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TIME TO REENGAGE WITH, NOT RETREAT FROM, EMERGING MARKETS

By Bernd Waltermann, David Michael, and Dinesh Khanna

AT A GLANCE

These are challenging times to operate in many emerging markets. But companies that plan to scale back should reconsider. With hundreds of millions of households joining the ranks of the middle class and affluent, and with enormous infrastructure needs, emerging markets will remain an unmatched source of growth in many industries.

A Tougher Competitive Landscape

As the era of superfast growth fades in many emerging markets, the competitive landscape is getting more complex. Consumers are more demanding, the domestic competition is tougher, and potential local partners have higher expectations.

Time for a Fresh Approach

Executives should adopt a more differentiated approach to emerging markets and market segments. Companies should build new capabilities, adjust their business models, and improve their execution.

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These are challenging times for emerging markets. China's economy is expanding at the slowest pace in more than a decade, and annual growth in once-booming nations like Brazil, Mexico, Russia, and South Africa has slowed to about 1.5 to 2.5 percent. Look around the developing world, and currencies are weakening, worries about asset bubbles and rising debt are mounting, and foreign direct investment has fallen sharply. This volatility leaves many companies wondering if they are overexposed to the risks of emerging markets.

The challenges in emerging markets go beyond volatility. Fundamental, longer-term changes are transforming the competitive landscape. In most emerging markets, domestic companies with low cost structures and intimate knowledge of local consumers are more aggressive and are quickly improving their operations. Competition for increasingly scarce talent is fiercer and is driving up labor costs. Such trends are hurting profits. In China, for example, the share of U.S. companies reporting that their operating margins were higher than the global average dropped from about 50 percent to just over 30 percent between 2010 and 2013, according to the American Chamber of Commerce in Shanghai.

Still Where the Action Is

But companies that plan to look for the exits or scale back in emerging markets should reconsider. The most fundamental trends remain promising. One is that emerging markets will remain an unmatched source of growth in most industries. Another is that hundreds of millions of households will continue to join the ranks of the middle class and affluent in the decade ahead.

Despite the discouraging headlines, emerging markets are more important today than ever before. Even with all the turbulence in 2013, these economies accounted for 68 percent of global growth. Although the overall pace has slowed, Oxford Economics projects that GDPs of emerging markets will grow 2.2 percentage points faster than those of developed economies over the next four years. Just in terms of infrastructure, demand for investment in emerging markets will total a stunning $25 trillion through 2025, according to some estimates.

The biggest driver of growth will be rising incomes. The Boston Consulting Group projects that in Turkey, an additional 6 million households will enter the middle and affluent classes in the next five years. In Indonesia, we project that 68 million people—roughly equivalent to the entire population of the UK—will make a similar leap by 2020. Thirty-seven percent of Brazil's 60 million households will belong to the middle and affluent classes by 2020, compared with 29 percent now, and will represent a $1.2 trillion market. In China and India, such households will represent $10 trillion in buying power. Companies will have to look beyond a country's GDP and focus instead on the more significant factors that will generate growth: rising consumption by relevant segments of consumer markets, and signals that purchasing power is about to take off.

To win in emerging markets, executives will need to rethink their approaches. As many of these economies make the transition from superhigh growth, tapping major new sources of revenue will become harder than in the past. Executives should adopt a more differentiated approach to emerging markets and market segments. Companies should build new capabilities, adjust their business models, and improve their execution. We believe that the following are the primary corporate challenges.

Executives should adopt a more differentiated approach to emerging markets.

Refining the Emerging-Market Footprint. Growth prospects, consumer behavior, and the local competitive environment differ widely from one emerging market to another, as well as among industries. Each company must define the most promising emerging-market priorities, taking into consideration its own unique context and starting point.

We offer two specific ideas for how executives should revisit their market portfolios. First, they should think beyond the popular acronyms. In the past few years, attention has been focused on the so-called BRIC economies—Brazil, Russia, India, and China. More recently, there has been more talk about MINT (Mexico, Indonesia, Nigeria, and Turkey). Of course, no company with global aspirations can ignore China and India. But companies should also build positions in markets that may offer better opportunities in the short term. While many multinational companies still target Indonesia, for example, material opportunities are also opening in adjacent Southeast Asian economies such as Vietnam, a recharged Philippines, and the frontier market Myanmar. Africa is also drawing greater attention from multinationals. Hyundai, for example, has surpassed Toyota in the five African countries that account for 70 percent of new-auto sales: Algeria, Angola, Egypt, Morocco, and South Africa. Samsung, also of South Korea, has set two goals for 2015: achieving $10 billion in African sales and training 10,000 African engineers and technicians in order to develop the capabilities it needs to succeed. (See *Winning in Africa: From Trading Posts to Ecosystems,* BCG report, January 2014.)

Second, executives should simplify their strategies in order to expand and compete. Rather than always approaching each country individually, for example, they should think in terms of clusters. The sheer challenge of understanding and winning in more than 100 emerging markets can be so intimidating that most executives dare not try. So they should develop strategies to address promising segments across a number of neighboring countries or consider regional sourcing strategies in order to achieve critical mass. In Southeast Asia, for example, one major automobile company is taking advantage of the region's free-trade pact to manufacture diesel engines and steering columns in Thailand, transmissions in the Philippines, gasoline engines and parts in Indonesia, and engine control units and steering gears in Malaysia. (See *Beyond BRIC: Winning the Rising Auto Markets,* BCG report, October 2013.)

Winning Over More Demanding Consumers. Emerging-market consumers expect more from foreign brands than they used to. Even average consumers in the lower rungs of the middle class are quality conscious. They can no longer be consistently won over by Western or Japanese products whose features and functions have been stripped down in order to hit a certain price point.

One reason for this development is that the quality gap between foreign and domestic products is closing fast. China's Haier, for example, has emerged as the world's largest appliance maker, in part because of its obsession with quality, according to a recent article in the *Economist*. Haier began by establishing a reputation for high-quality products and service in China. When it expanded overseas, Haier first pushed into the U.S. and Europe—rather than into less competitive markets such as Southeast Asia and Africa—because it wanted to learn how to meet the demands of the world's most sophisticated consumers. As a result, Haier's revenues have increased fourfold since 2000, topping $26 billion in 2013.

Multinationals must also move beyond selling off-the-shelf products and services that are aimed at the top of the income pyramid in emerging markets. Yum! Brands' famous success story in China, where it has averaged annual growth of about 30 percent, is based on a strategy of customizing its restaurant concepts to local tastes, from restaurant design to food choices.

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Adapting to the Big Competitive Squeeze. A decade ago, many multinationals regarded their global peers as their main competitors. This orientation has fundamentally changed. Foreign companies in emerging markets are being squeezed by different kinds of players.

One major source of competition is what BCG refers to as "global challengers"—fast-growing, globally minded companies with roots in emerging markets that are on track to establish leadership positions and to fundamentally alter their industries. In fact, 124 of the global *Fortune* 500 companies for 2013 were headquartered in emerging markets—more than double the number in *Fortune*'s 2008 list. In a recent BCG survey of more than 150 multinational executives, 40 percent of the respondents said they regarded other multinationals from developed economies as their primary competitive threats in emerging markets. But a greater proportion—50 percent—saw multinationals based in emerging markets as their main threats. (See *Playing to Win in Emerg-*

Seventy-eight percent of the multinational executives in our survey said they regard domestically focused companies as principal threats in emerging markets.

ing Markets: Multinational Executive Survey Reveals Gap Between Ambition and Execution, BCG report, September 2013.)

A second major challenge comes from companies that we call "local dynamos": smaller emerging-market companies that focus only on their domestic markets. Such companies are catching up in terms of performance and distribution. They also have developed an intimate understanding of local consumers and strong relationships with local governments. In Brazil, where Wal-Mart Stores and Carrefour are both investing aggressively, the regional supermarket chain Super Muffato is the market leader in interior cities in the country's south and in cities with more than 300,000 residents in the state of Paraná. Its 40 stores are just as profitable as stores in bigger cities owned by major international chains. For such reasons, 78 percent of the multinational executives in our survey said they regard domestically focused companies as principal threats in emerging markets. In other words, these local companies are viewed as more serious rivals than other multinationals or new global challengers.

Meeting the Higher Expectations of Local Partnerships. Multibillion-dollar cross-border mergers and acquisitions in emerging markets tend to grab headlines. But the real payoff on the ground for foreign companies is less than satisfying and often is not far-reaching. Organic growth, however, is challenging. To succeed, companies will have to up their game both in M&A and in forming local partnerships. While the rationale for and approach to a partnership agenda must be thought through in detail and tailored to each company's own context, the emerging-market landscape is already witnessing different approaches to partnering.

One challenge for executives is to address the higher expectations of local partners. Emerging-market joint ventures in many sectors were traditionally based on a simple pact: foreign companies provide access to technology, capital, and sophisticated management solutions while domestic partners provide market access, government relationships, and, in many cases, low-cost production.

But this relationship has become obsolete. Today, partnerships between foreign and emerging-market companies are on a more equal footing. Local partners may inject capital or contribute valuable technology. They may even insist on a global partnership. When a Japanese provider of hospital equipment recently approached three preferred local-partner candidates for the India market, each company requested not only to help build up the local business but also to be the partner for expansion into other overseas markets. Indian motorized-vehicle manufacturer Bajaj Auto formed an alliance with Japan's Kawasaki to obtain technology support for new-product development and to address a wider range of markets at home and abroad.

Organizing for Global Success

If a company views emerging markets as important to its success, this must be reflected in its organization structure. We see four imperatives regarding organization in these markets.

A Seat at the Table. One critical element is the way in which the corporate center supports its overseas units. Frequently, companies marginalize their organizations in emerging markets, all but guaranteeing that they will underachieve. They do not have a proper seat at the table of decision making, corporate strategy, and product development and have insufficient access to capital and people. If these markets are to deliver a larger share of growth, they deserve a *disproportionate* share of attention and support. At the home-product and beauty-care-product direct-sales company Tupperware Brands, which generates more than half of its annual sales in emerging markets, CEO Rick Goings is on the road 70 percent of the time, much of it in developing nations. Members of Siemens's board learn about important emerging markets by spending two days in a region meeting with customers, government officials, and other key stakeholders.

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An Accelerator Mindset and Organization. Multinational companies must adapt their organizations so that they can better cope with the tremendous speed with which many emerging markets are developing. Fast decision-making and consistent execution are paramount to compete with what we call the "accelerator mindset" of many emerging-market companies, such as their relentless pursuit of growth. Copying organization and governance structures that are successful in home markets may put multinationals at an unnecessary disadvantage against their local peers.

True Market Immersion. The most important imperative relates to leadership and people. Upper management must be familiar with emerging markets, ideally through on-the-ground experience. Senior executives must also remain sufficiently exposed to key customers, distributors, partners, and government officials in these markets. Too often, a foreign company's senior executives experience only new airports and five-star hotels, rather than the realities of living on the ground.

Talent as a Competitive Advantage. Typically, foreign companies are at a competitive disadvantage when it comes to recruiting top local talent. Talent is increasingly scarce, and attrition is high. Two out of three Indonesians change their employer within the first three years, for example, and one out of three does so more than once. The annual attrition rate in India is close to 15 percent.

This high turnover suggests that executives must redouble their efforts to attract, develop, and retain local talent. They should also work harder to build organizations for the long run in emerging markets. When filling management positions, they must move away from the traditional practice of "expatriate stints," in which a manager from headquarters is assigned to an emerging market for about three years. Instead, executives must invest in future local leaders. They should expose top emerging-market talent to global activities and get them excited about their future growth potential in a company where individuals can thrive independent of their nationality. Wherever possible, leaders should instill in their companies a global mindset, in which a diversity of backgrounds is understood to contribute to international success.

Success in emerging markets has become more challenging than it was in the past. But there is still plenty of opportunity for growth—most likely more than developed economies can offer. Rather than retreating from emerging markets, it's time for executives to retool and reposition their businesses for sustained success.

About the Authors

Bernd Waltermann is a senior partner and managing director in the Singapore office of The Boston Consulting Group. You may contact him by e-mail at waltermann.bernd@bcg.com.

David Michael is a senior partner and managing director in BCG's San Francisco office. You may contact him by e-mail at michael.david@bcg.com.

Dinesh Khanna is a partner and managing director in the firm's Singapore office and the worldwide leader of BCG's Global Advantage practice area. You may contact him by e-mail at khanna.dinesh@bcg.com.

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