Winning in Emerging Markets: A Roadmap for Strategy and Execution, by Tarun Khanna and Krishna G. Palepu

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Book Review

***Winning in Emerging Markets: A Roadmap for Strategy and Execution,* by Tarun Khanna and Krishna G. Palepu. Harvard Business Press, 2010.**

The financial crisis has made emerging markets even more relevant for two reasons, say Tarun Khanna and Krishna G. Palepu, authors of *Winning in Emerging Markets*. First, many in business and government are convinced that a significant part of growth in the next several decades is likely to come from these markets. In the first six months of 2009, they note, the FTSE International Emerging Markets Index was up 41.1 percent, whereas the FTSE All World Developed Markets Index was up 7.2 percent (more recent data from the *Financial Times* corroborates this: the MSCI Emerging Markets index returned 13.2 percent annualized for the ten years ended December 2010, versus just 0.6 percent for the MSCI World Index of Developed Markets). Second, lessons and innovations from these markets may be relevant for mature Western markets, as consumers become more cost and value conscious.

How should firms determine which emerging market(s) to enter? The conventional wisdom is to focus on size or growth potential. But Khanna and Palepu take a refreshingly different approach. The primary exploitable characteristic of an emerging market, they argue, is its lack of institutional infrastructure. Emerging markets are thus defined as those where specialized intermediaries in capital, product, and labor markets are absent or poorly functioning. However, although these institutional voids throw up obstacles to expanding business operations, they also create major opportunities, and the authors provide an actionable framework for identifying and capitalizing on them. Armed with a more granular understanding of the underlying market structure of emerging economies, they argue, multinationals and local firms alike will be better equipped to gauge their potential, avoid mistakes, and define and execute winning business strategies. The book is based on the experiences of nine multinational companies and the same number of emerging market companies.

DEFINING EMERGING MARKETS

The authors reject the notion that emerging markets are simply at an earlier stage of development: “A fundamental premise of our work is that emerging markets reflect those transactional arenas where buyers and sellers are not easily or efficiently able to come together," they write, "Ideally, every economy would provide a range of institutions to facilitate the functioning of markets, but developing countries fall short in a number of ways" (6). Importantly, these shortcomings are not captured by measures such as per capita gross domestic product, which would put the United Arab Emirates among the world's most developed economies in spite of its relatively undeveloped market structure.

Nature of Institutional Voids

In Part 1 of the book (chapters 1–2), the authors unpack their structural definition of emerging markets by examining the institutional anatomy of these economies. In Chapter 1, they emphasize that although "hard" physical infrastructure (roads, bridges, telecommunication networks, water and sanitation facilities, power plants, and so on) are needed for product, labor, and capital markets to function efficiently, less recognized is the importance of institutional development that underpins the functioning of mature markets—"soft" infrastructure. "The most important feature of any market is the ease with which buyers and sellers can come together to do business," they say, "In developed markets, a range of specialized intermediaries provides the requisite information and contract enforcement needed to consummate transactions. Most developing markets fall short on this count" (14).

Although institutional voids take many forms, the three main causes of market failure are absent or unreliable sources of market information, an uncertain regulatory environment, and inefficient judicial systems. Their discussion of transaction costs (i.e., all the costs associated with conducting a purchase, sale, or other enterprise-related transaction, such as forming a business or building a warehouse), and the role of institutions in mitigating them, draws on the vast literature on institutional economics. For example, Nobel Prize winner George Akerlof's work on the used car market showed the difficulty of creating a well-functioning market when the quality of goods and services being bought and sold is uncertain. Information asymmetries and incentive conflicts between buyers and sellers create significant problems in markets that will lead to a crisis of confidence if not addressed through intermediaries (such as the independent mechanic whose objective evaluation helps the would-be buyer make an informed decision). Companies rely on such intermediaries to increase consumers' willingness to pay (WTP) and to lower their own costs. However, because some participants gain from institutional voids (such as those selling faulty vehicles), building market infrastructure is a matter of politics as well as economics. History and culture also shape the nature and "stickiness" of institutional voids, and help explain why it takes significant time and expertise to eliminate them.

Spotting and Responding to Institutional Voids

Chapter 2 illuminates the particular combination of features that prevent efficient exchange and offers a toolkit to help spot and respond to institutional voids in any given market. This toolkit consists of twelve questions relating to product markets (e.g., "Can companies easily obtain reliable data on customer tastes and purchase behaviors? Are there cultural barriers to market research? Do world-class market research firms operate in the country?"); labor markets (e.g., "How strong is the country's education infrastructure, especially for technical and management training? Does it have a good elementary and secondary system as well?"); and capital markets (e.g., "How effective are the country's banks, insurance companies, and mutual funds in collecting savings and channeling them into investments?").

The authors also pose 24 questions about the macro context. For example, "To whom are the country's politicians accountable? Are there strong political groups that oppose the ruling party? Do elections take place regularly?" Unsurprisingly, each emerging market has its own unique signature. Whereas Chile's capital markets are relatively efficient, Korea's remain constrained by entanglements between banks and its *chaebol* business groups. On the other hand, Korea's product markets are generally more developed than Chile's.

EXPLOITING INSTITUTIONAL VOIDS

In Part 2 of the book (chapters 3–6), the authors apply their framework to the challenges facing various actors in the emerging market context. Chapter 3 identifies six types of market institutions: credibility enhancers (e.g., auditors, certification and accreditation agencies); information analyzers and advisers (e.g., research firms, stock analysts, rating agencies, specialized publications); aggregators and distributors (e.g., mass retailers, logistics companies, venture capital firms, trading companies); transaction facilitators (e.g., executive search firms, online payment and auction companies, stock exchanges, brokerage houses, credit card issuers); adjudicators (e.g., courts and arbitrators); and regulators and policymakers. Firms can use this taxonomy to identify the missing pieces of market infrastructure that might contain viable opportunities.

Next, firms need to identify which segments of the market they can serve with their current capabilities; or, which new capabilities they need to acquire. Both local and multinational firms bring advantages as market intermediaries. In larger emerging markets the former can grow into large domestic businesses, and in smaller markets grow into adjacent businesses where they can add value (e.g., a print media company could expand into digital media), although some types of intermediation are easier to adopt than others. According to the authors, emerging markets can be exploited in a number of different ways—as consumer markets, regional or global production platforms, innovation and product development hubs, sources of talent, raw materials, or other inputs, and opportunities to develop market infrastructure.

All multinationals face similar strategic choices as they confront institutional voids in emerging markets. For example, all must determine the extent to which business models cultivated in developed markets have to be adapted for emerging markets. For example, General Motors adapted its Buick brand to penetrate the Chinese market, and L'Oréal exploited its global brand credentials after a failed attempt to enter the Indian market. Also, though they may bring brands, capital, talent, and other resources to these markets, they must gauge whether collaborating with a local partner makes sense, just as the latter must gauge what capabilities and credibility might be gained from tying up with a multinational. For example, Microsoft successfully established a business in China only after it collaborated with local players and invested in the development of the local software industry. Similarly, GE Healthcare acquired local capabilities through partnerships. Multinationals must also decide whether to sidestep institutional voids or develop intermediary-based businesses to fill them. Thus, McDonalds invested heavily in its supply chain in Russia to deliver food of comparable quality to that in the United States, and when intellectual property rights violations threatened to undermine its business in Brazil, Monsanto "borrowed" global market institutions to press for change. Finally, based on an assessment of institutional voids, companies need to decide whether to enter and operate in an emerging market, wait and pursue opportunities elsewhere, or exit from the market altogether. Waiting can be a problematic in industries where first-mover advantages are highly valuable, as Home Depot discovered to its detriment. Tetra Pak's example showed the value of committing to emerging markets undergoing crises because of their long-term potential.

Khanna and Palepu examine four in-depth cases of companies that identified opportunities to fill various institutional voids in emerging markets. Blue River Capital, an investment firm, targeted middle-market, largely family-owned businesses in India, turning institutional voids into opportunities. *Deremate.com* sought to replicate the success of auction site eBay in Argentina but had to adapt its model because of infrastructure limitations. Hong Kong-based Li & Fung started out as a deal-brokering transaction facilitator between Chinese factories and western firms but grew to take on a range of value-added intermediary functions. German wholesaler Metro Cash & Carry faced entrenched opposition as it sought to carve out a niche in India—driving home the point that changing a market context requires a great deal of awareness of and sensitivity to various stakeholders. Of particular interest is a chart showing the evolution of Li & Fung's intermediary businesses from the early 1900s to the early 2000s (70).

EMERGING GIANTS

Chapter 5 argues that companies that merely replicate business models developed in foreign contexts ensure their own downfall by paving the way for incoming multinationals. Emerging giants (based in emerging markets) are only able to become globally competitive because of a sustainable competitive advantage over incumbent multinationals. Although prospective emerging giants face a set of strategic choices mirroring those faced by multinationals, their home location and unique capabilities create different ways for them to respond. For example, emerging giants may leverage their in-depth understanding of local customer preferences and their first-hand experience in dealing with institutional voids to find creative solutions to the challenges of undeveloped hard and soft infrastructure. Tata Motors responded to the challenge of foreign competition by exploiting its product market knowledge and adapting business processes to develop the Ace, a $5,000 four-wheeled mini-truck positioned to replace the unsafe, slow, frequently overloaded yet ubiquitous three-wheeler. Less than a year after its introduction, Tata had sold 30,000 units. Although Tata proved the concept for the competition, Khanna and Palepu explain how its innovative procurement process and investments in developing the ecosystem for the vehicle through its distribution and service operations helped Tata sustain its competitive advantage. Similarly, SABMiller exploited its local product market knowledge to build an efficient distribution system that could reach South Africa's traditional beer-drinking outlets called *shebeens*—a feat that would have been difficult for a Heineken or an Anheuser-Busch. Cosan exploited its ability to adapt to institutional voids in the factor markets of Brazil (i.e., lack of information analyzers and advisers, credibility enhancers, product market aggregators and distributors, labor market regulators) to emerge as one of the world's leading sugar and ethanol producers.

Since many multinationals are required to collaborate with local firms when they enter emerging markets, collaboration is often more of a strategic choice for emerging market companies. The authors examine how emerging giant Bharti Airtel of India forged early foreign partnerships that helped nurture its growth with much-needed capital, resources, and strategic advice, enabling it to combat the inherent advantages of state-owned and business group-affiliated rivals. Dogus Group, one of Turkey's largest business groups, preserved its flagship financial services brand—a valuable asset in a market that lacked sophisticated information analyzers and advisers—while using a partnership with GE Consumer Finance to compensate for other voids in its home market. Haier Group of China is an interesting case of a company that profited from offering highly differentiated products to meet market needs, from a washing machine that could wash vegetables as well as clothes (for rural areas), to a tiny one for a single change of clothes (an instant hit in Shanghai).

Although Westerners might consider the diversified business group an anachronism, Khanna and Palepu demonstrate that this form of organization makes perfect sense in emerging markets. When starting a new line of business, for example, these organizations can draw on the capital, talent, or reputation of other businesses in the group. Examples include Ayla Corporation of the Philippines, the Korean *chaebols*, and Jardine Matheson of Hong Kong. Although there are costs to such arrangements (e.g., overly complex organizational structures and lack of external monitoring, such that internal cash flows are more easily diverted to ill-advised investments), the empirical evidence gathered to date seems to suggest that the benefits of group affiliation outweigh the costs in many emerging markets—at least as long as they are properly managed.

Having established a viable business model, prospective emerging giants must overcome a number of obstacles to compete and succeed as multinationals in their own right, including limited access to expansion capital, sophisticated R&D capabilities, and top-quality talent. Moreover, business models tailored to emerging markets must be adapted to new markets having different contextual features. In chapter 7, Khanna and Palepu explain how successful emerging giants such as Kuwait-based Zain, Israel's Teva Pharmaceutical Industries, and ICICI Bank of India managed these challenges as they moved out of their home markets. One suggested strategy is to extend the capabilities they have developed in other emerging markets while simultaneously stepping into more developed markets for stretch and learning, as practiced by ICICI, which entered the Middle East, the UK, and Canada around the same time. To succeed, they need to maintain the entrepreneurial drive cultivated in their home markets, while instilling a global mindset throughout the organization. They also need to develop and manage innovation as they move into higher-value products and services and raise standards in management and corporate governance. Such "corporate cleanups" build confidence and social capital in consumer, supplier, and investor circles and are a prerequisite for any firm wanting to enhance their credibility by tying up with global institutions.

EMERGING MARKET ACTION ITEMS

The authors conclude with four key points. First, multinationals should accept that they are unlikely to get things right the first time and be willing to experiment to fit their business models to emerging markets. Second, multinationals should position themselves as "partners in progress"—building businesses that also advance market development by, for example, building the infrastructure needed for efficient transactions, creating jobs, generating tax revenues, and so on. Third, multinationals should balance ambition with humility in emerging markets—not only because they may be viewed with suspicion (a legacy of colonialism), but also because they may not have the requisite knowledge or capabilities to succeed.

This observation seems prescient given the recent failure of Best Buy and other Western retailers in China. According to the *Financial Times*, the company failed to deduce that most Chinese customers wouldn't buy warranties, need installation, or pay more for goods available elsewhere for less. More fundamentally, success in its home market made Best Buy overconfident in its ability to change an industry. The need to stay humble and recognize what you do not know applies also to emerging giants, which usually do not have the collective memory of mistakes, and may underestimate the challenge of integrating radically different corporate cultures through global acquisitions. Finally, it is important to appreciate the risks of emerging markets, including abrogation of contracts, wanton expropriation, as well as competitive responses. A company's best defense is to maintain high standards, withdrawing from the market if and when the situation demands it.

One suggested avenue for further research is the extent to which models built for emerging markets will migrate to developed markets. Another is how emerging giants can handle the strains on their organizations as they go global and move up the value chain. Khanna and Palepu conclude that institutional voids present tremendous opportunities for entrepreneurs. One shortcoming of this concise and practical book is its exclusive focus on the experiences of large companies. This seems a pity given the persistent lack of confidence in small enterprises' ability to yield both high returns and socioeconomic development in emerging markets. What leading business schools in emerging markets are realizing is that they have to go beyond their traditional boundaries to support the development of a profitable small and medium-sized enterprise sector with an outsized social impact. As reported by the *Financial Times*, the Indian School of Business convinced a hedge fund to take the risk of investing in a small waste management group in Mumbai that grew into a $100 million business in less than four years because it exploited a market opportunity overlooked by big enterprises. This, in turn, enticed the Soros Economic Development Fund, the Omidyar Network, and Google to chip into a $17 million in-house fund (called Song) to improve access to risk capital in the small- and medium-sized enterprise (SME) segment. Such initiatives may ultimately be more crucial to job creation and social development in emerging markets than those undertaken by multinationals and emerging giants.

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