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Ideation Center insight

How GCC companies can become global competitors

Adopting a capabilities-driven strategy to avoid growth traps

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Contacts

Beirut

Karl Nader
Partner
+961-1-985-655
karl.nader
@strategyand.ae.pwc.com

Rawia Abdel Samad
Director, Ideation Center
+961-1-985-655
rawia.abdelsamad
@strategyand.ae.pwc.com

Detroit

John Jullens
Principal, PwC US
+1-313-394-6000
john.jullens@pwc.com

Dubai

Alessandro Borgogna
Partner
+971-4-436-3000
alessandro.borgogna
@strategyand.ae.pwc.com

Andrew Horncastle
Partner
+971-4-390-0260
andrew.horncastle
@strategyand.ae.pwc.com

Per-Ola Karlsson
Partner
+971-4-436-3000
per-ola.karlsson
@strategyand.ae.pwc.com

About the authors

John Jullens is a thought leader for Strategy&, PwC's strategy consulting group. Based in Detroit, he is a principal with PwC US. He has more than 20 years of management consulting and industry experience in North America, Europe, and Asia.

Per-Ola Karlsson leads the organization, change, and leadership practice in the Middle East for Strategy&, part of the PwC network. He is a partner based in Dubai whose main areas of expertise are strategy formulation, organization development, corporate center design, and governance. In addition, he frequently supports companies in the areas of change management and people capabilities.

Rawia Abdel Samad is the director of the Ideation Center, the leading think tank for Strategy& in the Middle East. She was previously a manager with Strategy& in Beirut and a member of the communications, media, and technology practice in the Middle East. She has extensive experience in information and communications technology policies, sector strategies, and impact assessment.

Melissa Rizk and Yara Itani also contributed to this report.

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Executive summary

Following a period of growth, globally and locally, Gulf Cooperation Council (GCC)[1] companies must now focus on capabilities if they want to maintain their growth and improve their positioning. Failure to adopt this new focus will put them at risk of falling into growth traps.

In their eagerness to grow, many companies in emerging markets focus primarily on top-line growth or country-specific comparative advantages, and neglect to build the foundations for future success. Typically, they initially benefit from being first movers in their home markets, but eventually they have to play catch-up with more experienced multinationals in global industries.

Multinationals are formidable competitors: They possess established brand names, advanced technologies, and access to efficient financial and labor markets. More importantly, these multinationals have a set of entrenched capabilities that they have developed over time. In this regard, their emerging market competitors are often decades behind. GCC companies, particularly those that are linked to their government, also have to deal with region-specific issues (such as poor corporate governance practices) that could weaken their competitiveness.

To circumvent these growth traps, GCC companies need to develop powerful capabilities through internal development, mergers and acquisitions, or partnerships. Each of these methods has advantages, drawbacks, and potential trade-offs. Companies from the GCC that have succeeded in this endeavor have followed a deliberate and stepwise plan for moving from basic capabilities to more sophisticated ones that can support world-class innovation, technology, and design.

With more than two-thirds of the top companies in the GCC linked to the state, governments also have a role to play in helping them become globally competitive. Government leaders should take measures to upgrade corporate governance practices within these companies and help them fulfill their potential. In turn, these companies would reap economic benefits from improved performance.[2]

The importance of developing world-class capabilities

In their early stages, GCC companies may be well positioned to gain market share in their rapidly expanding home markets thanks to their understanding of local business dynamics, their access to cheap natural resources and expatriate labor, the high purchasing power of GCC consumers, and the limited competition from multinationals. These early advantages disappear over time as multinationals overcome entry barriers in GCC markets. If GCC companies are to sustain their growth and compete against multinationals, they need to look beyond their relatively small home markets (with the exception of Saudi Arabia, the largest GCC market).

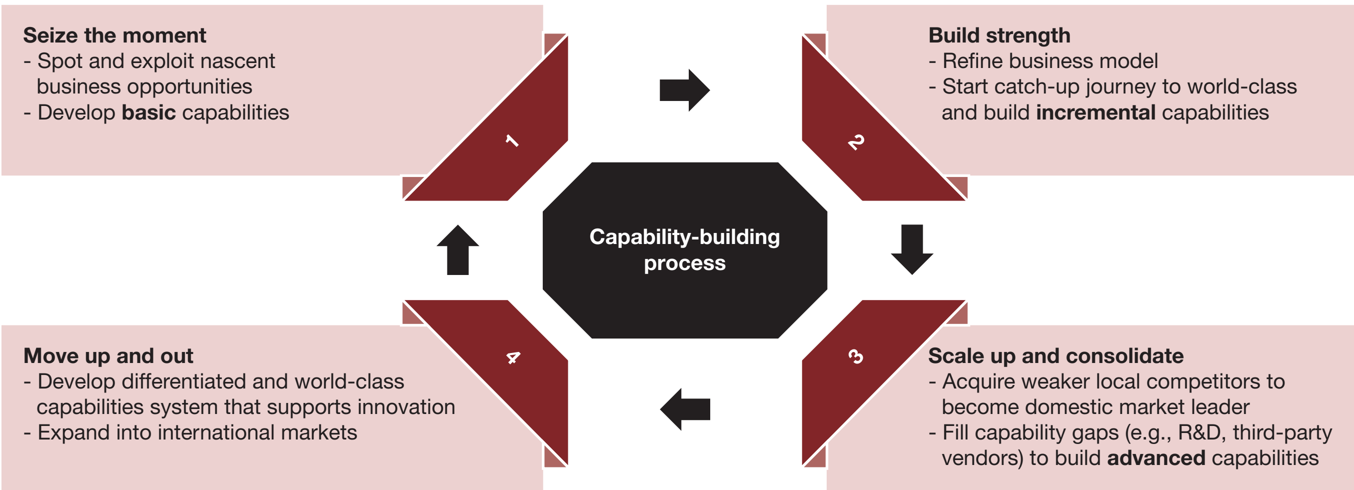
In their eagerness to exploit such new opportunities, however, many companies focus too narrowly on top-line growth or country-specific advantages such as government subsidies or cheap labor, and neglect to build the foundational capabilities they will ultimately need to compete with foreign multinationals in global industries.

GCC companies must upgrade their organizational capabilities, in particular their strategic management practices.

GCC companies must therefore upgrade their organizational capabilities, in particular their strategic management practices. This involves figuring out how they can best transition from relying primarily on country-based comparative advantages to developing their own firm-specific competitive edge, and how they can progress beyond copying basic production capabilities from other companies to mastering world-class innovation capabilities themselves. In other words, they should cumulatively develop advanced capabilities,and continually refine and update them.

Successful companies typically follow a four-phase process for improving capabilities cumulatively over time. This starts with enhancing basic production (know-how) and progresses all the way to acquiring world-class innovation capabilities (know-why). These companies first identify opportunities to develop their basic capabilities, then they build their strength by refining their business models, scale up and consolidate through acquisitions, and finally move up and out to enter international markets. Each phase allows them to incrementally develop their capabilities by building on previous successes (*see Exhibit 1, page 6*).

Exhibit 1
Four phases of capability development



Source: John Jullens, "How emerging markets companies can avoid growth traps," *strategy+business*, December 2015 (www.strategy-business.com/blog/How-Emerging-Markets-Companies-Can-Avoid-Growth-Traps?gko=8907e).

As companies transition from one phase to the next, not only do they find that the underlying sources of competitive advantage change, but they also confront a succession of new growth traps around which they need to navigate. In the transition between seizing the moment and building strength, for example, many companies are ultimately hampered by their inattention to building the individual capabilities they will need for subsequent phases. As they move to scaling up and consolidating, they need to adapt, deepen, and link these capabilities so they can optimize their advantages and defend their market positions against competition from foreign multinational corporations. In the final transition, as they prepare to move up and out, they need to develop fully integrated, differentiated capabilities systems in order to compete at world-class performance levels. Below, we describe three possible approaches to developing these capabilities.

Approach 1: Developing capabilities in-house

One approach for gaining more strategic, distinctive capabilities is to develop them in-house. Since its founding in 1976, manufacturing company SABIC has focused on developing and evolving its core capability of managing complex plants. This has allowed it to run more than 60 manufacturing and compounding plants in 40 countries, with high levels of profitability. Many companies in the region have acquired such technical capabilities through hiring experienced expatriates, but

SABIC has managed to do so more sustainably by making significant investments in employee training and development initiatives — including the SABIC Academy and on-the-job training and development — to enhance local expertise.

To achieve geographic diversification and scale, SABIC has also developed over time its internationalization capability. Based in Riyadh, it has transformed its organization from a model of separate regional entities to a global operating model comprising strategic business units with worldwide responsibility. These capabilities have made SABIC the world's third-largest chemicals company by revenue and the 116th-largest public company by market capitalization.

Of course, the drawback to building capabilities in this fashion — particularly for companies in fast-moving markets — is that it is a lengthy process at best. It also carries risks such as unplanned additional expenses or difficulties involving recruitment, training, and implementation. These variables make it hard to guarantee the successful outcome of such an approach.

Approach 2: Buying capabilities

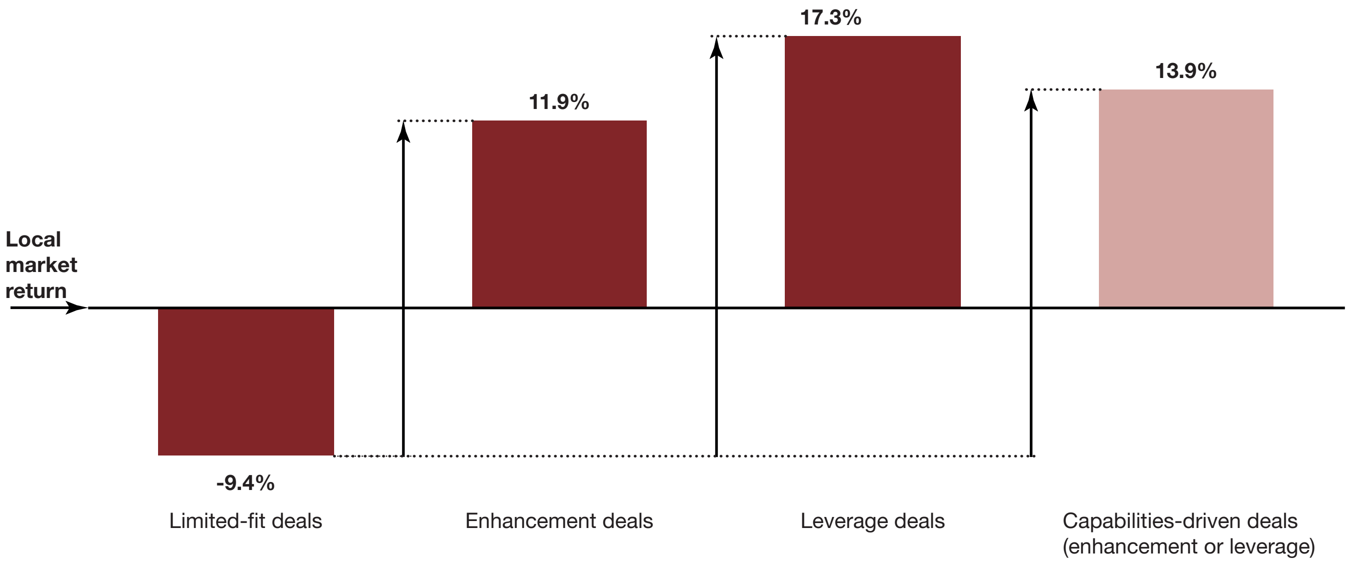
Mergers and acquisitions (M&A) allow companies in emerging markets to gain new capabilities quickly while simultaneously developing their existing ones, putting them on a fast track for growth. In the wake of the most recent global economic downturn, emerging market companies have been able to choose among many potential acquisition targets at attractive prices. In addition, financing is cheap, thanks to monetary policies that have kept interest rates low; and governments in emerging markets often encourage and incentivize companies to expand and become more technologically advanced.

However, an M&A approach also presents challenges that can be mitigated only by choosing deals that call upon or enhance the acquirer's capabilities, and by developing core M&A-related organizational capabilities, such as turnaround management, integration management, and stakeholder management. In fact, an assessment of the 75 largest acquisitions made by GCC companies between 2009 and 2014 reveals that one-third have resulted in the acquirer performing more poorly than the market average on the basis of total shareholder return.

Capabilities-driven companies are able to determine which potential acquisitions offer assets that are a good fit for their capabilities, allowing them to reach their potential (*see "GCC deals that win," page 12*). In the GCC, M&A deals that took into account the buyer's key capabilities performed better than returns on local stock market indices or deals with a limited capabilities fit (*see Exhibit 2, page 8*).

Exhibit 2
Capabilities-driven deals in the GCC outperform limited-fit deals

Two-year annualized total shareholder return post announcement of M&A deal in the GCC



Note: Based on 75 deals between 2009 and 2014 in which the acquirer was from a GCC country.

Source: Zawya; Strategy& analysis

To grow their capabilities via acquisition deals, GCC companies should make M&A itself a core capability, standardizing and streamlining the knowledge transfer and absorption process after each acquisition. This requires three sets of essential organization capabilities. First, companies need to focus on stakeholder management to ensure a smooth transition, an exchange of skilled professionals between the firms, and an understanding of each other's workplace culture after the M&A deal. Second, they need a sound integration management plan to successfully absorb the technology and knowledge they are trying to obtain. Finally, because potential acquisitions are often under financial or other types of stress, acquiring companies should be ready in terms of turnaround management.

The Saudi Arabian food company Almarai implemented a successful M&A strategy thanks to the sound organizational capabilities it had built up. This allowed it to diversify its operations in terms of products and geographies, becoming the 10th largest company in the GCC by market cap.

Since its establishment in 1977, Almarai has focused on building world-class capabilities across the dairy value chain by investing in high-quality farms to manage livestock, developing an efficient supply chain through vertical integration, and improving its sales and distribution infrastructure. Thus the company has become the largest vertically integrated dairy player with the highest market share across all categories of dairy in the regional markets in which it operates.

In 2007, Almarai decided to diversify and go regional, so it began a series of acquisitions to expand its business into new products and geographies. It acquired Western Bakeries in 2007 to get into bakery products, Hail Agricultural Development Company in 2009 to get into poultry, and Beyti in Egypt in 2009 to get into dairy and juice outside the GCC. It also established a joint venture with PepsiCo in 2009 to form the International Dairy and Juice (IDJ) Company, and another joint venture with Mead Johnson beginning in 2010 to get into infant nutrition. Almarai ensured that its M&A deals involved a capabilities fit, and also focused on postmerger integration, inducting acquired companies into its management system and paying particular attention to capturing and internalizing their knowledge. For example, it set out to replicate its successful dairy model in the poultry sector after it acquired the Hail Agricultural Development Company by applying its existing capabilities in supply chain management and distribution. It made significant investments to establish vertically integrated poultry value chains, which allowed it to launch the new Alyoum premium brand.

Approach 3: Developing capabilities through partnerships

In some cases, forging partnerships may be more suitable for GCC companies than making outright acquisitions. Partnerships offer an attractive opportunity for knowledge transfer from industry leaders. Because these opportunities can often be addressed on a project-by-project basis, there is no need to manage or integrate the foreign partner's business. For their part, foreign companies seeking expansion opportunities in emerging markets often lack the specific capabilities and resources required for these markets. In the current context of overall slow global economic growth, the GCC region represents an interesting growth market thanks to certain factors. These include a strong ICT infrastructure and an environment conducive to trade — such as Dubai's Free Zone incentives. The GCC also acts as a gateway to other regions (the Middle East, Africa, Southeast Asia, etc.), capitalizing on the trade and logistics capabilities it has developed, in addition to its geographic location.

This intersection of needs creates many potential "win-win" opportunities, as partners can share complementary firm capabilities, country-specific advantages, and geographic proximity. Depending on their industry and market maturity, GCC companies can partner with

GCC deals that win

GCC companies can catch up with more established competitors quickly and develop multiple capabilities simultaneously through M&A deals. Acquisitions based on capabilities fit and strengths can be divided into the following categories:

- **Leverage deals** make use of the buyer's capabilities to improve the situation of the acquisition through its own capabilities system, thereby generating considerable added value. This was the case with the Saudi Arabian food company Almarai; it first developed its production and supply chains in its home market, then acquired Egypt's Beyti in 2009 to expand its business beyond the GCC and enter the Egyptian market.
- **Enhancement deals** involve extending the capabilities of a buyer into a closely related functional area through acquisition, allowing it to further intensify its capabilities system — as with Almarai's other acquisitions that allowed it to diversify into baked goods, poultry, and infant nutrition.
- By contrast, **limited-fit acquisitions** do not begin with a capabilities rationale and therefore they neither enhance nor deploy the buyer's core capabilities. In 2012, a global leader in nutrition, health, and wellness had acquired one division from a competitor to increase its global coverage, but the deal did nothing to improve the company's capabilities. A GCC-based energy company had a similar experience when it acquired part of a U.S.-owned company in 2007. Such deals generally have lower returns.

Capabilities-driven acquisitions include leverage and enhancement deals. These deals have a better chance of increasing total shareholder return (TSR). An assessment of the 75 biggest M&A deals in the GCC between 2009 and 2014 shows that capabilities-driven deals outperformed limited-fit deals by 23.3 percent in annualized two-year TSR and achieved returns that were 13.9 percent higher than the local market index. By contrast, limited-fit deals usually result in negative returns (9.4 percent lower than local market indexes).

Furthermore, intra-GCC deals performed better than deals in which GCC companies targeted companies outside the region (7.2 percent higher than local market return for intra-GCC deals compared to 2 percent for outside-GCC deals). Intra-GCC acquisitions typically involve complementary businesses in near geographies. This leads to strong synergies that are relatively easy to capture. Most of these deals are done on a friendly basis, which prevents unnecessarily high acquisition prices.

By contrast, limited-fit deals usually result in negative returns (compared with local market indexes), and this is the case across geographies and industries. There is also a fine line between a bad enhancement deal and a limited-fit deal. If an acquirer has miscalculated, some deals conceived of as adding important new capabilities to the acquirers' existing systems turn out to be nothing but limited-fit deals.

Companies with a capabilities-driven approach to deal making don't stick to one type of deal all the time. They may switch between leverage deals and enhancement deals, depending on how much growth they think they can achieve in their existing markets and with their current capabilities systems.

developed market companies in three ways: by jointly developing versions of existing products for GCC markets, or by introducing products and services for emerging markets that are easily accessible from the GCC, or by combining capabilities to create innovative products and services.

Most partnerships between GCC companies and developed market companies so far have taken the form of equity participation or financial sponsorship. With the right fit, this approach could align incentives between the two sides and promote a more meaningful partnership. The key is for GCC companies to make sure that they are capturing all the potential benefits from their partnerships and gaining generous returns on their investments. They should also explore other types of strategic partnerships, including joint ventures, joint research and development, and co-development/marketing.

Etihad Airways' global expansion, for example, involves a unique partnership strategy that rests upon its existing in-house capabilities. The United Arab Emirates carrier started off in 2003 by building all the capabilities of a global airline internally. This entailed multibillion-dollar investments in aircraft, people, technology, real estate, and brand, to rival global industry standards. Most notably, the airline invested heavily in its service and hospitality capabilities — especially for business and first class passengers — by offering innovative ground and in-flight services. Its internal capabilities made it into a top-quality airline, but partnerships helped it grow into a global player. Beyond sharing codes, the airline made minority equity investments in airlines in strategic markets, including Virgin Australia, Alitalia, Jet Airways, Air Berlin, Air Serbia, Air Seychelles, Etihad Regional/Darwin Airline, and Niki. These investments have allowed it to acquire a combined network of more than 300 destinations and operate almost 700 aircraft. It has also aligned frequent flyer benefits across all partners and achieved better network offerings (flight frequency and connectivity). Additional benefits include joint marketing and distribution, as well as scale to reduce operating costs and fleet requirements.

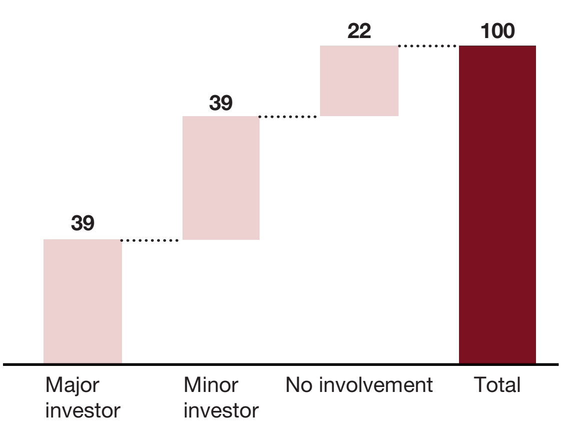
Air Transport World named Etihad Airways Airline of the Year for 2016, in recognition of its innovation and strategic thinking. The award considers airlines' achievements and capabilities across their operations, as well as their financial performance, customer service, safety, and employee relations.

The role of governments in promoting the strategic management of GCC firms

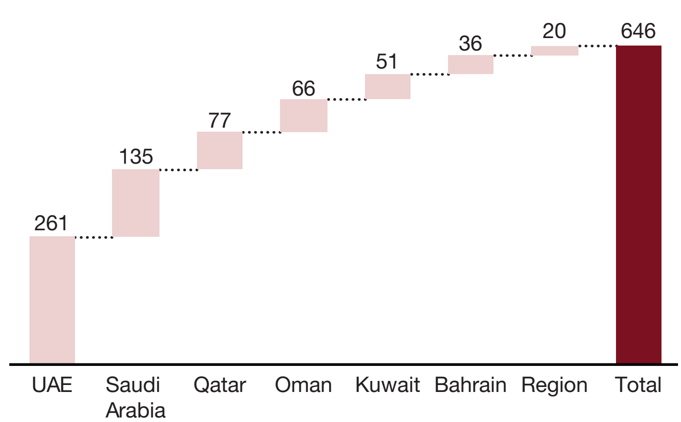
Although the onus is on company leaders to focus their organizations on building world-class capabilities, GCC governments also have a significant role to play, especially for those firms in which governments retain ownership stakes. There are approximately 550 state-owned enterprises in the region, and GCC governments are major or minor investors in 78 of the top 100 publicly listed companies (*see Exhibit 3*). To ensure that these firms are ready for capabilities-driven growth, governments need to take measures to upgrade the corporate governance practices within them.

Exhibit 3
Governments across the GCC dominate the economy

Government involvement in top 100 listed GCC companies



Number of state-owned enterprises in the GCC[1] (by country)



Note: All data for 2015.

[1] Excluding government institutions. Regional state-owned enterprises include companies in which the joint ownership of two or more GCC countries represents more than 50% of the total ownership.

Source: Zawya; Strategy& analysis

This will enable these local companies to realize their potential on the global level. In turn, these companies can create an economic base in their home markets that could diversify the economy, provide jobs, and invest in local communities.

GCC governments can implement best practices for governing state-owned enterprises from the Organisation for Economic Co-operation and Development (OECD).[3] First, governments should centralize ownership arrangements within a single agency or through sovereign wealth funds in order to improve the efficiency of state-linked companies. Governments should also ensure that their policies toward state-owned firms are consistent and transparent. This entails reevaluating subsidies, identifying and disclosing extra-commercial objectives for state-owned enterprises, and putting in place mechanisms to compensate them for realizing these objective. Governments should adopt a more structured board selection process to make sure the ultimate selection criterion is competence. Best practices typically include appointing a nomination committee, maintaining a nationwide database of qualified candidates, and setting up induction training programs that include training in board responsibilities. Regular evaluation of individual board members and the board as a whole is critical for demonstrating accountability and generating public trust.

Conclusion

For GCC companies to avoid growth traps and become world-class, it is imperative that they build the necessary organizational capabilities and resources to compete head-to-head with world-class companies. They can either spend the time and effort required to do so in-house, or they may be able to pursue acquisition and partnership opportunities to accumulate new capabilities and resources more rapidly. However, their M&A strategy itself needs to be capabilities driven if they are to absorb their acquired capabilities seamlessly and leverage them effectively. They need to recognize that an organization's capacity to absorb other firms through M&A is an important organizational capability in itself.

Emerging world-class companies from the GCC — both state-owned and private — are capable of accelerating their countries' economic diversification and transformation efforts through job creation and investments in local communities. This can make them an important key to economic development in the region.

Endnotes

[1] The GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[2] John Jullens, "How Emerging Markets Can Finally Arrive," *strategy+business*, May 2015 (www.strategy-business.com/article/00331?gko=4c42b); John Jullens, "How Emerging Markets Companies Can Avoid Growth Traps," *strategy+business*, December 2015 (www.strategy-business.com/blog/How-Emerging-Markets-Companies-Can-Avoid-Growth-Traps?gko=8907e).

[3] OECD (2015), *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, 2015 Edition, OECD Publishing, Paris.

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