

BUSINESS LIFE SUMMER SCHOOL

Emerging markets give flight to new industry champions

Businesses that have survived extremely tough economic conditions at home have valuable lessons for western managers, says Donald Sull

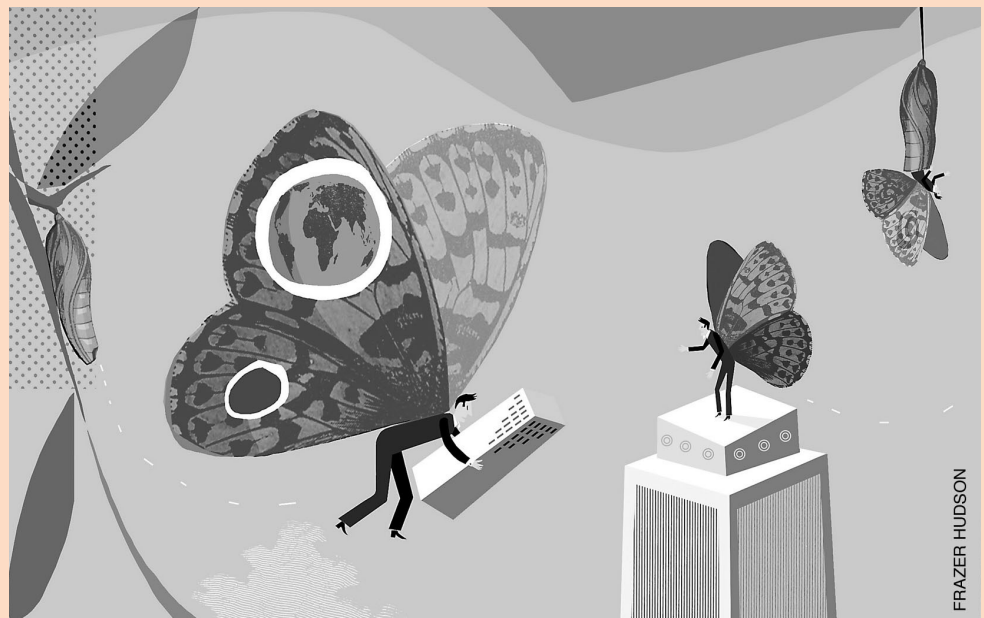
Does China's remarkable economic rise threaten the dominance of western corporations? For some, the answer is emphatically No.

China's success, they argue, resembles that of Japan in the 1980s. In this view, the recent failure of CNOOC, the Chinese oil group, and Haier, the Chinese appliance maker, to acquire western companies shows that, like their Japanese counterparts before them, Chinese companies are overpaying for damaged assets in their naïve zeal to go global.

The reassuring implication for western managers is that executives have no more to fear from expansionist Chinese rivals than they did from the supposed menace posed by Japan.

The immense hardship of doing business in emerging markets serves as a rigorous training ground for companies

The analogy to Japan is reassuring – but flawed. Recent Chinese bids reveal a much broader phenomenon: the rise of fiercely



competitive companies from the crucible of emerging markets, including India, Brazil and Mexico as well as China. These emerging market champions pose a much greater threat than most western managers recognise.

Comfortable myths

The success of companies from developing countries is of ten attributed to low labour costs. Of course, many emerging market producers compete only on price, but they are not the ones western managers should fear.

The most successful emerging market companies start with low costs, but differentiate themselves on

speed to market and innovation. Haier, for example, enjoys a reputation for rapidly launching high-quality new products tailored to the needs of local consumers.

Innovations include washing machines that clean vegetables as well as clothing for sale in some rural provinces. Haier has extended its new product development to western markets, featuring wine coolers, mini refrigerators and freezers in the US and Europe.

Government support is another reason given for the rise of emerging market champions. Yet political intervention is a mixed blessing: politicians can

provide tariffs, quotas and access to low-cost capital, but in exchange they may meddle in decision-making, often imposing non-economic objectives including local job creation and regional development.

Many emerging market champions, such as Mittal Steel and Brazil's Embraer, rose to global leadership only after freeing assets from the heavy hand of government ownership and running them as private enterprises. Most Chinese companies have worked strenuously to reduce government ownership through successive rounds of refinancing.

Of course, emerging market governments set

policies that benefit specific companies. But this is not limited to emerging markets: recall the heavy-handed intervention of George W. Bush, US president, to protect American steel producers or simmering trade tensions between Airbus and Boeing over government subsidies.

Finally, like their Japanese counterparts before them, emerging market companies are sometimes accused of snapping up western assets using cheap capital. Such deals are the exception.

Most companies in emerging markets endure a cost of capital that is significantly higher than that faced by businesses in countries that are part of the Organisation for Economic Co-operation and Development. Embraer, AmBev and CVRD, for instance, rose to prominence during a decade when real interest rates in Brazil often topped 20 per cent. Even expensive capital can dry up during currency crises, such as that in Asia in the late 1990s.

The real story

If conventional wisdom does not explain the rise of emerging market champions, what does?

First, the immense hardship of doing business in emerging markets serves as a rigorous training ground for companies. The high cost of capital, for instance, forces the best companies to do more with less.

The volatility of emerging markets also provides excellent training in risk management. Cemex and CVRD, for example, compete in many emerging markets, but manage their risk through a sophisticated strategy of geographic diversification and hedging. Consumers in emerging

markets are discriminating buyers, despite their low disposable income. To succeed with these customers, companies must relentlessly innovate to offer desirable products at low prices.

The best of the emerging market companies excel at fighting a two-front war: holding local rivals at bay at the low end of the market while battling multinationals at the high end. Lenovo, for example, emerged as China's leading PC maker by introducing low-priced computers tailored to local needs six months before Dell and IBM introduced their products in China.

The harsh environment overwhelms the majority of emerging market companies. The few that survive the brutal process of Darwinian selection, however, emerge as fierce competitors that excel at efficiency, innovation and risk management.

Having conquered local markets, they have strong incentives to expand abroad. Global expansion allows them to tap new markets, spread risk geographically, build economies of scale and compete in many places with multinationals. By acquiring assets in Europe and the US, Cemex had a means to strike back if developed-country rivals attacked its profitable home turf. Global expansion also provides access to valuable resources, including technology, expertise and diversified sources of capital.

If emerging market champions have an incentive to globalise, they can nowadays more easily raise the funds to expand.

When groups such as Samsung and LG of South Korea went global in the 1970s and 1980s, they relied

on government money to fund their growth. Today institutional investors and banks are more willing to back such moves by strong management teams.

Private equity firms and hedge funds provide another source of funding and are willing to bear big risks in the hope of achieving outsized rewards.

The most critical element of these emerging market champions is their diversity. Here the facile analogy with Japan is at its most misleading. Japan's push towards globalisation was co-ordinated by the government's trade ministry, targeted at a handful of industries, and pursued by similar companies coming out of the same cosy home market. Emerging market champions, in contrast, vary in headquarter country and industry as well as their strategies to go global. While early pioneers such as Samsung built from scratch their own research capability and brand, companies including Mittal, Cemex, Haier, Lenovo and BenQ are

attempting to accelerate the process by acquiring western companies with established brands, technology and distribution.

China's Galanz, which produces microwave ovens, pioneered a business model in which it would transplant state-of-the-art production equipment from western Europe to China, and manufacture microwaves in China under established western brands.

Consolidating production for many of the world's leading branded suppliers in China allowed Galanz to build economies of scale in sourcing and production, keep its fingers on the latest product and process innovations and gain insights into emerging consumer trends around the world. Obviously, many of these experiments will fail. Recall Acer's struggle to build a global brand from scratch and Daewoo's failed drive to dominate small emerging markets by partnering with governments.

Some of these battle-hardened management teams, however, will evolve winning strategies and find investors willing to fund their growth. And these are the ones western managers should worry about. Executives who lull themselves to sleep with reassuring bedtime stories about Japan may sleep well for now. But they risk waking up to a very unpleasant reality.

*The writer is an associate professor of management practice at London Business School. He is the author of *Made in China: What Western Managers Can Learn from Trailblazing Chinese Entrepreneurs* (Harvard Business School Press, 2005) 1*

EMERGING POWERS

- High costs of capital force companies to learn to do more with less
- Volatility of emerging markets provides training in risk management
- Champions must fight a two-front war: holding local rivals at bay at the low end of the market while battling multinationals
- Companies have strong incentives to expand abroad to spread risk geographically
- Unlike their Japanese counterparts, emerging market champions are not concentrated around a handful of industries
- Private equity firms and hedge funds now willing to bear big risks in the hope of achieving outsized rewards.

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