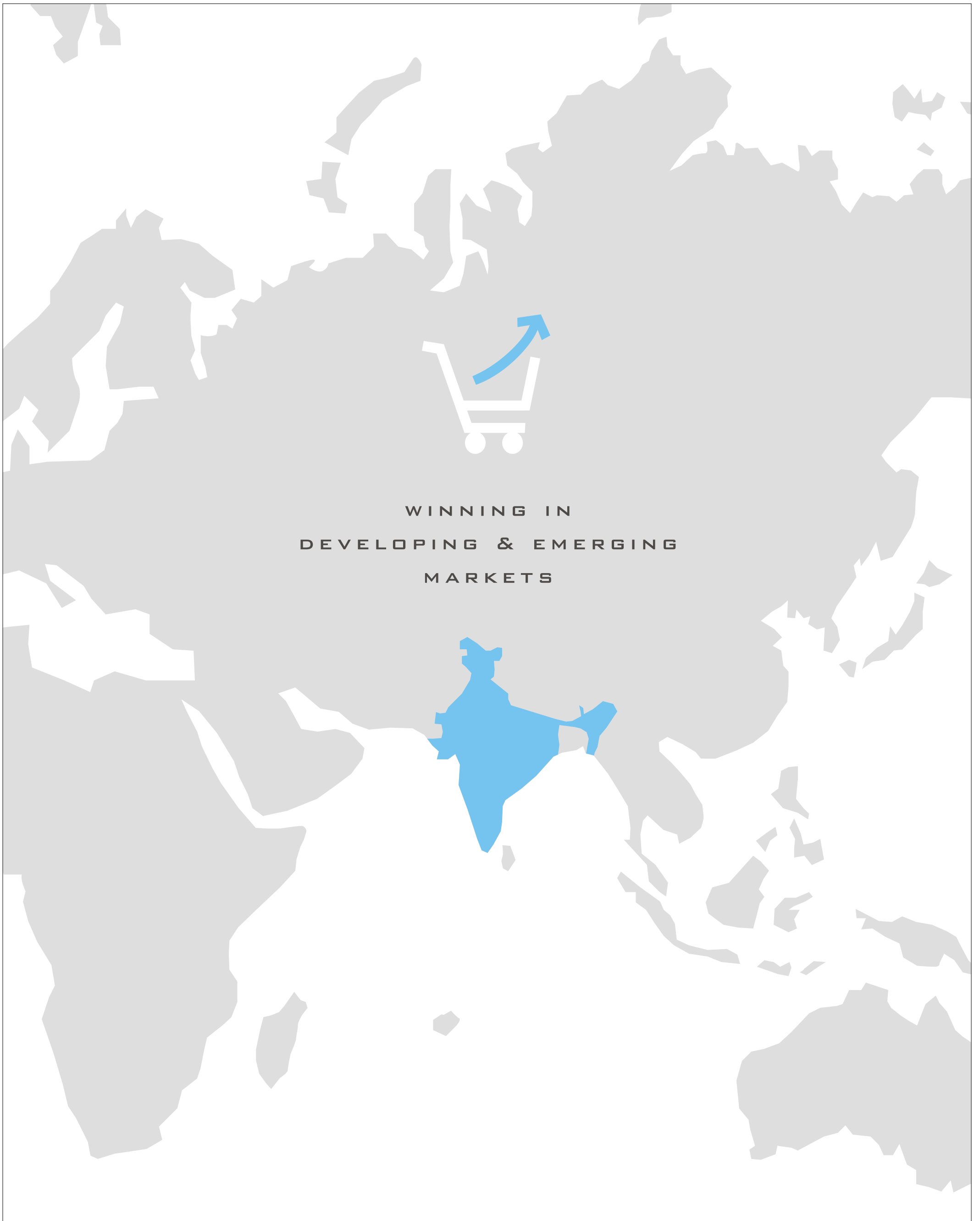

WINNING IN DEVELOPING & EMERGING MARKETS

HARISH MANWANI

2006

WINNING IN DEVELOPING AND EMERGING MARKETS

was the subject of the speech,
delivered by Mr. Harish Manwani,
Chairman, Hindustan Lever Limited,
at the Annual General Meeting,
held on Monday, May 29, 2006

Disclaimer: The map shown on the cover is not to scale nor is it intended to represent the geographic or political boundaries of any region or nation, but is solely used as a graphic portrayal of the same.

WINNING IN DEVELOPING AND EMERGING MARKETS

Hindustan Lever is on the threshold of an exciting era: capitalising on the massive market in one of the new power centres of the world – India. By 2010, consumer spending in developing and emerging (D&E) markets will overtake that in developed countries in purchasing power parity (PPP) terms. India will be at the forefront of this new world thanks to continued high GDP growth for the next several decades. With current projected growth rates, by 2025, India is expected to be the fourth largest economy in the world only after USA, China and Japan and, by 2035, India would have overtaken Japan to become the third largest economy in the world.

Winning in a leading D&E market like India will require that FMCG companies dispel traditional beliefs of focusing on narrowly-defined consumer segments. Instead, they have the opportunity to grow disproportionately by *'straddling the pyramid'* – offering premium brands to the affluent, value-for-money brands to middle-income consumers and affordable pricing to low-income consumers. Hindustan Lever is uniquely positioned to capture these opportunities in India as we have a long history, a deep understanding of consumers, a differentiated brand portfolio, the innovation and execution capabilities to straddle the Indian pyramid.

SECTION 1: D&E MARKETS, THE NEW POWER CENTRES OF THE WORLD WITH INDIA AT THE FOREFRONT

Importance of D&E markets

D&E markets contribute significant volumes to the global consumer goods market since the bulk of the world's population lives in these markets. For example, in 2005, Asia and Africa alone accounted for 75 % of the world's population. Estimates suggest that an additional 1.2 billion consumers across the world will buy packaged goods for the first time by 2010; the bulk of these consumers will be in D&E markets like India and China. With significantly higher GDP growth, these markets will also overtake the more developed markets, in consumer spending - adjusting for purchasing power, the D&E world will contribute more than $23 trillion in spending in 2010, which will be higher than North America and Europe put together.

We should also remember that this is not so much a future story as a present opportunity. We are seeing these trends and numbers as we speak today. With such massive untapped opportunities, D&E markets offer higher growth potential than developed markets. Recent years have seen a shift in business focus to D&E markets as companies strive to build sustainable positions in the fast developing regions. For several large global corporations, D&E

markets have already overtaken the developed markets, as a priority source of revenue and profit growth.

India, a key part of the D&E world

India now is ready for substantial change. Rising incomes, thanks to robust economic development, accompanied by changing lifestyles augur well for the growth across the FMCG sector in the coming years.

The socio-economic break-up of India expressed as a pyramid, has a large low income population, and a growing middle and affluent class. National Council of Applied Economic Research (NCAER) data estimates that by 2010, the "aspirant class" – consumers with incomes of Rs.90,000-2 lakh a year – will grow by at least 9 % and constitute 34 % of households. They will become first-time users of several branded FMCG products, heralding increased penetration of these products. In the same timeframe, the "climbing class" (consumers with incomes of Rs.2-5 lakh p.a.), the "strivers" (consumers with incomes of Rs. 5 - 10 lakh) and the "rich class" (consumers with incomes of more than Rs.10 lakh) are likely to grow at 12.5 %, 17 % and 20 % respectively. This will drive consumption and uptrading across categories. Further, India has a very young population and it will remain so for the next few decades: even in 2030, the working numbers will be about 70 % of India's population. The higher propensity to spend among young consumers and the softening of financing rates will continue to fuel consumer spending.

Per Capita income has risen 55 % in the last 6 years and by 2010, there will be 142 million people in the middle class, up from 83 million today.

SECTION 2: KEY CHALLENGES IN INDIA

Primary challenge: a pyramid with large, differentiated segments of consumers

The Indian market is not homogenous. It has many 'Indias' rolled into one: urban and rural, rich and the poor and diverse cultures across regions. Despite India's high GDP growth over the next many years, the socio-economic disparity in income is likely to increase. These factors will create a large pyramid of consumers with vastly segmented needs.

For FMCG companies, a unique challenge arises in such markets – adopting a 'one-size-fits-all' approach to the market does not work. Also, focusing on any one segment will mean limiting growth and profitability. The most value-creating strategy will be to straddle the entire pyramid. This, however, is easier said than done. For instance, for affluent consumers brand offerings need to be as good as the best anywhere in the world. At the same time, the challenge is to create products that meet the aspirations of those who strive to improve their lives but have very low incomes. These consumers do not want cheap or poor quality products at low prices but quality products which are affordable.

Secondary challenges:

Well entrenched traditional trade but also growing influence of Modern retail

India is estimated to have over 7.5 million small stores stocking FMCG products. These family-run stores will continue to be a large and important part of the Indian retail environment. However, other D&E countries have seen rapid growth in modern trade and there is no reason to believe that India will be any different. In the last three years modern trade has grown by 25 % p.a. with a huge interest from local and international players. FMCG companies will need to build new capabilities in supply chain management, in-store merchandising and key account management to cater to the needs of modern retailing. Doing this without diluting the established intimacy with the traditional trade will be a challenge.

Nascent branded foods market that is both a big challenge and a big opportunity

The other discontinuity in D&E markets is the growth of branded mass-market foods. India is one of the world's largest food producers, third only to China and the US. Yet, branded processed foods are conspicuous by their absence in India. More than 90 % of foods are still bought in unprocessed form. There is no food processing industry worth the name and almost no cold chain infrastructure.

There is also very high wastage and value loss in the Indian food chain – estimated at over Rs.50,000 crore due to poor storage and transportation infrastructure and, unfriendly regulation, all of which hamper market development. As a result, despite the large size of the market and its potential, most FMCG companies have been unable to achieve scale and profitability.

With growing incomes, changing lifestyles and emerging modern trade, the branded foods market offers enormous potential for those who can tackle the challenges of this industry and find the right consumer triggers for market development.

SECTION 3: HINDUSTAN LEVER – WELL POSITIONED TO CREATE SUBSTANTIAL VALUE IN INDIA

For Hindustan Lever and Unilever serving D&E markets is in our DNA. We have the global scale as Unilever operates in over 100 countries and enjoys leadership positions across several D&E markets. In India, an estimated 700 million consumers use HLL brands every day and nine of our brands are amongst the top twenty most recognised brands in the country. It is this relationship with our consumers and our century old operating experience, that has made HLL a household name and a market leader in a large number of categories ranging from fabric cleaning, hair care, face care, skin cleansing, tea and deodorants and a strong number two in others.

Six factors make Hindustan Lever well-positioned to continue to succeed in India. In each case, Hindustan Lever's local strengths are complemented by Unilever's global strengths.

1. ***An unmatched brand portfolio to serve the many Indias that make up this market***

2. ***The innovation and R&D capabilities that position us uniquely to straddle the pyramid***

3. ***A track record of building large and profitable mass markets, giving us a head-start in new, growing segments***

4. ***A versatile distribution network that is capable of managing both traditional and modern trade***

5. ***A good track-record of combining corporate responsibility and business strategies to aid rural development in India***

6. ***A strong local talent base***

Let me expand on all these factors:

HLL's unique product / brand portfolio

Our wide brand portfolio spans products for all income groups. We also have the capabilities and mindset to simultaneously span multiple consumer segments, product categories, technologies and business systems.

In the case of laundry we have Wheel, Rin and Surf Excel. Across these three brands we cover multiple benefits, product forms, pack sizes and a price range that makes our portfolio accessible to every segment of the market. This is true for all our core categories: from Clinic to Lakme Hairnext in hair care, from Lifebuoy to Dove in personal wash and from Brooke Bond Taaza to Lipton Yellow Label in tea.

Going forward, we will continue to strengthen our portfolio across categories by leveraging our strong R&D expertise and a deep category and consumer understanding.

Hindustan Lever's innovation and R&D capabilities are unique to straddle the pyramid

Hindustan Lever's capabilities of multi-faceted innovation, is core to seamlessly serve each segment of the consumer pyramid – innovation not only in product development but also in business processes, packaging, distribution channels, format and delivery mechanisms.

Our R&D and innovation skills are critical for success in each segment. For the affluent consumers, we draw upon Unilever's global and regional brand mixes. Equally, over five hundred Unilever R&D managers are dedicated to developing appropriate mixes for the mass markets in the D&E world. Moreover, we have institutionalised a "challenge cost" mindset in the company where the target price for consumers drives our business model for each specific segment and category.

An example will illustrate how these capabilities help us drive market development among lower-income consumers. We have seen consumers move from washing their hair with simple bar soaps to using branded shampoos. They could see and appreciate the benefits but few families could afford such purchases. The introduction of the single-use sachet for Re 1, helped us build the shampoo market in India. This success encouraged us to replicate the low unit price (LUP) concept in other categories: detergent, toothpaste, fairness cream sachets, mini-deodorant sticks, and single use tea bags. It is no surprise that all these have turned out to be highly successful for the company and key drivers to market development.

We have a similar story to tell in our laundry category. Over 100 years ago, Unilever introduced Sunlight, a branded oil-based laundry soap in India. Since then, the performance of our laundry products has been consistently improved through a combination of technology and consumer insights. For example, the patented flouroscer technology delivered superior whitening on clothes, a key consumer benefit.

In the seventies our R&D team pioneered the use of 'minor oils' like castor, rice bran and linseed, which were locally available but were previously considered unviable for commercial use in soaps because of odour, toxin and colour issues. This helped us retain quality while keeping prices at affordable levels and, at the same time, conserved foreign exchange for the country. The introduction of Rin, the synthetic detergent bar, marked another landmark in the laundry market – all the benefits of a detergent powder in a bar which retained the prevailing consumer habit of direct application. More recently, recognising the scarcity of water our scientists developed a detergent powder (Surf Excel Quick Wash) that delivered excellent cleaning while reducing the water requirement for rinsing by almost half.

HLL will continue to leverage its strong R&D and innovation capabilities to deliver performance and value to consumers across all segments of the pyramid.

Building large and profitable mass markets and shaping new, growing segments like branded foods

Hindustan Lever has had significant success in building large, mass-markets from scratch and this gives us the confidence to replicate the same success in the branded foods market. We have a solid base in tea with Brooke Bond as the clear market leader and strong equities in brands like Annapurna, Kissan and Knorr. The challenge is to build scale. Indian women have a high sense of pride in and emotional attachment to cooking for the family. This makes nutrition, vitality and functional benefits more important in India than mere convenience. And all this of course, at an affordable price.

Unilever's extensive presence in foods globally, complements our local consumer knowledge and insights in the Indian food and beverages categories. In India, we face the challenge of both malnutrition (and the resultant lack of sufficient and correct vitamins and proteins) and over-nutrition (over eating and a poor balance of foods). Unilever is leading the development of foods that deliver vitality and well-being – everyday products that control blood pressure, cholesterol or deliver daily requirements of fruits and vegetables in one shot! Equally, the challenge at the bottom end of the pyramid is to supplement basic everyday food products with daily requirements of vitamins and other "do good" ingredients. For example, over 40 % of India's population shows symptoms of Iodine deficiency and our Annapurna iodized salt addresses this problem effectively. In beverages, Unilever's tea science program allows us to offer consumers substantial functional benefits of "drink better, live better". The launch of Brooke Bond Red Label Natural Care, is a recent example of delivering superior functionality in the category.

Our versatile distribution capabilities, in managing both traditional and modern trade, give us another critical advantage

HLL brands are available in 6.3 million outlets and that makes our products accessible to every consumer segment in every single market in India. Our distribution reach is a huge competitive advantage and another area where we have consistently innovated to stay ahead of the game. We are currently in the process of establishing real time connectivity with all our redistribution stockists using state-of-the-art technology. This will substantially improve customer service. Equally, the emergence of modern trade is a reality and our strong portfolio of leading national brands and Unilever's experience in developed markets, where modern trade dominates, puts us in a strong position to build partnerships with strategic customers. This is a clear priority for the future and we have taken the lead in dedicating resources and building new capabilities for servicing this emerging channel.

Our practice of combining corporate responsibility and business strategies to aid the development of rural India

We live in an era when business is increasingly called upon to be an active partner in development. To tackle the increasing economic disparities in India, Hindustan Lever is working at combining corporate responsibility and community service with sustainable business models. We are focusing on women empowerment, health & hygiene and water management & conservation.

To illustrate, our Shakti initiative builds a network of local, credible brand endorsers reaching out to a rural Indian population of 85 million. This model serves three key business purposes: first, a significant increase in penetration and market shares for Hindustan Lever, already accounting for 15 % of our rural business in geographies where it has been operational for some time, second, a deterrent to counterfeits that account for 10-15 % of the total industry, and third, ongoing direct contact for the company with over 2 million rural homes every month in a cost-effective manner.

This strategy also plays a significant role in aiding economic development in rural India. The Shakti brand endorsers (the Shakti Ammas) are underprivileged rural women trained to manage businesses. Their average earnings are around Rs.800 per month and have helped double household incomes. We now have a network of over 22,000 entrepreneurs reaching over 70,000 villages. There are 600 million rural consumers living in 500,000 villages across the country. Our vision is to make Project Shakti a reality across this universe.

Another telling example of our ability to combine business strategy and economic development is the Lifebuoy Swasthya Chetana initiative. In India, almost 5 lakh children die of diarrhoea every year. Studies have revealed that washing hands with soap reduces the risk of diarrhoea by almost half. But there is little awareness of these basic hygiene habits, especially in rural India and also, soap usage is very low. To address this issue, we launched the Lifebuoy Swasthya Chetana initiative in 2002, spreading the message of health and hygiene using simple communication tools like flip charts, glow germ demonstrations, germ mask games and other activities. We have covered nearly 18,000 villages so far and plan to cover another 10,000 in 2006.

Water scarcity is a serious concern in India. Eight of the twenty major river basins are water-deficit. Through a series of technology innovations and novel processing routes we have reduced our ground water consumption in our manufacturing operations by over 50 % in the last 6 years. The company recycles effluent water after treatment, and 70 % of our sites are now 'zero discharge'. Reduction of water usage has also conserved energy that otherwise would have been consumed in drawing, pumping or processing water.

We are also committed to extending our efforts on water management to the larger community in which we operate and have taken initiatives such as Greening Barrens, Water Harvesting, etc.

Our strong local talent in India

HLL is well known for attracting and retaining the best talent in India. Our employees represent the diversity of our country and the shared values of 'Middle Class' India. This allows us to connect with our consumers and the communities in which we do business. Our broad portfolio of product categories, brands and geographies offers rich development opportunities for our people. Hindustan Lever offers its managers exposure to business challenges in the innermost villages of the country to the corridors of Unilever's Head office in London and Rotterdam. As a result, Hindustan Lever is one of the key sources of talent for Unilever globally.

As D&E markets like India become increasingly important for multi-national companies and, at the same time, India opens up to global competition, a two-way traffic of talent will be critical as we go forward. HLL is well poised to achieve this.

SECTION 4: WHAT WILL IT TAKE TO MAKE THE INDIA FMCG GROWTH STORY MORE DRAMATIC ?

While annual GDP growth of 7- 8 % for India is a prospect now widely acknowledged, India needs GDP growth of 10 % p.a. to ensure that, in the next 10 years, 75 million new jobs are created and unemployment restricted to 7 %. This calls for close collaboration between industry and government. The Government must do only what it can do best and so must the industry. The government should focus on creating an enabling policy environment and address key issues like education and adequate infrastructure. Industry should deliver world-class productivity, high standards of governance and cost competitiveness.

It is in this context that we should see the FMCG industry. The enormous growth potential in India shows that FMCG will keep growing robustly. But growth could be even more dramatic if the FMCG industry and the Indian government work closely to help create an enabling environment for such explosive growth. India has already seen exponential growth in telecom, automobiles and airlines thanks to concerted government and industry actions. The obstacles to FMCG and overall growth have been discussed many times but bear repeating. There are three main policy obstacles: high indirect taxes, poor infrastructure and archaic labour laws.

Indirect taxation is a key concern. In most categories, indirect taxes as a per cent of retail prices are much higher in India than those in other markets, for example China.

China has a flat VAT of 15 % of the retail price for FMCG products like shampoos and soaps. In India, in contrast, indirect taxes account for 25-30 % of end-retail prices for certain FMCG products. Reducing these taxes would have a dramatic effect: every 25 % fall in prices has the potential to increase consumption three to five times. The increases in volumes will also more than neutralise the reduction in tax rates and government revenues from taxes will increase. For instance, in 1994-95, when the government reduced excise duties on cosmetics and toiletries from 75 % to 50 %, its excise duty revenues rose by approx 20 % and the industry grew by over 50 %. India has the potential to be the world's biggest FMCG market. If China can address its indirect taxation issues and become the world's largest domestic market and export hub for products like TVs, we should ask ourselves why India can't do the same in the FMCG sector.

Introduction of VAT in most states in 2005 and its expected extension to the few remaining but important states in the course of 2006, marks one of the most progressive steps in recent times in the arena of indirect tax regime. The next logical step is for the Government, Trade and Industry to work together towards a 'general tax on goods and services' which combines the present levies of excise, VAT/sales tax, local taxes like octroi and entry tax, etc. Such a tax if levied at a moderate level could significantly fuel demand, increase overall revenues, ensure better compliance and eventually lead to scale benefits.

Inadequate infrastructure also takes a toll. Poor roads and power conditions, badly equipped ports, lack of irrigation and the absence of a cold chain are forms of impediments to the supply chain. Worse, they prevent India from becoming a competitive FMCG source for developed markets. The Government must accelerate major infrastructural developments as a key priority.

Equally, the Government must influence the current regulatory framework that would help the industry to realize productivity gains and be cost competitive. Reforms in the Industrial Disputes Act and Contract Labour Act are overdue. These should no doubt be accompanied by improved social security measures, borne by industry – such that the rigidities in the employment market are removed while employee interests are well protected.

Past studies have shown that consumer goods industries have an employment elasticity – an increase in employment in response to economic growth – of 0.9. This implies that for a 100 % growth in consumer product industries, new jobs, both direct and indirect, will grow by 90 %. Therefore, an accelerated growth in FMCG sector subserves the policy objective of creating new jobs.

True, FMCG companies like Hindustan Lever have succeeded despite the above obstacles. But, unhindered, they could grow even faster, with untold benefits for consumers and the economy.

Conclusion

The expertise and strategic focus I have described have helped Hindustan Lever become India's leading FMCG company. By capturing the rich opportunities to serve India, one of the world's leading D&E markets, we will continue to build on this track record. We will fulfil our commitment to serve all parts of the Indian pyramid by meeting the needs of increasingly affluent Indians and equally serve the lower income consumers. We will continue to grow our current categories while building new successful mass-markets like processed foods offering nutrition and vitality. We shall partner with the traditional trade and the nascent but growing modern trade. We will continue to combine business strategies and social responsibility and foster unmatched local talent while simultaneously accessing global talent. We will surge ahead in this new journey, which echoes our past achievements but leads us to re-invent ourselves as India re-invents itself and work towards greater prosperity for Indians, for our shareholders and for all of us at Hindustan Lever.

Published by Paresh Chaudhry,
Head - Corporate Communications,
Hindustan Lever Limited, 165/166 Backbay Reclamation, Mumbai 400 020,
and printed by him at Image Production,
Unit No. 223, New Sonal Link, Heavy Ind. Est., Link Road, Malad (W), Mumbai - 400 064

The speech can also be accessed at
Hindustan Lever's website http://www.hll.com

"Our mission is to add vitality to life. We meet everyday needs for nutrition, hygiene, and personal care with brands that help people feel good, look good and get more out of life”