic Crisis: A Lost Opportunity or a New Beginning?

Brazil is facing its worst recession since its return to democratization. After an impressive and sustained period of growth under President Luiz Inácio Lula da Silva from 2003 through 2010, which earned the country worldwide attention and praise, the economic and political situation took a turn for the worse. Brazil has been facing difficulties on several fronts, despite having met one of its greatest challenges to date: hosting the 2016 Summer Olympics.

Much of the turmoil generated in 2016 stemmed from the people's intolerance for corruption. What once was a constant in Brazilian politics — that is, a weak judicial system working at the will of the executive power — is now changing. Operation Car Wash, led by federal judge Sergio Moro, uncovered the country's biggest corruption scandal, which involved high-level members of the Workers' Party (PT), owners of some of Brazil's largest companies, the management of state-owned Petrobras and even Silva himself.

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Brazil is desperate to reverse its current situation, and the new government will need to address specific sectors to accomplish this.

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The country's deteriorating macroeconomic indicators have also exacerbated the general sentiment of discontent. Historically, Brazil has depended on exports that rely heavily on international commodity prices, primarily of oil, iron ore and soybeans. The decline in their prices has had a significant effect on public accounts, and the worst may be yet to come. As Andre Figueredo, head of investor relations at Vale, Brazil's largest mining company and one of the biggest iron-ore producers in the world, notes, "current iron ore prices of around \$60 per ton are not sustainable for the remainder of the year.... Prices are expected to fall because of weakening demand from our main consumer, China."

Several figures help to put the current situation in perspective. According to the International Monetary Fund (IMF), Brazil's economy shrank by 3.8% in 2015,

marking its worst annual performance since 1981, when the country was still ruled by a military government. The IMF doesn't project a return to growth until 2018. Even more worrisome is that domestic demand, which was the main driver of gross domestic product growth until the third quarter of 2014, shifted to a staggering -8.4% by the first quarter of 2016. In addition, the unemployment rate, which had hovered in the 6% to 8% range during the golden years, rose to approximately 11% by mid-2016. Economists predict this figure could worsen as the indicator is already at a 12-year high.

Households in Brazil have also closely monitored inflation, which spiked to around 11% by the end of 2015 following two years in the 6% to 7% range. However, the economy is beginning to show signs of cooling, as experts at Brazil's Central Bank expect its projections and market sentiment to be aligned by mid-2018 at around 6%. Another factor drawing international scrutiny has been the weakening of the Brazilian real, which ranked as one of the worst-performing currencies in mid-2016. The weak exchange-rate environment resembles Brazil of the 1990s, which then transitioned during the Silva years to a period of artificial strengthening with improvements in purchasing power.

Brazil is desperate to reverse its current situation, and the new government will need to address specific sectors to accomplish this. The lack of infrastructure investments, as seen during the 2014 Soccer World Cup, marks one of the country's greatest challenges as it hopes to regain its former title as the investor darling. It remains to be seen if Michel Temer's confirmation as president, following the historic impeachment of President Dilma Rousseff, can bring calm to an already wearying series of events that has slowed Brazil's development.

## A Case Study in Real Estate

The real estate industry generally serves as a solid proxy of an economy's performance and its cyclical economic development — specifically in terms of the market premium, supply and demand and replacement cost. Observation of Brazil's industrial and logistic real estate market demonstrates a high correlation with the country's economic downturn and the accuracy of the analysis. This section excludes the political situation and other recent events.

In 2015, the significantly high returns claimed by the Brazilian economy — based on its risk, or market premium — were due primarily to an increasing depreciation of the Brazilian real, which began the year at R\$2.60 compared with the U.S. dollar and ended at R\$3.90, and an increasing SELIC (Special Clearance and Escrow System) rate, which is the Central Bank's overnight rate. The rate started at an average annual rate of 12.15% in January and ended 2015 at 14.15%. This pushed the Brazilian 10-year generic bond from 12.3% in January to 16.2% by the end of the year. At the same time, inflation rose from 7.1% to 10.7%.

Regarding equities, the BOVESPA stock exchange dropped from 48,512 points to 43,350 points, a decline of 10.6%. Journalists Cristiane Lucchesi, Jonathan Levin and Hui-yong Yu wrote in a June 7, 2015, Bloomberg article that, "The economy this year may experience its worst contraction in a quarter century."

Brazil received a significant amount of investment during this period from international investors, such as private equity firms Blackstone, Brookfield and JP Morgan, which found 2015 to be a bargain year to benefit from real estate groups in distress and from a lack of supply. The expected yield compression in subsequent years and the appreciation of the Brazilian real would ensure expected returns.

Fortunately for international investors, Brazil's turnaround began in 2016. Its market premium was driven primarily by the Central Bank's monetary policy for achieving inflation stability at around 4.5% and reasonable control over the Brazilian currency. This resulted in a decrease of both the 10-year government bond rate from 16.4% to 12.1% and the inflation rate from 10.7% to around 8.8% by the end of the first semester of the year. A slight appreciation in the Brazilian real with respect to the U.S. dollar, from R\$4.00

to about R\$3.20, also demonstrated greater confidence in the Brazilian market. At the same time, the BOVESPA saw a strong trend, growing from 42,141 points on January 1 to 51,527 points on June 30 — an increase of 22.3%. Taking into account Damodaran's country risk premium analysis as of February 2016, Brazil's total equity risk premium and country risk premium reached 13.77% and 7.77%, respectively.

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Fortunately for international investors, Brazil's turnaround began in 2016.

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In terms of supply and demand, real estate investment manager CBRE's "Latin America Industrial MarketView Q4 2015" report lists Brazil as the country with the highest vacancy rates in industrial and logistic assets in Latin America. Coming off 2% growth in its industrial production index change in 2013, it suffered a 2.3% decline in 2014, followed by an 8% decline in 2015. An additional 7.8% decline was expected for 2016. These figures align perfectly with the Brazilian crisis period.

In São Paulo, the country's largest industrial hub, the vacancy rate amounted to 25.4% in the last quarter of 2015, comprising almost 54 million square feet, and completions significantly surpassed absorptions for the first time since 2013. Similarly, Rio de Janeiro's vacancy rate was 15.9%, comprising 13.4 million square feet, and net absorption reached almost 97,000 square feet. At the same time, completions in 2015 significantly surpassed the year's total absorption. With inventory exceeding absorption, rental fees dropped substantially from the first quarter of 2015 but stabilized by the end of the year due to the lack of premium new assets.

Regarding replacement costs, circumstances such as the lack of credit from financial institutions, political uncertainty, the economic crisis, and corruption scandals that resulted in the imprisonment of top executives of some of the most important construction companies, have combined to build strong barriers to real estate development.

## The Economic Crisis Hits One of Brazil's Champions

Petrobras, Brazil's national oil company, was a source of pride under the administration of President Lula da Silva. Today, it's one of the most disgraced companies in Latin America, following a wide-ranging scandal that exposed corruption, bribery and diverted funds. Its case is interesting because it encapsulates what happened to Brazil in just three years.

Three different lenses can be applied to understand not only the underperformance of the oil and gas industry but also the effects of the economic downturn in other important segments of Brazil's economy: the industry as a whole and the overdependence on commodities in global markets; Petrobras' inefficiency in terms of its operations; and the company's inappropriate risk reward profile and its effects on its long-term strategy.

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Petrobras has become one of the most inefficient companies among the 10 largest oil and gas operators in the world.

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The oil and gas industry is a broad global market with many interconnecting variables. Over the last five years, the CL1 oil barrel index dropped from US\$87.24 to US\$44.95. This resulted from the U.S. becoming an autonomous oil and gas producer (net exporter), Saudi Arabia becoming an increasingly consistent producer and China's GDP growth showing signs of economic slowdown in terms of precious GDP growth rates (among other reasons). This was important for Petrobras because, like many industry champions in Brazil, it relied on exports and failed to develop an internal value chain and market.

Petrobras also faced increased costs and a lack of competitiveness in terms of international benchmarks considering same-sized oil and gas integrated companies around the world. For example, Petrobras' cost of production in February 2016 was US\$16.96 per barrel of oil equivalent (boe), while costs for other nationally owned companies such

as Pemex and Statoil were US\$8.22 boe and US\$8.73 boe, respectively, and comparable in terms of deep-water assets such as ExxonMobil and BP at US\$12.55 boe and US\$12.68 boe, respectively.

Petrobras' cost for exploration and development was US\$24.68 boe, compared with the costs for Pemex, Statoil, ExxonMobil and BP of US\$17.97 boe, US\$27.25 boe, US\$19.17 boe and US\$19.71 boe, respectively. This means that, on average, Petrobras has become one of the most inefficient companies among the 10 largest oil and gas operators in the world, from the perspectives of both per-barrel production costs and overall company productivity. For example, the protectionist measures of the Petrobras union resulted in an inefficient number of employees per barrel produced; higher costs incurred because of the corruption in procurement, as shown in Operation Car Wash in Brazil; and the slow improvement in innovation that resulted from the lack of a local oil and gas value chain.

Finally, Petrobras' strategy, compared with that of Mexico's Pemex, and the payoff from the investments, considering the oil and gas break-even cost curve, demonstrate that the projects Petrobras undertook in the subsalt regions left little room for error. This means that the break-even costs of those projects under consideration were too close to the selling price per barrel, even when that price exceeded US\$90. Petrobras was the only company in the world undertaking such projects, which reflected a particular corporate decision-making process that was not as focused on profits as others. This resulted in an ambiguous long-term strategy and in investments in projects that never became productive, resulting in a weak equity/debt ratio.

### What Lies Ahead?

The Brazilian government under President Temer is undertaking three key initiatives to restore Petrobras to its former stature.

First, Petrobras has agreed to a US\$13.7 billion divestiture to secure its financial situation while improving its equity/debt ratio. While it's too soon to ascertain what the plan will entail, experts predict the company will start by first selling mid-stream oil and gas assets to capitalize certain opportunities and will later resume selling exploration assets as oil and gas prices improve in subsequent years. The

valuation of the exploration assets is based on the amount of reserves that such basins contain. Thus, the valuation is highly sensitive to the price of the oil per barrel. These initiatives will help the company comply with its debtors, among whom BNDES, the Brazilian development bank, is one of its most important. In addition, to improve the financial situation, this initiative will also help the company divest assets that will not be productive in the near term or would require large amounts of capital commitments that the company will not have in the future, thus aligning the financial situation, the focus of the management team and the long-term strategy.

Second, Petrobras will designate a professional management team to align strategy, operations and the workforce. This new team, under the leadership of chief executive officer Pedro Parente, will have a strong agenda to reduce production costs, focus the company on projects that can be expanded in the future and make the procurement process transparent and efficient.

In addition to Petrobras' specific optimistic views, the oil and gas market has not shown signs of any decrease in projected prices for crude oil for 2017. In fact, the company's stock is already demonstrating a strong recovery, increasing from US\$5.81 on June 1, 2016, to US\$9.37 on August 29, 2016.

To summarize, we believe that Brazil presents a lost opportunity given the trend observed during Silva's administration, which has now proven to be unsustainable. However, we also believe that the improvement of the macroeconomic environment, the large domestic market and the dynamic oil and gas and real estate markets will provide new investment opportunities at a time when the world has few opportunities to find positive yield. Thus, Brazil's newfound stability comes at a perfect time.

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*This article was written by Said Mena, Nicolás Raelé and Eduardo San Martín, members of the Lauder Class of 2018.*

# Supply-side Economics, with Chinese Characteristics

On a hot summer day in July 2016, a group of men stood outside a lecture hall at Shanghai's Tongji University smoking cigarettes and drinking tea in an attempt to give themselves a jolt of energy before the next lecture, flagrantly disregarding the "no smoking" signs posted in the hallway. These attendees were Communist party cadres from the industrial city of Changzhou, a two-hour, high-speed rail ride away. But their attempts didn't work. Ten minutes into the lecture on "Supply-side Structural Economic Reform and Urbanization," even as the instructor from a party training academy earnestly introduced his subject, most of the audience began to fall asleep while the rest played with their smartphones.

Supply-side structural economic reform is Chinese President Xi Jinping's signature economic initiative and the latest slogan gaining popularity across the Chinese political and economic landscape. These lectures let government officials, civil servants and party workers maintain the appearance that they are promoting the party line. As the supply-side reform message has gone out, however, its actual meaning has grown broader and vaguer, with some likely coming up with interpretations that work to their own benefit.

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Supply-side structural economic reform is ... the latest slogan gaining popularity across the Chinese political and economic landscape.

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## Not Your Father's Supply-side Economics

In the West, the term "supply-side economics" is traditionally associated with the 1980s economic policies of U.S. President Ronald Reagan and British Prime Minister Margaret Thatcher. Guided by the desire to let industry invest more in production (thereby increasing supply), both leaders enacted sweeping tax cuts. Thatcher also famously privatized several state-owned industries and sharply restricted trade unions. Chinese officials have touted what seems to be an attempt to legitimize the policy by using the two leaders' strong legacies. "Thatcher and Reagan

are highly regarded because it was proven that they made the right choices under heavy pressure," said Jia Kang, an economist in China's Ministry of Finance and a noted supply-sider, according to a March 2016 article in *The New York Times*. "Their spirit was one of boldly taking on challenges and innovating, and that's certainly worth Chinese people emulating."

Further examination, however, reveals that Xi's supply-side economics has very little to do with the policies of Reagan or Thatcher. Whereas both advocated for less government intervention in the economy, Xi's reform package contains strong government dictates for the state-owned and private sectors. According to He Fan, chief economist at the Chongyang Institute for Financial Studies, the Chinese government "uses the name 'supply-side,' but the background is quite different, the content is quite different." To make matters more confusing, the policy is often linked to disparate initiatives — from foreign policy to e-commerce — that seem to have little to do with China's macroeconomy, or with each other.

## "Three Get Rid Of's"

The government phrase "three get rid of's" refers to the parts of Xi's policy that are most widely acknowledged in both China and the West as necessary and important economic reforms. They aim to reduce production capacity and inventory, as well as aid in deleveraging while reversing economic distortions caused by years of economic stimulus by the Chinese government.

The first refers to the consolidation of inefficient and unprofitable state-owned industries that have become bloated after years of easy credit extended by government-backed banks. Excess production capacity in sectors such as iron and steel, glass, cement, aluminum and solar panels arose after years of easy credit and financial subsidies to state-owned enterprises combined with local government pressure to maintain employment and economic growth. According to *The Economist*, China's excess steelmaking capacity is greater than the entire steel production of Japan, the United States and Germany combined. Credit ratings agency Fitch reports that China's coal industry could have 3.3 billion tons of excess capacity by 2018.

Similarly, inventory reduction is also aimed at specific industries such as real estate where supply has outpaced demand. While news reports about fully developed and completely occupied "ghost cities" are overblown, there are certainly many second- and third-tier Chinese cities in which developers are struggling to sell their newly built housing stock. Finally, deleveraging refers to the need to wean state-owned enterprises and local governments off their addiction to easy credit. This measure could cause some of the greatest short-term pains, as it would likely require firms to both sell off assets and lay off workers.

Beyond the "three get rid of's," other much more poorly defined and seemingly unrelated reforms are added under the supply-side reform banner, including "lowering costs" and "fixing shortcomings." In official media reports, "lowering costs" has referred to everything from the cost of labor to the cost of health insurance and capricious taxation, all of which are controlled by different factors. Zhou Shixun, information director of the Development Research Center of the Shanghai Municipal People's Government, cites reining in traffic-law violations in the city as an example of a shortcoming that would be fixed under supply-side reforms.

Another program integrated into Xi's supply-side agenda is "One Belt, One Road," an earlier foreign policy initiative that is intended to integrate China economically with the rest of Eurasia. Explaining the policy's connection to supply-side reform, Zhou notes that it's a way for China to "propose capability cooperation with those countries in the regions where the infrastructure is lacking." He adds that this is part of a broader movement of "going out," as Chinese

companies attempt to enter markets abroad and acquire overseas companies. Chief economist He, on the other hand, rebuffs this line of thinking. He compares it to the failure of a previous Chinese government initiative to have wealthier coastal provinces assist poorer inland provinces develop their infrastructure. "The policy didn't work in one country with one central government. Trying to copy that strategy with 50 to 60 different countries with added political risk is a daunting job."

## Just Chinese Politics as Usual?

One plausible explanation for the lack of clarity surrounding supply-side reform is that there is no single coherent reform package. "While the central government had provided a general direction for the policy, the details of the agenda are, in fact, separately structured by the stakeholders," says Tongji University Professor Ying Guo.

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Xi's supply-side economics has very little to do with the policies of Reagan or Thatcher.

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Although many have an impression of the Chinese government as highly centralized, there are precedents for this sort of decentralized policy implementation. China's previously mentioned "going out" policy, for example, was first announced in the 2000s in order to encourage state-owned companies to acquire overseas natural resource assets. Over time, though, it provided political cover for ambitious business people in the state-owned and private sectors to import business practices, technological expertise and other intangible values to China — essentially the opposite of "going out."

Another example is Deng Xiaoping's famous quip that "it doesn't matter if a cat is black or white so long as it catches mice." This is the strategy that supported the single-minded pursuit of gross domestic product growth at the expense of anything else, leading to a series of problems ranging from income inequality to overcapacity growth. This resulted from the vagueness of the concept that gave more freedom

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One plausible explanation for the lack of clarity surrounding supply-side reform is that there is no single coherent reform package.

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to public and private sectors to pursue economic gains as the most important factor in making decisions. Supporters used this to justify decisions that were more beneficial to themselves than for the country. These days, China seems to be applying Deng's logic to its neighbors: It doesn't matter if they are democratic or despotic as long as they safeguard China's interests — another example of how a vague policy can be made favorable.

### **Projections for the Future**

Less than a year after the term “supply-side reform” was first put forward by President Xi as a measure to aid China's

economic restructuring, it remains little more than a vague buzzword and has made scant progress on the ground. According to a report in *The Economist*, in the first seven months of 2016, provincial governments achieved only 38% of their full year's targets for coal production cuts. Some speculate that these governments are slow-rolling or even backpedaling their implementation of the reform to avoid the unrest that would come from inevitable worker layoffs. There are factors both within China (e.g., growth of the services sector) and globally (e.g., commodity prices) that could drastically change the impetus for this reform package. For now, though, China observers will just have to watch and wait.

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*This article was written by J.T. Kennedy, Charles Wilson and Sheng Xu, members of the Lauder Class of 2018.*

# Uniting a Nation: Colombia's Ambitious Infrastructure Program

Colombia is a nation rich in natural resources and home to nearly 50 million people, making it South America's second-most populous country after Brazil. However, poor infrastructure has hindered economic growth in recent years, with it being relatively slower than other markets in the region such as Mexico, Brazil and Peru. This deficient infrastructure has resulted in some of the highest export costs. In addition, the costs of transporting goods inland often rivals, if not exceeds, the costs of receiving shipments from foreign markets.

According to the World Economic Forum's Global Competitiveness Index 2015-2016, Colombia ranks 126th in quality of roads, 106th in quality of railroad infrastructure, 85th in quality of port infrastructure, 74th in quality of air-transport infrastructure and 98th in overall quality of transport infrastructure. It's worth noting that these rankings are much improved from as recently as 2014, but they signal that the country's infrastructure is still far from where it needs to be for its market to be competitive on a global scale.

Colombia has faced enormous challenges in developing its infrastructure. Geography aside, expansion efforts have either been delayed or remain undone due to the corruption that previously plagued the agencies tasked with tendering the projects, as evidenced primarily by the Colombian government agency responsible for planning its development, the Instituto Nacional de Concesiones (INCO). INCO was established in 2003 under the auspices of the Ministry of Transportation with the purpose of planning and executing infrastructure projects through the public-private partnership (PPP) model at the national level. Following a series of scandals, President Juan Manuel Santos dismantled the agency in 2011.

The corruption scandal not only tainted the reputation of the Ministry of Transportation, but also, more importantly, either halted progress on a number of vital infrastructure projects or resulted in their faulty execution. The mismanagement was multidimensional. The embezzlement and misappropriation of funds resulted in insufficient resources for the execution and completion of projects as well as the existence of the contract "mafia," which created a process that often bestowed contracts not on the basis of

reputation or ability, but rather on a company's willingness to offer bribes or incentives.

In the aftermath of the INCO debacle, President Santos introduced new legislation to govern public-private partnerships and established the Agencia Nacional de Infraestructura (ANI), which is devoted to the structuring and management of concessions through PPPs for the development of roads, railways, airports and ports. ANI included important transparency and corporate governance safeguards, a larger technical workforce and a better pay scale.

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Because the Andes split into three separate mountain ranges in the southern part of the country, construction projects can be extremely costly and time consuming.

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With ANI's creation, the Colombian government sought to efficiently and ambitiously develop the infrastructure sector, which has the potential to deliver significant value to the country's economy and to renew confidence in the institutions that lead development efforts. In his aim to restructure the Colombian infrastructure sector, President Santos appointed as ANI's president Luis Fernando Andrade (a Wharton MBA), who had established and presided over McKinsey's Bogotá office for nearly 17 years.

On September 18, 2012, Andrade unveiled the most comprehensive and ambitious infrastructure development program in the country's history: La Cuarta Generación de Concesiones (4th Generation of Road Concessions, or 4G). This program, which encompasses approximately 40 new roadway concessions, aims to transform over 8,000 kilometers of roads while building 141 new tunnels and 1,300 new viaducts. At the outset, the program will improve roadways across 24 departments (or states) in Colombia. Employing a PPP-based strategy, the government tenders projects and selects private companies to build and subsequently operate each new roadway for a specified period of time. In return for their initial construction investment, the companies may collect tolls and receive direct government subsidies, thereby generating a financial return.

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Geography aside, expansion efforts have either been delayed or remain undone due to the corruption that previously plagued the agencies tasked with tendering the projects.

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Historically, geographic challenges have limited Colombia's ability to expand and improve its infrastructure. Because the Andes split into three separate mountain ranges in the southern part of the country, construction projects can be extremely costly and time consuming. Due to the difficult nature of the projects as they relate to these geographic features, as well as the breadth of the government's vision, the total investment required to successfully complete 4G is estimated at over COL47 trillion (approximately US\$16 billion) over the next six years. While roadway concessions are ANI's primary focus, the agency has also initiated a series of concessions related to improving the country's ports, railways and airports.

Even though the Colombian economy has grown rapidly over the last decade, President Santos and his administration believe that the country's poor infrastructure will ultimately inhibit its ability to reach full economic potential. By addressing these challenges through the development and

implementation of 4G, the government hopes to promote foreign trade and enhance regional connectivity through reduced transport times and costs. According to estimates from Colombia's Departamento Nacional de Planeación, (National Planning Department), the successful completion of the 4G roadway projects will result in transport time savings of roughly 30% and vehicle operation cost reductions of approximately 20%.

The government thus believes it can improve competitiveness in relation to other countries both in Latin America and globally and, as a result, improve Colombia's economic potential. Per government estimates, GDP is expected to expand by up to 1.5% during the construction phase of 4G while ultimately growing by an additional 0.7% in the long term as a result of improved infrastructure. In addition, through the creation of over 180,000 jobs related to the projects' construction needs, the government believes it can reduce unemployment by up to 1%.

While the size and scope of the 4G infrastructure project are unparalleled in the nation's history, President Santos is not the first Colombian leader to initiate such plans. However, his administration is attempting to improve the efficacy of the process through new laws passed by Colombia's Congress that directly address issues that previously inhibited this development. One of the main improvements centers on payment structures for the private companies operating toll roads. In the past, these companies received advances and payments that were fixed in time and not necessarily tied to a project's completion percentage. As a result, many projects took far longer than expected or were never completed because there were no financial incentives involved. With the passage of a new PPP law in January 2012, however, the government has strengthened the financial incentive structure for private companies.

ANI president Andrade notes, "What differentiates 4G from the previous generations of concessions is that we only provide government payments and access to toll revenues with the delivery of infrastructure. These are what we call 'availability payments.'... So, we turned the incentives around. Now we say, 'No, you have to invest first. And once you deliver, then we start paying.'" In addition, the Colombian government passed a new infrastructure law in November 2013 to help deal with, among other things, issues related to land acquisition, a problem that plagued

previous infrastructure development efforts in Colombia. Through its enactment, the government expects to improve completion rates while simultaneously making the projects more attractive to investors. While the impact of improved infrastructure in Colombia appears to be sizable, financing these projects still remains an important challenge.

Due to the sheer size of 4G, one of the largest obstacles the program faces is raising sufficient funds to finance the projects. In January 2016, the Santos administration demonstrated its commitment to 4G when it authorized the sale of a majority stake in the state-owned power generator, Isagen, to the Canadian investment fund Brookfield Asset Management for US\$2 billion in order to capitalize the newly created national infrastructure development bank Financiera de Desarrollo Nacional (FDN). This marked the largest privatization in Colombia in over a decade. While selling the interest in Isagen means the Colombian government will now collect fewer dividends to fund the national budget, prominent figures such as Rudolf Hommes, the former finance minister of Colombia, claim it is imperative that the government procure the funds to finance 4G, thereby ensuring future economic growth and sustainable development.

Since 4G is a PPP program, the government relies on private companies and banks to procure the equity and debt financing required to construct the projects. Thus, ANI has made important efforts to attract financing that will provide liquidity throughout the projects' construction. One of the most important players tasked with helping ANI raise funds from global investors is PROCOLOMBIA, the government agency responsible for promoting foreign investment in the country. Representatives for PROCOLOMBIA and ANI traveled the world and held meetings with both financial and strategic investors, constructors and operators.

Investors were initially skittish about the perceived lack of transparency and the presence of violence that, although drastically reduced since their peak in the 1990s, still linger. However, the tremendous progress the Colombian government has made in 2016 with the advancement of a peace treaty and the ceasefire with FARC, the largest Colombian revolutionary group, has encouraged some investors to look past Colombia's violent past and view the compelling economic benefits that an interconnected infrastructure grid would provide. European investors have expressed a considerable appetite for Colombian

infrastructure assets, as ANI has received investments for projects from more than 15 international companies, ranging from sponsors to construction firms and equipment providers.

While ANI was actively seeking equity sponsors, it was simultaneously in the market to attract debt financing. From the onset of structuring the 4G program, it advocated for the creation of a new Colombian development bank, FDN, to assist in the campaign. FDN is a joint venture between the Colombian government, two development banks (the IFC and the Corporación Andina de Fomento) and the Japanese commercial bank Sumitomo Mitsubishi. It has played an instrumental role in structuring the projects' financing and providing bank guarantees to equity sponsors.

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European investors have expressed a considerable appetite for Colombian infrastructure assets.

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According to Infrastructure Journal, the whopping COL2.5 trillion (US\$900 million) of credit lines available to finance 4G will enable ANI to proceed with many of the flagship projects of its first and second waves. As further proof of the improving credit profile and promising growth potential that Colombia has to offer, 4G sponsors have been able to tap private lenders, such as investment and international banks, to provide some of the largest-ever project-finance loans and bonds in the country's history.

Even as Colombia has experienced its share of trials and tribulations in the past, its keen self-assessment and identification of the strategic importance of its national transportation infrastructure will enable it to further enhance its competitiveness and lay the foundations for sustained economic growth. Under the leadership of President Santos and ANI's Andrade, undertaking the most ambitious infrastructure program in the country's history is a welcome challenge that will transform the lives of Colombians for many years to come.

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*This article was written by Chris Dell'Amore, Shriti Rath and Ian Stewart, members of the Lauder class of 2018.*

# Kenya's Startup Scene: How Private-sector Innovations Are Filling Gaps in Public-sector Services

In 2014, the Kenyan government triumphantly announced that 89% of the country's public facilities, including schools and hospitals, now have electricity. This decade-long effort had been accomplished in collaboration with the World Bank and other international organizations at an annual cost of \$100 million. Despite this much-touted achievement, electrification rates for households remain low in Kenya, at a national average of 32%. This includes the highly electrified urban areas in and around the capital, Nairobi, hinting at the nearly complete lack of electrification in rural areas. New connections are either totally unavailable or pose prohibitive timeframes and capital costs.

The challenge Kenya faces in providing electricity to its citizens is only one of many for a government plagued by budgetary shortfalls and endemic corruption. However, there is cause for optimism. The country's vibrant entrepreneurial scene has produced many startups looking to fill the void left by the government's failure to provide public goods. The private sector is stepping up by developing creative and affordable solutions to help underserved Kenyans access power, clean water, education, the internet and other basic services.

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Private companies are often recognized as a critical driver of economic growth and innovation.

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In order for these businesses to overcome scale and sustainability bottlenecks, private providers of public utilities may partner with the government, creating a private-public development model that has the potential to satisfy shareholders and Kenyan citizens alike.

## Kenya's Challenges in Providing Basic Services

As of 2016, setting up a new electric connection in Kenya can take an average of 100 days at a subsidized connection fee of \$400 for covered areas, an amount that can increase significantly in unelectrified rural areas. The low electrification rate is not surprising for a country where the average annual per capita income is \$1,250. It's not just

access to electricity that is an issue, but also the reliability of that access. In 2014, 30% of the country's electrified households experienced a two-week interruption in service.

Kenya's government is also failing significantly when it comes to providing basic sanitation and water treatment. In the urban areas, only 16% of 12 million residents have access to residential sewer lines, while across the country over 15 million people lack direct access to clean, potable water.

Even where they exist, sewer lines are subject to poor construction and management issues that pose real health threats; nearly 90% of the untreated sewage in Nairobi ends up in the aquifer system. Yet the Kenyan government consistently underfunds the provision of a basic public good. While it's estimated that access to sewer lines in urban environments would cost the government \$57 per person, the 2015 national budget allocated the equivalent of \$12 per person to that end.

Kenya has been unable to grant its citizens access to basic services for a number of reasons, including corruption, politicization of strategic utilities, chronic underinvestment and the lack of an appropriately trained workforce. But all is not lost, as east Africa's largest economy leverages its entrepreneurship tradition to breed dynamic startups looking to use the government's shortcomings as an opportunity for socially impactful financial success.

## Private Companies Are Well-equipped to Step in

Private companies are often recognized as a critical driver of economic growth and innovation. According

to the International Finance Corporation, the private sector contributes nearly 90% of employment in the developing world, including both formal and informal jobs. Private-sector innovations are also attempting to address issues that are generally considered public-sector responsibilities. And the private sector attracts large sums of foreign direct investment (FDI) to implement and execute solutions, with Kenya alone receiving inward FDI flows of \$1.4 billion in 2015.

Private-company approaches to what have traditionally been public-sector domains have the potential to be successful because of their dual-pronged focus on innovation and sustainability. For example, Powerhive is a private technology venture that has developed a proprietary solar-energy microgrid to bring electricity to rural Kenyans who lack access to the grid.

In terms of sustainability, not only is Powerhive's solar solution cleaner than the traditional grids or diesel-power generators that run on fossil fuels, it also costs rural Kenyans a fraction of what they would have to pay to access Kenya's state electricity grid. Powerhive charges \$30 for a connection fee, and customers are charged per use. This pay-per-use fee, which works similarly to prepaid fees for mobile phones, is designed to generate a sustainable profit for the company while being affordable for the rural customers. Backing Powerhive's mission are companies including Total and Caterpillar, venture capital funds and even angel investors such as actor Leonardo DiCaprio. With this support, Powerhive's founders aim to reach 2 million people with electricity in the next two years.

Another company with innovative solutions to providing both reliable energy and telecommunications services is BRCK, which sells a portable internet hotspot device that lasts up to eight hours per charge for a cellular data-enabled Wi-Fi connection. This is especially useful for small-to-medium enterprises that need stable access despite Kenya's persistent blackouts. To increase profitability and sustainability, BRCK is testing a strategy to provide additional free cellular hotspot locations, given the realities of Kenya's low purchasing-power environment. This new model should help the company expand well beyond its 70 current hotspots throughout Nairobi.

Education is another area in Kenya where the private sector is finding the opportunity to have an impact. The founders of Moringa School, an education startup that provides coding classes to aspiring software developers, sought to create a framework for higher-education solutions that would be more practical than what is found currently at Kenyan universities. Audrey Cheng, the school's chief executive officer and co-founder, explains that "we want to be focused on systemic change, on how to transform education. The work we're doing is exciting because we're questioning the core idea of education itself."

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As the Kenyan government continues to struggle to provide reliable public goods to its people, it is increasingly willing to look to the private sector to fill this need.

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Moringa pairs online learning tools with teachers, the majority of whom are practitioners rather than researchers or academics, and wants students to be ready for the workforce immediately upon completing the program. Unlike traditional universities, Moringa maintains a dialogue with private-sector employers to adapt its teaching approaches based on practical market needs. Successful graduates see a 95% job-placement rate as well as an average salary increase of 250%. But Moringa is highly competitive, with only 7% of applicants being accepted. There is also a question of how far it could scale given the hurdles common to many startups when it comes to funding, talent and government support. Nevertheless, Cheng says, "we don't foresee them as barriers to our scale."

### **Private Companies Face Specific Challenges**

As companies try to scale and fill the gaps left by the Kenyan government, they face significant challenges in three areas: expanding their business to different markets, obtaining funding and adapting their model to accompany their growth.

Most of these companies are targeting new markets in other African countries for expansion in the short

or medium term. Many are looking to enter adjacent countries where there are opportunities to address similar infrastructure shortcomings and gain more customers beyond the limited pool in Kenya. For example, to be profitable, Powerhive's electrification solution requires a minimum of 200 households connected to a single microgrid system. Considering this and other constraints, such as accessibility and terrain, Powerhive estimates its potential market share to be only 10% to 20% of the unconnected population in Kenya. In a similar way, only a certain part of the population can afford Moringa's high tuition costs. This aligns well with the school's strategy of limiting the number of students and focusing on quality, but it limits its scaling and expansion outlook.

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Conditions in Kenya are ideal for a private-sector-led approach to development that fosters innovative solutions.

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Funding is another key challenge for these organizations. Moringa's Cheng said that although the school cannot afford to hire and pay more employees at this point, she does not see it receiving funding from the government because of the issues of corruption. The challenge is different for Powerhive. Most of its funding currently comes from private donors from the United States who impose other requirements. For example, they're seeking short-term returns, which prevents Powerhive from developing larger, riskier projects.

Erik Hersman, chief executive officer of BRCK, said another challenge of scaling is "the difficulty of doing business development in Kenya and in many areas of Africa." This requires a thorough knowledge of markets in order to find the right avenues for development, market fit and geographies for expansion. Developing a business in Kenya is particularly difficult because of the lack of infrastructure and regulations: Electricity is unreliable, power outages are frequent, imports are highly taxed, local manufacturing capabilities are limited and several services such as customs operate inefficiently. It's also hard to find an educated

workforce with relevant skills to help grow a business. For example, Cheng recalled that, "We tried bringing a traditional teacher on board who failed miserably because he couldn't teach the new curriculum."

A final challenge for companies to scale is the necessity of adapting their model and organization as they grow, which often requires producing technical innovation. Sanergy, a company that is addressing Kenya's sanitation crisis by providing clean, pre-fabricated Fresh Life toilets to slum areas via a franchise model, has come up with a strategy for the next five years that involves piloting new solutions to present to municipalities: an in-home system, a service-fee-only model (no capital expenditures for consumers) and converting existing latrines to Fresh Life. Sanergy wants to adopt a franchise model that doesn't require more staff but raises new process and logistical challenges. In terms of innovation, Moringa is looking at flipping its classroom model to rely less on teachers and more on pairing online learning and teaching more efficiently.

Private companies must also maintain a delicate balance in their dealings with the Kenyan government. The legal and reputational liabilities associated with widespread corruption worry entrepreneurs and investors alike, and the pervasiveness of red tape and bureaucratic delays is a major source of risk for fledgling businesses trying to reach the market as quickly as possible. Due to the major mistrust that continues to exist between the Kenyan government and businesses, many entrepreneurs have weak ties to the government at best. However, when approaching issues of developing and provisioning public goods, a close relationship with the government will likely be critical for these growing ventures.

## Are Public-private Partnerships Viable?

As the Kenyan government continues to struggle to provide reliable public goods to its people, it is increasingly willing to look to the private sector to fill this need. In 2011, the government created Vision 2030 — an ambitious project to transform the country into an industrial success with a strong middle class. This venture, which hopes to provide a high quality of life to all Kenyans in just over a decade, comes with a huge price tag. Two of its features are particularly interesting with regard to the companies profiled here.

First, the Kenyan government acknowledges that it can't afford to fund its development agenda without the support and involvement of the private sector and stresses the importance of public-private partnerships (PPP). Second, the policy statement on the matter highlights the importance of "high-quality services and facilities with investment in infrastructure facilities." In other words, the government is increasingly looking for support to provide basic public services.

Companies such as those noted above are stepping up to meet some of Kenya's infrastructure and development needs. Successful partnerships with the government will help these companies grow and ensure that some of the country's key needs are met. In striving to improve sanitation in the country, Sanergy has become a vocal advocate of working with the government to be successful. It's collaborating with the Ministry of Education, among other agencies, and several universities to install Fresh Life toilets in schools. While support, advocacy and access are provided by the public sector, Sanergy and its private partners are delivering the funding for the project. Of course, Kenya's citizens are the beneficiaries. School attendance has improved, costs are lowered and sanitation has improved.

In the future, successful partnerships will require increased commitment by the government. As Sanergy notes, PPPs must be structured to support innovation, and regulation must allow for manufacturing, importing and a supportive business environment. According to Medora Brown,

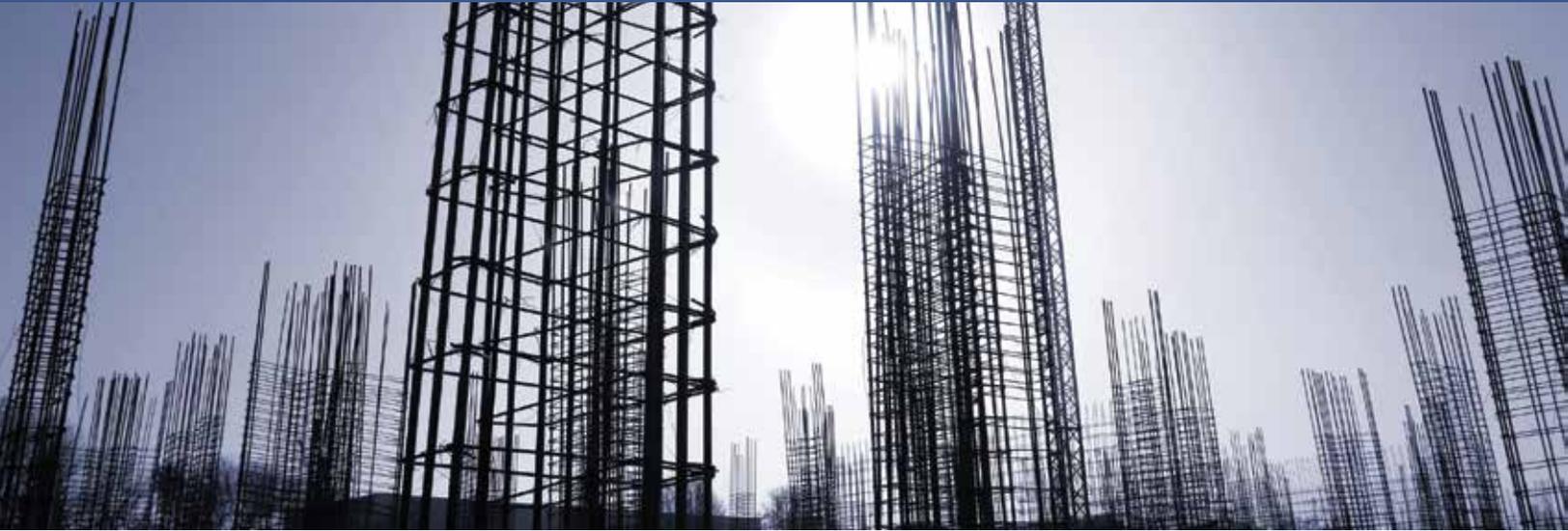
communications manager at Sanergy, "the only way that we can move from donor funds, which currently cover about 50% of our model, is to partner with the municipalities, who we believe should be playing a role here.... The best way for us to get to scale is to have government invest in this solution as well."

## Looking Ahead

Recommendations of development models for sub-Saharan Africa vary widely. There is no clear consensus on whether growth would be driven by Western aid, Chinese investment in infrastructure, local government programs or other development models. Still, conditions in Kenya are ideal for a private-sector-led approach to development that fosters innovative solutions. Hersman notes, "There's usually nobody doing it, so [we are] building it. Lagos, Nairobi and Cape Town are tech hubs because they have critical mass of the right things. It is universities that spit out decent graduates. It is capital. There are large multinationals that have their headquarters there. They provide jobs and a place for you to sell your products. And as bad as we say the governments are, there are worse ones elsewhere. We're the best in this area."

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*This paper was written by Sebastien Barruol, Julia Hoos, Marc Lanthemann and Kevin Vichyastit, members of the Lauder Class of 2018.*



## Cameroon's Colonial Legacy: Lessons for the Modern Day

Cameroon is often described as being “all of Africa in one country.” This includes the continent’s legacy of colonialism. Unlike many other African countries, Cameroon was colonized by three major powers. Germany was first, followed after World War I by France and Great Britain, which together oversaw a divided country. The vestiges of this division are evident today. Cameroon is officially bilingual, and discussions there often touch on the differences between the Anglophone and Francophone areas.

Within this context, Cameroon serves as the gateway to much of central Africa. It possesses the largest economy in the Economic and Monetary Community of Central Africa (CEMAC) and is also part of the larger Economic Community of Central African States (ECCAS). Unfortunately, the effects of the country’s colonial history

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The most lasting contributions from Germany’s colonial period were the infrastructure investments in roads, bridges, railroads, hospitals and buildings across the country.

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are still visible, and understanding this heritage is key to understanding modern-day Cameroon. This article analyzes how the major colonial powers — Germany, France and

Great Britain — shaped the country’s development during and after each administrative period.

### The German Legacy

Cameroon’s colonial history began with Germany. The Germans were not the first European nation to “discover” Cameroon. That distinction belongs to the Portuguese, whose name for the area, Rio dos Camaroes (Shrimp River, after the large number of shrimp found in the Wouri River), evolved into the name Cameroon. German merchants arrived in 1868 around Douala, the present-day economic capital. As colonialism spread throughout Africa in the mid-to late 19th century, the merchant class and local leaders found themselves searching for a colonial partner. In a bit of ironic foreshadowing, some of the local chiefs attempted to have Great Britain take over. Administering the country was certainly not an easy task; Germany did not gain control over the entirety of what is now modern-day Cameroon until 1909. It would be ousted in 1916 during World War I.

The most lasting contributions from Germany's colonial period were the infrastructure investments in roads, bridges, railroads, hospitals and buildings across the country. While the Germans subjected Cameroonians to forced-labor conditions on plantations in the south, public opinion in modern-day Cameroon is mostly positive, likely because the remaining German-built bridges, roads and buildings are tangible evidence of the earlier investments. Perhaps the most important decision the Germans made was moving the geographic capital in 1909 from Douala to Yaoundé, where it remains today.

Germany continues to be a significant partner for Cameroon. Since the latter's independence, the former has donated approximately €1 billion (US\$1.25 billion) to aid development efforts and has hosted numerous Cameroonian students at German universities. Currently, they comprise the largest group of sub-Saharan African students studying there. In addition to Germany's cultural, educational and economic influences on modern-day Cameroon, it is important to acknowledge the foundational role that colonial infrastructure investments played in facilitating the nation's future growth and development.

## The French Legacy

Following Germany's defeat in World War I, the League of Nations partitioned Cameroon into two administrative zones in 1919. The larger, eastern section was administered by the French, and the much smaller western area was administered by the British. The word "administered" is key as Cameroon was never technically colonized after World War I. When the League of Nations was replaced by the United Nations in 1946, Cameroon transitioned from a mandate territory to a Trust Territory.

In the 10 years after World War II, France designed a development program for Cameroon and invested over 90 million francs in the country — more than in any other French colony during the same period. When Cameroon was officially granted its independence on January 1, 1960, French politicians were called upon to help draft a constitution. The two countries have since maintained what they call a "special relationship" and remain closely aligned on most global issues.

While the elites in Cameroon culturally identify with the French, the young population is distinctly anti-French. Some

of this rejection is due to strict French immigration policies that awarded only 7,000 work or student visas from among the 800,000 who applied in 2014. During the European Soccer Championships in 2016, nearly 75% of Cameroonians said they supported nations other than France.

Economically, France and Cameroon were closely aligned due to fiscal requirements that placed around 50% of Cameroonian reserves in France. This gave France significant power over Cameroon's economy. While there are still numerous French multinationals — such as Total, Bolloré and AXA — operating in Cameroon today, trade relations between the two nations have diminished in importance. France currently accounts for only 4.4% of Cameroon's exports and 9.8% of its imports, and it has been supplanted in significance by other nations such as China, Nigeria and Spain.

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While the elites in Cameroon culturally identify with the French, the young population is distinctly anti-French.

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## The British Legacy

After World War II, Great Britain was awarded just one-fifth of Cameroon's land mass. The area was split into the Northern Cameroons, which ultimately became part of Nigeria upon independence, and the Southern Cameroons, which remains part of Cameroon. Today, the English-speaking region is relatively poor and neglected by the French-dominated central government. However, it is also known for being better organized and more high-functioning relative to the rest of the country.

Even before the country became an official British colony, there was a significant British influence. Baptist missionaries as well as neighboring Nigeria had laid the foundation for successful colonization. Joseph Merrick was the first missionary to arrive in 1849 and began providing education and exposure to the British culture. Today, the region continues to identify strongly with Anglo-Saxon and Protestant traditions and culture.

Great Britain oversaw its part of Cameroon through a policy of indirect governance. It empowered local heads who were then responsible for administering the government on behalf of the Crown. Cameroonians living in this region appreciated and valued this autonomy, which better prepared them for independence, as they were given a skill set for managing a people and providing a stable, British-influenced style of government.

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Great Britain oversaw its part of Cameroon through a policy of indirect governance.

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From an economic standpoint, the region benefited from its historical occupation by German planters as well as Nigerian traders and business people. This unique combination enabled English-speaking Cameroon to have a strong economy at the time. In fact, when the British came to power, forced labor ended in this part of the country and

migration to the region increased as farm workers were offered higher salaries. In addition, the British created the Cameroon Development Corporation, which is the second-largest business in the country today. This company produces rubber, palm oil, bananas, coconuts, tea and other agricultural products.

A significant divide remains between French- and English-speaking Cameroonians. Indeed, each group views itself as superior to the other, and both push for their agendas to be reflected in the government.

Cameroon is a country with many advantages, such as its coastal location, its role as the leading economy in the CEMAC monetary community, its currency, its trade union and its bilingualism. Those interested in doing business there need to understand its unique history and context to make the most of the opportunities the country offers.

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*This article was written by Ross Caton, Robert Millock and Nicholas Olson, members of the Lauder Class of 2018.*

# The Effects of China's Population Policies

With the implementation of the one-child policy in 1980, China created a demographic experiment on a scale never seen before. The new, top-heavy family structure has shifted family dynamics to focus on the family's sole offspring, who receives substantial resources toward health care and education. The child also faces the diverse aspirational pressures of the entire family on his or her personal and professional lives.

Initially, China benefitted economically from a relatively large working-age population as well as a high labor-participation rate because each family had fewer dependents. However, China now has a disproportionately older workforce, where the young will be unable to provide sufficient care for their elders as the population ages further. In addition, the one-child policy combined with a cultural preference for boys has led to a substantial gender imbalance. This has resulted in significant tensions within Chinese society and has been cited as one of the reasons for the country's high household savings rate, as families with sons are traditionally responsible for purchasing a house when their sons wed.

An aging population has become a worldwide challenge. In China, as a result of the one-child policy of the past 35 years, family structures and the composition of the workforce have changed dramatically. The generation born during this period will face pressure from families, the workplace and society as never before. In the next two decades, a Chinese typical family will comprise seven members: a couple, the parents from each side and one child. The parents of this generation have contributed their utmost to the lives of their children. Thus, the couple will bear responsibility for caring for all four parents.

China is now trying to repopulate its workforce by allowing and encouraging couples to have a second child. In traditional Chinese culture, giving birth to more babies means having more good fortune. Within this new norm of Chinese families, the couple is the sole workforce as well as the sole source of income. They are also the central point of three or even four generations. The double identities in both society and the family will exhaust their energy and time, whether they're ready or not. Most of those affected understand their roles in this situation. Nevertheless, they do express their concerns and expectations to their

family members — wishing their parents will have sufficient financial resources and focus more on their own lives after they retire. They also expect their own children to be more open when dealing with them. Interestingly, most couples put greater priority on their parents than on their own children. For example, they feel their time with their parents is limited, while they believe they'll have more than enough time with their children in the more distant future.

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China now has a disproportionately older workforce, where the young will be unable to provide sufficient care for their elders as the population ages further.

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Another issue in this new era is the elder-care challenge most families face in China. In 2015, those ages 60 to 64 made up 15% of the total population, while those ages 65 and older accounted for 10%. Both groups require health care and companionship. While their children are busy working, most of them will need to stay at elder-care facilities in the near future. This industry is significantly underdeveloped in China in both its structure and its workforce for several reasons. First, the high savings rates in China do not benefit the older generation as much as they do the young working class. The elderly do not represent the society's primary consumer group. Thus, the financial reward of joining this industry is not attractive enough. Second, with the growing proportion of the elderly in society, the younger generation will be pushed to join more productive industries. This will exacerbate the lack of workers in the elder-care sector. In a culture that values the elderly so much, the lack

of sufficient and appropriate systems for them will lead to other social issues.

Chinese society has long held a preference for sons over daughters. Traditionally, a daughter would marry into her husband's family, and her caretaking duties would be focused almost exclusively on her new family. Thus, having sons was essential for old-age caretaking and security purposes. Despite the Communist Party's best efforts toward gender equality in the 1950s and 1960s, this preference remained firmly ingrained. With the strict implementation of the one-child policy, most families had a strong preference for this child to be a son, which led to a significant number of sex-selective abortions. According to an article in *The Economist*, between 2010 and 2015, 116 boys were born for every 100 girls. In addition, because boys were generally deemed more deserving of high-quality nutrition and medical care, especially in rural areas and during times of scarcity, the child-mortality rate among girls was statistically higher.

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China is trying to repopulate its workforce by allowing and encouraging couples to have a second child.

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As a result, there are more than 60 million "missing" women in China. So far, the problem has been forestalled to some degree by men waiting longer to marry and then marrying younger women. However, this work-around has been all but exhausted, especially given the increased number of educated women and women in general in the workforce. In addition, as implementation of the one-child policy marks its 35th anniversary, relatively older men now realize they might never find a wife. This problem is particularly acute because marriage and family have always taken center stage in Chinese society. That rare uncle or aunt who never married, referred to as a "bare branch," has always been looked at with a slight suspicion and is often deemed to lead an incomplete life. Competition for brides is increasing and has been considered one of the reasons for China's high household savings rate. Traditionally, the groom's family is

responsible for purchasing a home for the newlyweds, and its ability to do so is key for a son's decision about whom to marry. Combined with the rapidly increasing prices of residential property in China's desirable cities, families find they really need to save and stretch to stand a chance.

Relative desirability is still a zero-sum game, even though hard numbers show that many men will be unable to find a wife: Within 10 years there will be more than 150 men for every 100 available women. This poses a serious challenge as the Chinese culture tries to quickly adopt new attitudes about unmarried men. Of even greater concern is the consistently strong correlation observed around the world between the percentage of unmarried men and levels of crime and violence.

Another issue that exacerbates the gender imbalance is the fact that women in China previously tended to marry men of higher education and/or social standing. Traditionally, this was quite a natural fit. However, now that the genders have become more equal, new societal norms have not kept pace. As a result, at the highest levels of education and standing there is an oversupply of women — often referred to rather derogatorily as "leftover women" — which distorts the imbalance in the marriage "market" even further.

In the past, Chinese family units comprised three to four generations living under one roof. This created a large support network, as most nuclear families had many children. Conservative values encouraged marriage at younger ages to boost the quantity and healthiness of future offspring. There were clearly defined rules and a hierarchy between the elders and youth in the family. All members were expected to contribute to the household by nurturing the young and protecting the old. However, Chinese family values have now shifted considerably, adapting to the needs of modern society and the government's strictly enforced population policies.

The one-child policy had immediate impacts on family structures and values. Expectations and aspirations placed on future offspring were suddenly focused on a single child, who ultimately received all the resources generated by the family. Many families found ways to compensate for the new smaller units by becoming closer to their extended families. Chinese offspring who grew up as single children often referred to their cousins as their brothers and sisters

because they had no siblings. As the first generation of one-child-policy babies ages, the financial burden to support the elderly is magnified. Each couple now has to support two sets of parents alone, unlike in the past where responsibilities were shared among a number of siblings.

Interviews about current family values and structure were conducted among several Shanghai residents with various backgrounds, including regional origins, education levels and professional experiences. When asked about familial financial support norms, most of the respondents maintained the traditional view where the parents feel obligated to make financial contributions to support their children's education and set up their future households. According to a 28-year-old female, "Education is a priority. I would use all of my financial means to give my children the best education possible. I would also help my future children purchase a home and a car to insure that they are off to a good start when starting their own families."

However, there is a slight shift in the expected financial contribution between husbands and wives. Most respondents supported gender equality within marriage, where the financial burden would be shared equally; however, if the earning capabilities are unequal, the couple would split responsibility proportionally. A 32-year-old male noted, "Times are different now. Women and men are expected to financially contribute equally to the marriage in current times. However, if either happens to earn more, I think that is OK, too, as long as the other gives in his or her own way."

Interestingly, when asked about care for their elderly parents, the respondents were divided between having

their parents live with them in the future or having them live in a facility. Nevertheless, the majority of the respondents expressed strong opposition to living with their own children in the future and preferred to remain independent.

With regard to expectations of marriage age and number of children, many respondents noted that they had received pressure from their own parents, peers and society. In response to the negative stresses from outside pressure to get married, most respondents wanted their children to marry without time constraints. A 25-year-old male added, "After all the peer and societal pressure I receive when it comes to marriage, I would not want the same for my children. I believe they can find love and build a family in their own time. Why rush when there is so much time now?"

While the definition of family and expectations about roles and responsibilities now differ from those held traditionally, several values and priorities have remained constant. Education is still highly valued in Chinese culture, as evidenced by parents' willingness to pay incredibly high tuition fees to ensure their children are fully prepared to be competitive in the future. Despite the new norm of loose-knit families, respecting elders is still considered a common value, even though it may not be held to as high a standard as it once was.

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*This article was written by Laurence Groot, Deyang Ren and Carissa Teng, members of the Lauder Class of 2018.*

# Venture Capital in Europe and the United States: Differences in Economy and Culture

The history of venture capital (VC) is much longer in the United States than in Europe. While it's about 40 years old in the U.S., this industry wasn't established in Europe until the late 1990s. The timing was not ideal. The vast majority of firms didn't survive the dotcom bubble, and investors refused to throw good money after bad, which delayed VC's rise in Europe for almost a decade.

Fifteen years have passed since the dotcom bubble burst. How does venture capital compare in these two economies today? Europe's gross domestic product and population are slightly larger than those of the U.S., making a fair comparison possible. Many contend that Europe's VC industry has developed quickly in the last decade, even faster than its American counterpart. After all, in the past five years the growth rates of VC-invested amounts in Europe have been almost double those in the U.S. (20% vs. 13% CAGR).

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There is no single stock exchange in Europe that operates on a scale similar to NASDAQ.

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However, a simple overview of the most relevant indicators signals that there's no reason for too much enthusiasm. In the past five years, the amount of VC money invested in the U.S. has been five to seven times higher on average than that invested in Europe. Furthermore, Europe accounted for just three of the so-called unicorns (companies that have achieved a valuation of \$1 billion) in 2010, while the U.S. had 40 and counting, growing at a steady pace of four per year. Even as 24 new unicorns have appeared in Europe since 2011, the U.S. has seen a similar acceleration, driven in part by a global increase in valuation multiples.

In the years following the financial crisis, European cities have been home to several promising startups focused on verticals: advertising technology in Paris, e-commerce in Berlin and financial technology in London are a few examples of specific verticals concentrated in certain cities. This is attracting the attention of new VC players all over Europe. Still, the question remains: Why is it taking European VC so long to catch up with VC in the U.S.?

The key factors behind this gap in scale fall under two broad headings — economic and cultural.

## Economic Drivers

The key economic drivers include less lucrative exit opportunities for VCs in Europe; the limited role played by institutional investors, especially pension funds, in providing capital to VC funds; the relatively heavy emphasis VC funds place on revenue-stage startups; and higher capital gains taxes.

Initial public offerings (IPOs) represent the most lucrative exit opportunity for startups, and every VC firm seeks an attractive exit to maximize its return on investment. VC-backed startups in Europe are less likely to go public through an IPO than those in the U.S. Based on data from Invest Europe, an association representing private equity and VC players in Europe, only 2% of the total divested amount for VC funds were accounted for by IPOs in 2015. Trade sales and sales to other private equity firms accounted for 60% of the total divested amount for VC funds. The amount received by VC funds from divestments via trade sales and sales to other private equity funds were 30 times greater than the amount received by VC funds from IPOs.

While mergers and acquisitions and trade sales are also more common in the U.S., IPOs represent a significantly greater exit opportunity for U.S.-based startups. Even for VC-backed startups that do exit via IPOs, the average amount raised in the U.S. is greater than that in Europe. In its report on global VC trends, EY, a professional services company, reports that VC-backed IPOs in Europe raised on average \$50 million in 2015, compared with \$97 million in the U.S. during the same period.

Why are exit opportunities in Europe less lucrative? The presence of NASDAQ, a well-developed and widely traded

stock exchange catering to technology companies in the U.S., has played a significant role in improving the access of U.S.-based startups to the stock market. There is no single stock exchange in Europe that operates on a scale similar to NASDAQ, which lists over 3,100 companies with a combined market capitalization of over \$9 trillion.

Another reason Europe's VC industry lags behind its U.S. counterpart is the relatively limited role played by institutional investors, especially pension funds, in providing capital to these funds. Pension funds are not permitted to invest in VC funds in certain European countries because of risk. In the U.S., however, they represent a significant source of capital.

After the relaxation of the Prudent Man Rule in the U.S. in 1978, pension funds became a major investor in the private equity and VC asset classes. Based on data from Invest Europe, pension funds in Europe accounted for only 7% of the total amount raised by European VC funds in 2015. In the U.S., however, this figure is estimated to be around 20% based on the 2014 Dow Jones Private Equity Analyst Sources of Capital Survey. There is also a significant difference across European nations, with countries such as Germany, France, Belgium, Luxembourg and the Netherlands having a low pension fund participation rate of 5% to 10%. Meanwhile, the U.K. has a relatively high rate of 29%.

In addition, VC funds in Europe tend to be more focused on enterprises in the revenue stage relative to the U.S. Based on EY research, investments in companies in this phase accounted for 70% of the total amount invested by VC funds in 2015. This implies that VC funds in Europe have a strong tendency to back companies that have relatively mature business models. Companies looking to secure VC funding must exhibit a relatively quick proof of concept and thus cannot invest significantly in growth and increasing market penetration. On the other hand, while most VC investments in the U.S. are still targeted toward revenue-stage companies, U.S.-based VC funds have a better reputation for backing growth-stage startups and placing emphasis on the team behind the startup, in hopes of backing a unicorn.

Serial entrepreneur Giuseppe Belpiede, who co-founded Stellup, a networking app for college graduates, has raised a seed round with investors from both continents and understands this dynamic well. "VCs in Europe were more focused on metrics and more traditional during talks with

their early stage startups (for example, filling in a long business and operational plan on Excel), while in the U.S. they seemed more focused on the team and their vision," he said.

Furthermore, higher capital gains taxes in certain European countries tend to discourage VC and entrepreneurial activity. By imposing a relatively high tax rate on the gains made when assets are sold, tax regimes tend to dissuade venture capitalists and entrepreneurs from taking risks. The capital gains tax rate varies across European countries but is typically higher than in the U.S. The rate is as high as 33% in France, while rates in the Nordic countries range from 22% to 25%. In the U.S., companies can typically expect a capital gains tax rate of 15%.

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Higher capital gains taxes in certain European countries tend to discourage VC and entrepreneurial activity.

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## Cultural Drivers

Differing attitudes toward risk aversion, idolization of entrepreneurs, social responsibility, multilingualism and the role of universities in the innovation space help to explain the differences between VC activity in the U.S. and Europe beyond economic reasons alone.

## The Entrepreneur Role

Oprah Winfrey, Steve Jobs and Elon Musk are names that evoke success, creativity and grit in the American conscience. They're sterling examples of the entrepreneurial spirit that has made the U.S. a destination for innovative minds throughout the country's history. Indeed, entrepreneurs such as these are idolized because they embody the American dream: the idea that any individual, regardless of background and circumstance, can achieve great financial success through determination and a strong work ethic.

However, entrepreneurial success stories do not enjoy the same degree of adoration in Europe. Unlike in the U.S., where the goal for entrepreneurs is a speedy, lucrative exit strategy, in Europe greater emphasis is placed on the

social responsibility business owners must assume for their employees and the welfare of society as a whole. The European Union's single market most closely resembles a social market economy that champions private enterprise, as well as social policies and regulations that ensure a high standard of living for all members of that society. Thus, there exists no runaway success narrative for more profit-driven European entrepreneurs to emulate.

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Entrepreneurs and VC firms must reckon with 24 unique languages in the EU when assessing scalability and expansion prospects.

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As Belpiede notes about European investors' more risk-averse nature, "There is no doubt VCs and all the ecosystems in the U.S. have a bigger appetite for risk, and everyone supports startups to get started more easily. In our case, it took only a few days to get our company incorporated in Delaware and have a top Silicon Valley law firm to help set up our company and convertible notes at no costs (i.e., all fees were deferred for a Series A). In comparison, setting up a company in Italy can take weeks, and lawyers always charge a couple thousand dollars, which in initial stages can hurt a business. Similarly, when talking with funds, it was tricky to convince them to invest using SAFE (i.e., the Simple Agreement for Future Equity, a convertible note that YCombinator uses), as the standard is to get equity in return of small investments."

Just as the U.S.'s diversity is often highlighted as a reason for its thriving VC industry, multilingualism and cultural diversity are often cited as hurdles to VC-driven innovation in Europe. Entrepreneurs and VC firms must reckon with 24 unique languages in the EU when assessing scalability and expansion prospects. For example, if a Dutch developer creates an app in his or her native language, that app's maximum addressable market is capped at 21 million people (the number of Dutch speakers in the EU). This is a tiny fraction of the approximately 500 million consumers in the EU's single market.

In addition, cultural diversity plays an important role when VC firms vet possible investments. European countries are

home to numerous cultures and ethnicities with divergent values and norms. A startup's success within Germany is not a reliable indicator of its prospects for success in France, Spain or even another German-speaking country such as Austria. Cultural and linguistic diversity can actually heighten a startup's risk of failure, although the EU's single market encourages the development of products and services that can be made available throughout the continent.

Another possible consequence of the EU's cultural and linguistic diversity is that no European city has emerged as a central tech-hub like Silicon Valley in the U.S. While prominent startup scenes exist in London, Berlin and Paris, this fragmentation makes it difficult for VC firms and entrepreneurs alike. The former are unsure about where to focus their resources, and the cultural and linguistic barriers that exist across different startup hubs can create gaps in specific areas of expertise that stifle investment.

Similarly, this scattering of startups makes it more difficult for the latter to exchange new ideas and information with one another. In addition, the lack of tech giants located in close proximity to one another precludes the old Silicon Valley yarn of two employees leaving their respective companies to join forces and develop the next big idea.

Finally, universities play an important role as entrepreneurial hubs for aspiring startup founders in the U.S. Major universities invest in facilities and resources dedicated to this purpose, providing dynamic launch pads for American entrepreneurs who may not otherwise have the opportunity to get their ideas off the ground. While incubators and accelerators do exist in Europe, they are on a much smaller scale and are often unaffiliated with universities, where many enterprising young people are constantly exposed to new ideas.

While the VC industry in Europe has experienced sizeable growth in recent years, certain economic and cultural factors have prevented it from reaching the heights of its U.S. counterpart. Despite all the excitement surrounding its performance in recent years, whether it will be able to have a meaningful impact for the innovation and success of promising entrepreneurs is yet to be seen.

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*This article was written by Matt Alexander, Salvador Martinez-Igarza and Akshay Subramanian, members of the Lauder Class of 2018.*

# How Cameroon's Informal Sector Powers Its Economy

The informal economy is Africa's largest employer. According to the African Development Bank, the informal economy across sub-Saharan Africa represents 55% of the region's total gross domestic product and 80% of total employment. It's hard to ignore these numbers, especially as governments, nonprofits and the private sector alike are teeming with ideas about how to capitalize on the continent's untapped opportunities for growth.

Commonly called the next frontier for massive investment, entrepreneurship and innovation, Africa will boast a larger workforce than China or India by 2040. The business community is increasingly interested in understanding how to enter Africa's informal economy and navigate the many challenges in this nebulous space.

What is the informal economy? It can be defined as any economic activity, by individuals or entities, that isn't covered by formal arrangements or is unregulated without oversight from the state. In layman's terms, these economic actors are not registered with any government entity, meaning they lack proper licenses to operate a business, rarely possess a bank account and, most importantly, likely don't pay taxes.

For many, the first thing that comes to mind is the black market. Although that is one aspect, the informal economy is much more. Businesses in this sector often share many key characteristics that lend themselves to an informal arrangement. Most of these enterprises are small-scale, labor-intensive operations with only a few workers in industries that have low set-up costs and few barriers to entry. While the freedom of this proposition may sound appealing, it also means forgoing perks such as unemployment, welfare and pension benefits.

The International Labour Organization (ILO) estimates that nearly 41% of sub-Saharan Africa's economy is informal, and this figure is staggeringly higher when considering not only economic output but also labor. The ILO also estimates that nearly 75% of non-agricultural employment operates within the informal economy and that 93% of new jobs created in Africa during the 1990s were in this area.

How did such a large informal economy arise? References to it go as far back as historical records exist. However, the root causes of its rise in modern Africa are more poignant. For most individuals there, and Cameroon in particular, it is extremely difficult to access the formal markets. The lump-sum costs of paying for licenses, which often requires extra bribes to push paperwork through, and the costs to set up bank accounts and payment systems all discourage those with meager means from pursuing a formal business.

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The business community is increasingly interested in understanding how to enter Africa's informal economy and navigate the many challenges in this nebulous space.

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Moreover, because the state lacks the institutional capacity to regulate industry properly, aspiring entrepreneurs see little benefit in paying for a license. Most Cameroonians also don't trust electronic payment systems and prefer to use cash. Even though mobile penetration is substantial and expanding rapidly, Cameroonians prefer the tangible feel of real cash in their hands, a common phenomenon across the developing world.

In large part, Cameroon's informal economy stems from the country's weak government institutions and a labor market characterized by low-paying jobs and low productivity. The inability of these institutions to fulfill their essential

functions means that the tax system, regulations and property rights are neither thoroughly defined nor enforced. Cameroon's excessively high tax structure and complicated fiscal processes impose huge burdens on informal actors attempting to open a business. On average, it takes 86 days to follow five procedures to obtain a land certificate, and it costs 19% of the total value to register property in Cameroon. This explains why less than 2% of the land there is titled. The World Bank's 2015 Ease of Doing Business report ranks Cameroon as 172nd out of 189 countries.

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Another key factor contributing to the growth of Cameroon's informal economy is the gap between the curricula taught in universities and the skills required by growing industries in the formal economy. Despite an increase in access to education, a substantial portion of the workforce has not yet mastered literacy and numeracy. Graduates who lack basic competencies struggle to pick up the required skills through on-the-job training, making their insertion into the formal economy quite difficult. Even those with advanced degrees find themselves locked out of the formal economy, especially if they lack the requisite training and skills that high-growth industries require. For example, in 2012 a meager 5% of university students were enrolled in engineering, hampering Cameroon's plans to invest in energy and transport to meet its economic objectives for 2035.

Informal actors bear the brunt of these legal, institutional and educational deficiencies. Forced into a system where earning a livelihood means anything from setting up a fruit stand in Douala's largest open-air market to selling secondhand couches on the side of the highway to using one's truck to retrieve produce from remote villages, these informal workers forgo job security, fair wages and safe working conditions just to scrape by.

As of 2002, salaries in the informal sector were 44% lower than those in the formal sector. Moreover, these statistics don't reflect the likely further income disparities between men and women. Less explicitly, informal actors represent a largely marginalized population rarely acknowledged by legislators, even though their voices represent the bulk of the economy. Informal economy practices are often considered outmoded by the country's bureaucrats and private-sector leaders, even though Cameroon's dysfunctional market forces render the informal economy necessary.

From a wider perspective, Cameroon's government could quell the informal economy's expansion through a number of measures focused on improving the investment climate by cleaning up deep-rooted corruption as well as supporting the growth of agriculture through increased access to inputs, stronger ties to market information and comprehensive training through farmers' associations. More than anything, government and private-sector leaders must accept that "informal is normal." As long as massive structural deficiencies exist, the informal economy is not disappearing. So, how can decision-makers make progress in the near term?

The most immediate need is a restructuring of Cameroon's education sector. To revamp and revitalize it, the government needs to revisit the primary-education curriculum to boost literacy and numeracy rates, providing improved teacher-training programs and ensuring that families are incentivized to prioritize primary school for their children. The government should invest in a robust and easily accessible vocational training program to guarantee that students develop relevant competencies in high-growth industries, including construction, agriculture and tourism.

Few recognize this missing element better than Deputy General Manager Boma Donatus of the Agence Pour la Promotion des Investissements (API), Cameroon's one-stop shop charged with boosting foreign direct investment and economic diversification. Donatus recalls API's difficulty in staffing the construction of a pipeline running between Cameroon and Chad, a major infrastructure project that required highly technical skills. Unable to find specialists in Cameroon, the construction company was forced to hire technicians from abroad to ensure high-quality and timely

work. To Donatus, every instance of needing to fill a gap with foreign workers represents a failure on the country's part to train, educate and ensure the livelihood of its citizens.

Given the high prevalence of informal activity within Cameroon's economy, it should come as no surprise that most sectors — from agriculture to transportation to financial services — are naturally informal. On the agricultural side, the prevalence of smallholder farms throughout the country demonstrates the subsistence lifestyle of most Cameroonian families. The majority of rural households grow a mix of consumption and sale crops. The former, including maize, peanuts, cassava and tomatoes, are a staple of the Cameroonian diet and used in daily cooking. Other crops, such as cocoa, coffee, mangoes and avocados, are cultivated in small quantities and sold to local informal buyer/trader aggregators who form the first part of an extensive value chain leading all the way to the port city of Douala.

This value chain is regulated minimally by the Cameroonian authorities because the government prefers to tax larger aggregators and exporters rather than individual smallholder farmers. Moreover, given the convoluted land registration laws, many family farms, which form the majority of landholdings, are not registered properly unless there is an external buyer. The government allows informal transactions at the farm level but levies taxes at the market or export level to ensure it receives revenue from Cameroon's abundant crop production.

The informal economy reigns supreme in the transportation sector, where drivers use anything from motorcycle taxis to yellow Toyota Corolla taxis to pickup trucks and large lorries. Cameroon's large network of roads affords many industrious entrepreneurs the ability to earn cash quickly. Some do it as a side hustle while others engage in full-time work. But almost all do it within the informal economy because the registration of transportation companies and services is too costly for single-vehicle providers. The ability to earn fast and easy money by providing transportation services, coupled with a tedious regulation climate surrounding licensing and vehicle documentations, almost forces most Cameroonians to circumvent the government. Moreover, a lack of public transportation options and an underinvestment in meeting daily transportation demands

create an intense competitive market to move people and goods. Where the government collects in licenses, vehicle sales and registrations, it often fails to collect tax revenue generated from the use of those vehicles.

In any informal economy, middle men play a critical role in ensuring that goods get from source to consumer. In Cameroon, they are key to filling the gap between supply and demand. On any street in any city, town or village, one can find small kiosks selling everything from phone credit to soap to eggs. The prevalence of these vendors is the direct result of a lack of stores and supermarkets selling daily-use goods. Supermarkets are often far from most consumers, who don't always live in central market areas. They also have a reputation for high prices. Unlike supermarkets, street vendors normally do not pay rent nor do they have to register with the government, get costly licenses or pay taxes. The incentives to supplement other income with occasional street vending are high, especially when most Cameroonians understand that regulations hurt productivity and profits.

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More than anything, government and private-sector leaders must accept that “informal is normal.”

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One of the most prevalent forms of investment and savings in Cameroon is due in large part to the difficulty in accessing formal banking channels. Tontines, informal investment vehicles, are arranged in many communities across both urban and rural areas. They are pooled investment funds between community and family members that invest and allocate capital to entrepreneurs in the local neighborhood. Prominent businessmen from each community run these seed funds like angel investors and distribute sums to the best business ideas.

The investors then receive dividends and profit distributions according to their equity share. The funds are often locked up for years at a time and serve an important role as a form of forced savings. In a society where large families are prevalent, successful individuals find it hard to gain wealth in Cameroon through savings, as they're expected to support

this extended network of relatives. With funds tied up in investments through their local tontines, however, families are able to accrue wealth without the guilt of not dispersing funds to their extended family.

Cameroon is at an important juncture with regard to its political economy. The informal sector has grown so rampantly that most of the country operates outside of formal arrangements. This creates a negative feedback loop whereby the government collects less tax revenue and has less infrastructure, which stifles the growth of business, which then generates less tax revenue and so on. For investors, both local and foreign, these vicious cycles permeate into energy and health care, both vital to the future growth and economic development of Central Africa. Furthermore, it is nearly impossible to gauge the size of the economy and make educated decisions with regard

to strategy and operational implementation. Without a drastic overhaul of the judicial and education systems, corruption will continue to run rampant and undermine faith in institutions that are imperative for capital inflows and foreign direct investment.

Even though the “Africa Rising” narrative is gaining traction, it’s difficult to identify the opportunities amid so many structural and systemic challenges. At the end of the day, the best investments may still be the multimillion-dollar legacy industries such as agribusiness, oil and gas and telecommunications. But a business that creates added value for those operating within the informal sector may be just the ticket to a true “Africa Rising.”

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*This article was written by Julia Enyart, Ross Ionta and Michael Khassin, members of the Lauder Class of 2018.*

# Commercial Real Estate in Russia in a Time of Crisis

The ongoing economic crisis in Russia began with the collapse of the national currency on December 16, 2014, when the ruble lost nearly half its value against the U.S. dollar, sending shockwaves throughout the country's economy. Two key factors contributed to this crisis: the steep slump in oil prices and sanctions imposed by the West in response to Russia's unlawful annexation of Crimea. Oil prices plunged from \$115 per barrel in June to \$62 per barrel in December as a result of the slowdown in the global economy and the excess supply of oil. The dramatic decrease in oil prices had a detrimental effect on Russia's economy, where exports of oil and gas account for 50% of federal budget revenues. The country's heavy reliance on this industry has made its resource-oriented economy highly susceptible to fluctuations in the global markets for these commodities.

Russia's actions in Crimea, a peninsula in Ukraine, significantly undermined its global image and appeal to potential international investors. The ensuing sanctions restricted Russian companies' access to Western capital markets, which had a major impact on the financial sector.

Macroeconomic indicators attest to the unfavorable economic conditions in Russia. GDP contracted by approximately 4% in 2015 and (at the time this article was written) was expected to continue on a downward path through 2016. The inflation rate, which was triggered by the ruble's devaluation, was more than 15% in 2015. It was even higher in the food sector, reaching 26% in February 2015. This can be explained by the retaliatory counter-sanctions, banning American and European imports, that were imposed by the Russian government in August 2014. Because the inflation wasn't accompanied by a corresponding growth in wages, disposable income (in real terms) declined significantly. Russian economics experts, including Kirill Rogov, a senior expert at the Gaidar Institute for Economic Policy, hold a pessimistic view of the prospects for a speedy recovery.

While the crisis has affected the overall economy adversely, some sectors were hit especially hard. For example, the significant decline in the automobile industry resulted from the use of many imported goods in the production process. The economic crisis also has posed a number of challenges in the commercial real estate market, which includes retail, industrial and office properties. First, the geopolitical implications of the Ukraine crisis had a negative impact

on the market. Although some experts had anticipated an increase in foreign investments at the end of 2013, the crisis heavily damaged Russia's international reputation. The political and economic instability and the sanctions halted capital inflow into the country. In addition, as the economic situation worsened, many international companies closed their branches and left the country.

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Russia's actions in Crimea significantly undermined its global image and appeal to potential international investors.

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Second, the devaluation of the ruble by roughly 50% adversely affected tenants' ability to pay their rents. Under the terms of their lease agreements, rental rates were fixed in U.S. dollars. But the tenants continued to receive their revenues in rubles, meaning that their rental rates had doubled. As a result, many tenants struggled to pay their monthly rent and ultimately abandoned the properties, leading to the high vacancy levels. Given the oversupply in the market, landlords were motivated to maintain their landlord-tenant relationships. Thus, revisions of lease agreements and renegotiations of lease terms became widely accepted practices in an effort to keep the properties occupied. Renegotiated agreements continue to comprise a substantial part of the market.

## Debt Restructuring

Third, the revenues of tenants in the retail sector dropped significantly as a result of the decrease in disposable income. The loss in consumer purchasing power was linked directly to the slump in oil prices and inflation. The oil money wasn't pouring into the country the way it used to, and the prices of goods were increasing rapidly. As consumers became more savings oriented, they cut down considerably on their purchases. Retailers, in turn, were adversely affected by the devaluation of the ruble and hikes in the prices of imported products.

Many commercial real estate companies operating in Russia were faced with the challenge of paying off loans denominated in U.S. dollars, while earning income in rubles. Since 2015, debt restructuring has become a common practice for these firms to try to avoid defaults and bankruptcies. AFI Development, the Russia-based subsidiary of Africa Israel International Group, was one of the leading commercial real estate companies in the market. Over the past two years, it saw the value of its assets plummet by hundreds of millions of dollars. Under debt-restructuring negotiations, the Russian VTB bank assumed the repayment of a portion of this debt by taking possession of some of the company's assets. Other firms were unable to withstand the turmoil and eventually went bankrupt.

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As the economic situation worsened, many international companies closed their branches and left the country.

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As noted above, all three sectors of the commercial real estate market in Russia have been characterized by oversupply and fluctuating demand in recent years. In 2014, on the eve of the Russian military intervention in Ukraine, rental rates for commercial real estate were set almost exclusively in U.S. dollars. But revenues from stores, restaurants, factories and businesses that were renting office space were in rubles. Following the devaluation of the ruble, it was apparent that businesses across Moscow wouldn't be able to sustain the increasing rental costs, which essentially were doubled on paper.

Eventually, businesses began shifting the currency in the contracts to rubles. Inevitably, real estate construction and leasing companies were next in line to suffer from the immense effects of the devaluation. Andrei Protasov, managing director of investments and asset management at ILM, a Russian real estate consulting firm, said, "Bank loans that had been taken by real estate companies prior to the crisis in Ukraine were in dollars, since their revenues were in dollars. Once that changed, bank loans essentially doubled."

The retail sector, within the commercial real estate market, has been suffering from an oversupply in recent years. This started roughly in 2011 as real estate construction companies in the Moscow region began accelerating their production rate, substantially exceeding the growth in demand. This sector, which constitutes only about 1% of the market (in terms of demand for investments), was not affected as much as the other sectors by the increased supply. Nevertheless, in 2014, following the Ukraine events, the drop in oil prices and the devaluation of the ruble, rental rates began declining steadily. The vacancy rates of assets grew from 4% in 2014 to about 10% in 2016, and return on equity stagnated.

As of July 2016, according to Protasov, the negative trends were likely to continue through 2016. Following the 2014 financial events, as disposable income flagged steadily from roughly a 5% growth rate (in annual terms) to -5%, the retail turnover growth rate dropped as well, from roughly 4.5% (in annual terms) to about -14%. Nevertheless, according to recent Colliers International reports, this statistic improved substantially in mid-2016, with market turnover declining by about 5% (in annual terms).

## The Office Sector

The office sector has suffered the most. This is a key point of concern as this sector is perhaps the most active and significant, representing about 88% of the market, according to Colliers International. It has been hit repeatedly by most of the financial events that have occurred since 2011, when rental rates began to plummet. Following the events in Ukraine, these rates continued to decline as the drop in oil prices and the devaluation of the ruble took their tolls. Prices tanked by roughly 48% between the first quarter of 2014 and the second quarter of 2016, from \$760 to \$393 per square meter. Moreover, the percentage of vacant office space increased

from 16% in 2011 to 28% by the end of 2015. According to recent ILM reports, roughly 3.2 million square meters of office space are available in the Moscow region.

The industrial sector, which comprises about 6% of the commercial real estate market, has been rather stable in recent years and is generally not as sensitive as the other two sectors to financial and economic effects. This sector suffered from the supply spike in 2011, yet it experienced a comparatively small drop in terms of rental rates. In 2014, the industrial sector experienced a rather surprising undersupply, as opposed to the rest of the market, so rental rates peaked by the end of that year. Since then, however, rates have been dropping steadily, in line with general commercial real estate market trends and as vacancy rates increased from 3% to 4% in 2014 to almost 11.5% in mid-2016. In addition, rental rates have declined substantially, from about \$125 in 2014 to roughly \$60 per square meter in mid-2016 – a drop of approximately 52%.

As Protasov notes, “the Russian economy will not recover any time soon.” On the other hand, Andrew Matheny, senior economist at Goldman Sachs Russia, holds a more optimistic view. He forecasted a 1.5% to 2% economic growth and a reduction in the inflation rate, down to 5.5% by the end of 2016. As observed over the last two years, it seems that the commercial real estate market is part of this prognosis and is not operating as an independent entity.

Despite the volatility of the Russian market, some investors are confident that it will rebound in two to three years. Their optimistic outlook has led them to make investments in the amount of millions of U.S. dollars, primarily in the retail segment, which is currently the most attractive of the three, as contract periods are fairly short and rental

rates tend to be higher. These investors plan to benefit from sales of these assets once the market recovers. In light of the turmoil, companies that have maintained low levels of debt and have had strong local partners have been more successful in handling the crisis. On the other hand, those companies that have financed their projects through debt have been experiencing lengthy and challenging processes of negotiating debt-restructuring deals with their creditors.

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The oil money wasn't pouring into the country the way it used to, and the prices of goods were increasing rapidly.

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The commercial real estate market is currently experiencing a period of volatility. Decreased oil prices and the ramifications of the Ukraine crisis have had detrimental effects on the entire Russian economy. As the last two years have shown, this economy is highly susceptible to geopolitical risks. Going forward, its future relies heavily on the political course of the country, as well as on the situation in the global markets of oil and gas. Russian and international real estate investors hope to see that the risks they have been taking in recent years will eventually pay off in the long term.

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*This article was written by Tatev Amiryan and Roy Ben-Ami, members of the Lauder Class of 2018.*



THE LAUDER GLOBAL BUSINESS INSIGHT REPORT 2017

# CHANGE ON A GLOBAL SCALE



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