RUBBING SHOULDERS WITH EMERGING MARKET GIANTS

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AT A GLANCE

Many emerging market companies seek to grow by copying what leading global companies do, rather than analyzing how they do things. Instead, to grow and compete on the global stage, they need to carve out a clear right to win by gradually building, deploying and refining differentiating capabilities across their organization.

In 2011, after a decade of meteoric growth, the Chinese automobile manufacturer, BYD, suddenly saw its sales drop by 15 percent and then stay flat. Just a year earlier, the company had sold 500,000 vehicles and had topped the Bloomberg Businessweek Tech 100 list of large, fast-growing tech companies. What had gone wrong? Despite its strong brand awareness, BYD began to lose market share to competitors who built better vehicles. Like many companies in emerging markets, BYD had encountered a growth trap from which it still has not extricated itself.

In a widely repeated mistake, BYD had set very ambitious top-line growth targets and sped to expand its product portfolio, dealer network and sales. However, in doing so it neglected to focus on improving product development and quality, organizational planning, and customer insights1. Such growth traps are typical for companies in emerging markets: too often they focus on speed, market share and top-line revenues instead of taking the time to get their business model right, develop the required foundational capabilities and focus on bottom-line profits.

Avoiding these growth traps should be the main priority for other emerging market giants, whether in Asia, South America, or the countries of the Gulf Cooperation Council (GCC) where the next raft of top-tier global companies are likely to come from. This means rethinking their strategy. Many emerging market companies seek to grow by copying what leading global companies do, rather than analyzing how they do things. Firms in emerging markets start, often strongly, by copying basic production capabilities from multinationals and capitalizing on country-specific advantages such as access to cheap labor or abundant raw materials. However, that will only take them so far. When they go head-to-head with global competitors that are more experienced and better resourced, they flounder.

To avoid this, and to obtain the growth they seek, emerging market firms need to carve out a clear right to win by gradually building, deploying and refining differentiating capabilities across their organization, which they will need to enter the global top tier. These capabilities, which are explored in detail here consist of complex, cross-functional combinations of processes, skills, knowledge, technological tools and organization design, geared to reliably and consistently deliver a strategic outcome.

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Emerging market companies that have mastered these world-class capabilities have earned their place in the global market in the face of formidable competition from multinationals. In the GCC, for example, Saudi Arabia Basic Industries Corporation (SABIC) is now the fourth largest chemical producer in the world. Etihad Airways, which started operations in 2003, was named Airline of the Year 2016 by Air Transport World. Almarai, based in Saudi Arabia, has become the largest vertically integrated dairy company globally. Meanwhile, over the past decade, China's Haier Group has reigned as one of the top global brands for major appliances, and has recently acquired General Electric's appliance division for US$5.4 billion.

ENTERING THE TOP TIER

In the early stages, emerging market companies grab the advantages available to them in their home markets, including their understanding of local business dynamics and access to cheap inputs such as labor, commodities, feedstock or natural resources. In some cases, they receive support from their governments in the form of subsidies or financing. Moreover, until recently multinationals barely encroached on the territory of these local companies, giving them the time to grow and experiment before they encounter fierce global competition.

This situation has changed, however, with more global firms targeting emerging markets, due to the increasingly attractive opportunities they hold, as well as saturation in multinationals' home markets. In response, some governments in emerging markets have made corporate expansion, technological advancement and internationalization national development priorities. They are striking a balance between encouraging domestic companies to upgrade and offering them temporary protection to stave off foreign competitors.

Now that they are seeking to become global players, emerging market giants need to alter their worldview. Continuing to rely solely on the country-specific advantages that work so well for them locally is not a viable option. Instead, they should acquire their own firm-specific edge and master differentiating capabilities that can set them apart from their rivals and help them maintain growth on their own terms.

Building capabilities cumulatively over time typically involves a four-step development journey. This starts with enhancing basic production (know-how) and progresses by incrementally building world-class capabilities emerging markets companies can exploit as they expand (know-why).

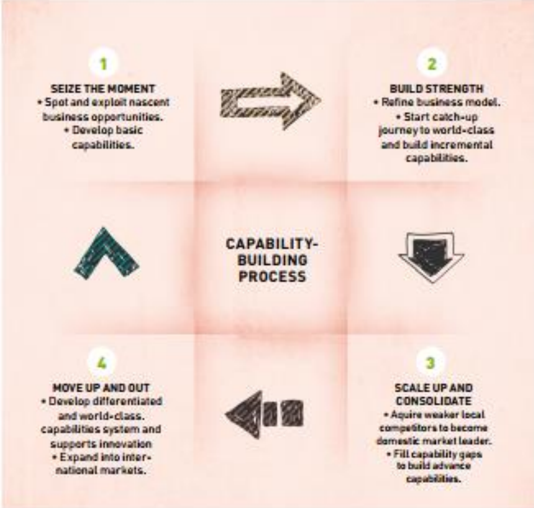
The first step is to seize the moment. Companies should start by identifying the right business opportunities–such as industry privatization or the emergence of a new customer segment with money to spend–and develop their foundational capabilities in product development, finance, factory operations and employee management.

The second step is to build strength. Companies should shift their strategic focus to refining their business model and becoming profitable. This requires them to develop incremental capabilities they will need in subsequent phases as they attain maturity, such as innovative product design, engineering and quality management in manufacturing and other activities.

The third step is to scale up and consolidate. Before they consider going international, companies need to adapt, deepen and connect their existing strengths so they can optimize their advantages. This also means they can defend their position in their domestic markets against competition from encroaching multinationals. In particular, they should aim to improve quality performance and reduce costs by enhancing their capabilities through research and development (R&D), mergers and acquisitions (M&A), or partnerships. Once they have acquired these advanced capabilities and have built this defense around their home markets, they can scale up and compete in global markets. As they do this, however, they should be cautious not to overstretch their management resources.

The fourth step is to move up and out. Emerging market companies can seek to become world-class by expanding into international markets and higher-value customer segments. This requires building differentiating capabilities in such areas as innovation, operations and brand »

FOUR PHASES OF CAPABILITY DEVELOPMENT



Source: John Jullens, 'How emerging markets companies can avoid growth traps', strategy+business, December 2015.

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management. These capabilities will need to be fully integrated into the corporate strategy to ensure that the company is coherent.

Etihad Airways' growth journey followed these four phases. After it began operations in 2003, the carrier started building all the capabilities of a global airline internally. It invested billions of dollars in aircraft, people, technology, real estate and brand, to rival global industry standards. It focused particularly on its service and hospitality capabilities, especially for Business Class and First Class passengers, by offering innovative ground and in-flight services. Afterwards, it sought partnerships with airlines in strategic markets in the form of minority equity investments– such as with Virgin Australia, Alitalia, Jet Airways, and airberlin– to acquire a combined network of over 300 destinations operating almost 700 aircraft. It has also aligned frequent flyer benefits across its partners and achieved a better network offering (flight frequency and connectivity).

HOW TO BUILD WORLD-CLASS CAPABILITIES

As they enter the fourth phase of their development journey, emerging market companies must rapidly build a fully integrated system of differentiating capabilities to succeed globally. They can do this using one or a combination of three methods: (1) in-house, (2) through M&A deals, or (3) via partnerships.

1. DEVELOPING CAPABILITIES IN-HOUSE

Developing differentiating capabilities in-house allows companies to tailor them to their business needs and social context, while continuously improving them. This is preferable to adopting ready-made solutions. SABIC, for example, enhanced its capability of operating complex plants, which has allowed it to manage 60 high-profit operations in 40 countries. It also made significant investments in employee training to roll out these capabilities across its organization, which reduced its dependence on expatriate experience.

However, in-house development can be a lengthy process and can drain money and resources without achieving the desirable outcomes. This is particularly true for companies in fast-moving markets where there is often a shortage of reliable suppliers, distribution networks and qualified managerial candidates. As a result, these companies may incur unplanned, additional expenses or face other difficulties such as being held back by legacy thinking – especially for (formerly) state-owned enterprises.

2. BUYING CAPABILITIES

Building new capabilities through M&A is a much faster alternative to developing them in-house and scaling them up. However, it is not a surefire strategy. The first consideration is the capability fit of the acquiring company and its target. Acquisition deals usually come in three types: leverage deals utilize the buyer's capabilities to improve the situation of the target company; enhancement deals use an acquisition to extend the buyer's capabilities; and limited-fit acquisitions neither enhance nor deploy the buyer's core capabilities. Evidence in the GCC also shows that limited-fit acquisitions provide lower returns. Capabilities-driven deals among the 75 largest acquisitions by GCC companies between 2009 and 2014, outperformed limited-fit deals by 23.3 percentage points in annualized two-year total shareholder returns (TSR) and achieved returns that were 13.9 percentage points higher than the local market index. The key to building capabilities through deals is making M&A itself a core capability, improving companies' ability to standardize, and streamlining the knowledge transfer and absorption process after each acquisition.

There are three aspects to M&A as a core capability. The first is stakeholder management to ensure smooth transitions throughout the process. The second is a sound integration management plan to successfully absorb the technology and knowledge from the target company. The Mexican company, CEMEX, for example, has developed a strong post-merger integration capability (the CEMEX Way). It promotes company-wide common processes for basic activities and rapidly inducts acquired companies into its management system to capitalize on synergies. The technological and managerial processes required to drive this integration are constantly refined to include the best practices of acquired companies. The third is turnaround management, which is needed because potential target companies are often under financial or other types of stress.

Governments in some emerging markets recognize the benefits of building capabilities through M&A, and are actually encouraging companies to increase their acquisitions. Low interest rates in many of these markets mean that companies can benefit from cheap financing for M&A. For example, the Singaporean government has raised grant schemes for companies venturing overseas from 50 percent to 70 percent over three years. It also increased the tax allowance for acquisition costs from five to 25 percent of the deal's value over five years, and introduced tax deductions for Singaporeans posted overseas. Finally, it is guaranteeing loans to national companies for financing overseas acquisitions. Governments may also provide companies with logistic support and market research, or create the international framework for them to operate in, as with China's Belt and Road initiative intended to build international infrastructure.

3. DEVELOPING CAPABILITIES THROUGH PARTNERSHIPS

Strategic partnerships are good ways for emerging giants to learn from other companies that already possess advanced capabilities. An advantage of taking this course is its project-based approach, which eliminates the need to manage or integrate the partner's business. Depending on the industry and market maturity, partnerships can take the form of equity participation, financial sponsorship, joint ventures, joint research and development, and co-development/marketing.

With the right fit, partnership agreements can align incentives between the two companies and create many potential win-win opportunities in the form of sharing or acquiring capabilities. The recent partnership between GE and SABIC aptly illustrates this type of arrangement. Under the terms of their agreement, GE and SABIC will roll out joint investments of US$1 billion in 2017, followed by a potential US$2 billion in the futureto finance initiatives in oil and gas, power and water, energy, aviation, digital and other sectors.

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These initiatives will aim to enhance and localize Saudi Arabian companies' manufacturing capabilities, build industrial know-how, and create jobs for nationals. By partnering with the Saudi Industrial Property Authority (MODON), for example, GE will help 10 factories achieve digitization with its Brilliant Manufacturing Software Suite, leading to increased efficiency and cost savings. Additional partnerships with other companies aim at building new facilities or enhancing existing ones. GE will also organize workshops and trainings for women and youth to encourage their participation in the labor force. In return, GE will gain a strong supply chain in Saudi Arabia, supported by a skilled labor force, and will increase its products and services exports.

ORGANIZING DIFFERENTIATING CAPABILITIES

Once emerging market companies have acquired these distinctive capabilities, they need the correct organizational framework to fully leverage these capabilities to increase efficiency and competitiveness. For some firms, this means moving away from traditional top-down management. Instead, they should aim to develop their fully integrated differentiated capabilities systems in a manner that allows them to coordinate their global operations while staying agile.

There are different organizational options. Most multinationals currently use a matrix structure, yet some have found that this system can create issues related to accountability, preventing them from seizing opportunities in emerging markets. Meanwhile, some emerging market companies are experimenting with new structures. Haier, the Chinese manufacturer of consumer electronics and home appliances, has globally dispersed semi-autonomous units heading specific projects. These teams are held together by governance organizations that provide support services such as marketing, supply chain management, sales, product development and manufacturing. These organizations also disseminate best practices among the different units.

ACCEPTING THE CHALLENGE

As they grow larger and more complex, emerging market companies need to look for new sources of competitive advantage and sustain them over the long term to avoid falling into growth traps. They stand a better chance of getting there if they build and properly organize a system of differentiating capabilities. These capabilities can lead to international success, propelling them into the global top tier while further strengthening their domestic positions.

Looking at the larger picture, when a local giant becomes a world-beating company, it can create a broad and resilient economic base in its home market. This can create high-paying local jobs, encourage a thriving services sector, and develop advanced technologies that promote national development.

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Notes:
1. John Jullens, 'How Emerging Giants Can Take on the World,' Harvard Business Review, December 2013
2. Thomas A. Stewart, 'CEMEX's Strategic Mix,' strategy+business, April 13, 201
3. Marissa Lee, 'Tax incentives, grants to help SMEs go international,' The Straits Times, Feb. 24, 2015