Strategies That Fit Emerging Markets

Fast-growing economies often provide poor soil for profits. The cause? A lack of specialized intermediary firms and regulatory systems on which multinational companies depend. Successful businesses look for those institutional voids and work around them.

by Tarun Khanna, Krishna G. Palepu, and Jayant Sinha

CEOs and top management teams of large corporations, particularly in North America, Europe, and Japan, acknowledge that globalization is the most critical challenge they face today. They are also keenly aware that it has become tougher during the past decade to identify internationalization strategies and to choose which countries to do business with. Still, most companies have stuck to the strategies they've traditionally deployed, which emphasize standardized approaches to new markets while sometimes experimenting with a few local twists. As a result, many multinational corporations are struggling to develop successful strategies in emerging markets.

Part of the problem, we believe, is that the absence of specialized intermediaries, regulatory systems, and contract-enforcing mechanisms in emerging markets – "institutional voids," we christened them in a 1997 HBR article – hampers the implementation of globalization strategies. Companies in developed countries usually take for granted the critical role that "soft" infrastructure plays in the execution of their business models in their home markets. But that infrastructure is often underdeveloped or absent in emerging markets. There's no dearth of examples. Companies can't find skilled market research firms to inform them reliably about customer preferences so they can tailor products to specific needs and increase people's

LEIGH WELLS

willingness to pay. Few end-to-end logistics providers, which allow manufacturers to reduce costs, are available to transport raw materials and finished products. Before recruiting employees, corporations have to screen large numbers of candidates themselves because there aren't many search firms that can do the job for them.

Because of all those institutional voids, many multinational companies have fared poorly in developing countries. All the anecdotal evidence we have gathered suggests that since the 1990s, American corporations have performed better in their home environments than they have in foreign countries, especially in emerging markets. Not surprisingly, many CEOs are wary of emerging markets and prefer to invest in developed nations instead. By the end of 2002 – according to the Bureau of Economic Analysis, an agency of the U.S. Department of Commerce – American corporations and their affiliate companies had $1.6 trillion worth of assets in the United Kingdom and $514 billion in Canada but only $173 billion in Brazil, Russia, India, and China combined. That's just 2.5% of the $6.9 trillion in investments American companies held by the end of that year. In fact, although U.S. corporations' investments in China doubled between 1992 and 2002, that amount was still less than 1% of all their overseas assets.

Many companies shied away from emerging markets when they should have engaged with them more closely. Since the early 1990s, developing countries have been the fastest-growing market in the world for most products and services. Companies can lower costs by setting up manufacturing facilities and service centers in those areas, where skilled labor and trained managers are relatively inexpensive. Moreover, several developing-country transnational corporations have entered North America and Europe with low-cost strategies (China's Haier Group in household electrical appliances) and novel business models (India's Infosys in information technology services). Western companies that want to develop counterstrategies must push deeper into emerging markets, which foster a different genre of innovations than mature markets do.

If Western companies don't develop strategies for engaging across their value chains with developing countries, they are unlikely to remain competitive for long. However, despite crumbling tariff barriers, the spread of the Internet and cable television, and the rapidly improving physical infrastructure in these countries, CEOs can't assume they can do business in emerging markets the same way they do in developed nations. That's because the quality of the market infrastructure varies widely from country to country. In general, advanced economies have large pools of seasoned market intermediaries and effective contract-enforcing mechanisms, whereas less-developed economies have unskilled intermediaries and less-effective legal systems. Because the services provided by intermediaries either aren't available in emerging markets or aren't very sophisticated, corporations can't smoothly transfer the strategies they employ in their home countries to those emerging markets.

During the past ten years, we've researched and consulted with multinational corporations all over the world. One of us led a comparative research project on China and India at Harvard Business School, and we have all been involved in McKinsey & Company's Global Champions research project. We have learned that successful companies work around institutional voids. They develop strategies for doing business in emerging markets that are different from those they use at home and often find novel ways of implementing them, too. They also customize their approaches to fit each nation's institutional context. As we will show, firms that take the trouble to understand the institutional differences between countries are likely to choose the best markets to enter, select optimal strategies, and make the most out of operating in emerging markets.

Successful companies develop strategies for doing business in emerging markets that are different from those they use at home and often find novel ways of implementing them, too.

Why Composite Indices Are Inadequate

Before we delve deeper into institutional voids, it's important to understand why companies often target the wrong countries or deploy inappropriate globalization strategies. Many corporations enter new lands because of senior managers' personal experiences, family ties, gut feelings, or anecdotal evidence. Others follow key customers or rivals into emerging markets; the herd instinct is strong among multinationals. Biases, too, dog companies' foreign investments. For instance, the reason U.S. companies preferred to do business with

Tarun Khanna (tkhanna@hbs.edu) is the Jorge Paulo Lemann Professor and ***Krishna G. Palepu*** *(kpalepu@hbs.edu) is the Ross Graham Walker Professor of Business Administration at Harvard Business School in Boston. They are the coauthors of "Why Focused Strategies May be Wrong for Emerging Markets" (HBR July–August 1997) and "The Right Way to Restructure Conglomerates in Emerging Markets" (HBR July–August 1999).* ***Jayant Sinha*** *(jayant_sinha@mckinsey.com) is a partner at McKinsey & Company in New Delhi.*

China rather than India for decades was probably because of America's romance with China, first profiled in MIT political scientist Harold Isaacs's work in the late 1950s. Isaacs pointed out that partly as a result of the work missionaries and scholars did in China in the 1800s, Americans became more familiar with China than with India.

Companies that choose new markets systematically often use tools like country portfolio analysis and political risk assessment, which chiefly focus on the potential profits from doing business in developing countries but leave out essential information about the soft infrastructures there. In December 2004, when the McKinsey Global Survey of Business Executives polled 9,750 senior managers on their priorities and concerns, 61% said that market size and growth drove their firms' decisions to enter new countries. While 17% felt that political and economic stability was the most important factor in making those decisions, only 13% said that structural conditions (in other words, institutional contexts) mattered most.

Just how do companies estimate a nation's potential? Executives usually analyze its GDP and per capita income growth rates, its population composition and growth rates, and its exchange rates and purchasing power parity indices (past, present, and projected). To complete the picture, managers consider the nation's standing on the World Economic Forum's Global Competitiveness Index, the World Bank's governance indicators, and Transparency International's corruption ratings; its weight in emerging market funds investments; and, perhaps, forecasts of its next political transition.

Such composite indices are no doubt useful, but companies should use them as the basis for drawing up strategies only when their home bases and target countries have comparable institutional contexts. For example, the United States and the United Kingdom have similar product, capital, and labor markets, with networks of skilled intermediaries and strong regulatory systems. The two nations share an Anglo-Saxon legal system as well. American companies can enter Britain comfortable in the knowledge that they will find competent market research firms, that they can count on English law to enforce agreements they sign with potential partners, and that retailers will be able to distribute products all over the country. Those are dangerous assumptions to make in an emerging market, where skilled intermediaries or contract-enforcing mechanisms are unlikely to be found. However, composite indices don't flash warning signals to would-be entrants

The Trouble with Composite Indices

Companies often base their globalization strategies on country rankings, but on most lists, it is impossible to tell developing countries apart. According to the six indices below, Brazil, India, and China share similar markets while Russia, though an outlier on many parameters, is comparable to the other nations. Contrary to what these rankings suggest, however, the market infrastructure in each of these countries varies widely, and companies need to deploy very different strategies to succeed.

	Brazil	Russia	India	China
Growth Competitiveness Index ranking* (out of 104 countries; for 2003)	57	70	55	46
Business Competitiveness Index ranking* (out of 103 countries; for 2003)	38	61	30	47
Governance indicators (percentile rankings)** (out of 199 countries; for 2002)				
Voice and accountability	58.1	33.8	60.2	10.1
Political stability	48.1	33.0	22.2	51.4
Government effectiveness	50.0	44.3	54.1	63.4
Regulatory quality	63.4	44.3	43.8	40.2
Rule of law	50.0	25.3	57.2	51.5
Control of corruption	56.7	21.1	49.5	42.3
Corruption Perceptions Index ranking*** (out of 145 countries; for 2004)	59	90	90	71
Composite Country Risk Points**** (for January 2005; the larger the number, the less risky the country)	70	78	72	76
Weight in Emerging Markets Index (%)***** (for February 2004; out of 26 emerging markets)	6.96%	5.16%	5.02%	4.76%

Sources:
* World Economic Forum, "Global Competitiveness Report," 2004–2005
** World Bank Governance Research Indicator Country Snapshot, 2002
*** Transparency International, Corruption Perceptions Index, 2004
**** The PRS Group, *International Country Risk Guide*, January 2005
***** Barclays Global Investors, iShares "2004 Semi-Annual Report to Shareholders"

about the presence of institutional voids in emerging markets.

In fact, composite index–based analyses of developing countries conceal more than they reveal. (See the exhibit "The Trouble with Composite Indices.") In 2003, Brazil, Russia, India, and China appeared similar on several indices. Yet despite the four countries' comparable standings, the key success factors in each of those markets have turned out to be very different. For instance, in China and Russia, multinational retail chains and local retailers have expanded into the urban and semi-urban areas, whereas in Brazil, only a few global chains have set up shop in key urban centers. And in India, the government prohibited foreign direct investment in the retailing and real estate industries until February 2005, so mom-and-pop retailers dominate. Brazil, Russia, India, and China may all be big markets for multinational consumer product makers, but executives have to design unique distribution strategies for each market. That process must start with a thorough understanding of the differences between the countries' market infrastructures. Those differences may make it more attractive for some businesses to enter, say, Brazil than India.

How to Map Institutional Contexts

As we helped companies think through their globalization strategies, we came up with a simple conceptual device–the five contexts framework–that lets executives map the institutional contexts of any country. Economics 101 tells us that companies buy inputs in the product, labor, and capital markets and sell their outputs in the products (raw materials and finished goods) or services market. When choosing strategies, therefore, executives need to figure out how the product, labor, and capital markets work – and don't work – in their target countries. This will help them understand the differences between home markets and those in developing countries. In addition, each country's social and political milieu–as well as the manner in which it has opened up to the outside world – shapes those markets, and companies must consider those factors, too.

The five contexts framework places a superstructure of key markets on a base of sociopolitical choices. Many multinational corporations look at either the macro factors (the degree of openness and the sociopolitical atmosphere) or some of the market factors, but few pay attention to both. We have developed sets of questions that companies can ask to create a map of each country's context and to gauge the extent to which businesses must adapt their strategies to each one. (See the exhibit "Spotting Institutional Voids.") Before we apply the framework to some developing countries, let's briefly touch on the five contexts.

Political and Social Systems. As we've discussed, every country's political system affects its product, labor, and capital markets. In socialist societies like China, for instance, workers cannot form independent trade unions in the labor market, which affects wage levels. A country's social environment is also important. In South Africa, for example, the government's support for the transfer of assets to the historically disenfranchised native African community – a laudable social objective–has affected the development of the capital market. Such transfers usually price assets in an arbitrary fashion, which makes it hard for multinationals to figure out the value of South African companies and affects their assessments of potential partners.

The thorny relationships between ethnic, regional, and linguistic groups in emerging markets also affects foreign investors. In Malaysia, for instance, foreign companies should enter into joint ventures only after checking if their potential partners belong to the majority Malay community or the economically dominant Chinese community, so as not to conflict with the government's longstanding policy of transferring some assets from Chinese to Malays. This policy arose because of a perception that the race riots of 1969 were caused by the tension between the Chinese haves and the Malay have-nots. Although the rhetoric has changed somewhat in the past few years, the pro-Malay policy remains in place.

Can companies sustain strategies that presume the existence of institutional voids? They can. It took decades to fill institutional voids in the West.

Executives would do well to identify a country's power centers, such as its bureaucracy, media, and civil society, and figure out if there are checks and balances in place. Managers must also determine how decentralized the political system is, if the government is subject to oversight, and whether bureaucrats and politicians are independent from one another. Companies should gauge the level of actual trust among the populace as opposed to enforced trust. For instance, if people believe companies won't vanish with their savings, firms may be able to raise money locally sooner rather than later.

Openness. CEOs often talk about the need for economies to be open because they believe it's best to enter countries that welcome direct investment by multinational corporations – although companies can get into countries that don't allow foreign investment by entering into joint ventures or by licensing local partners. Still, they must remember that the concept of "open" can be deceptive. For example, executives believe that China is an open economy because

the government welcomes foreign investment but that India is a relatively closed economy because of the lukewarm reception the Indian government gives multinationals. However, India has been open to ideas from the West, and people have always been able to travel freely in and out of the country, whereas for decades, the Chinese government didn't allow its citizens to travel abroad freely, and it still doesn't allow many ideas to cross its borders. Consequently, while it may be true that multinational companies can invest in China more easily than they can in India, managers in India are more inclined to be market oriented and globally aware than managers are in China.

The more open a country's economy, the more likely it is that global intermediaries will be allowed to operate there. Multinationals, therefore, will find it easier to function in markets that are more open because they can use the services of both the global and local intermediaries. However, openness can be a double-edged sword: A government that allows local companies to access the global capital market neutralizes one of foreign companies' key advantages.

The two macro contexts we have just described – political and social systems and openness – shape the market contexts. For instance, in Chile, a military coup in the early 1970s led to the establishment of a right-wing government, and that government's liberal economic policies led to a vibrant capital market in the country. But Chile's labor market remained underdeveloped because the government did not allow trade unions to operate freely. Similarly, openness affects the development of markets. If a country's capital markets are open to foreign investors, financial intermediaries will become more sophisticated. That has happened in India, for example, where capital markets are more open than they are in China. Likewise, in the product market, if multinationals can invest in the retail industry, logistics providers will develop rapidly. This has been the case in China, where providers have taken hold more quickly than they have in India, which has only recently allowed multinationals to invest in retailing.

Product Markets. Developing countries have opened up their markets and grown rapidly during the past decade, but companies still struggle to get reliable information about consumers, especially those with low incomes. Developing a consumer finance business is tough, for example, because the data sources and credit histories that firms draw on in the West don't exist in emerging markets. Market research and advertising are in their infancy in developing countries, and it's difficult to find the deep databases on consumption patterns that allow companies to segment consumers in more-developed markets. There are few government bodies or independent publications, like *Consumer Reports* in the United States, that provide expert advice on the features and quality of products. Because of a lack of consumer courts and advocacy groups in developing nations, many people feel they are at the mercy of big companies.

Labor Markets. In spite of emerging markets' large populations, multinationals have trouble recruiting managers and other skilled workers because the quality of talent is hard to ascertain. There are relatively few search firms and recruiting agencies in low-income countries. The high-quality firms that do exist focus on top-level searches, so companies must scramble to identify middle-level managers, engineers, or floor supervisors. Engineering colleges, business schools, and training institutions have proliferated, but apart from an elite few, there's no way for companies to tell which schools produce skilled managers. For instance, several Indian companies have sprung up to train people for jobs in the call center business, but no organization rates the quality of the training it provides.

Capital Markets. The capital and financial markets in developing countries are remarkable for their lack of sophistication. Apart from a few stock exchanges and government-appointed regulators, there aren't many reliable intermediaries like credit-rating agencies, investment analysts, merchant bankers, or venture capital firms. Multinationals can't count on raising debt or equity capital locally to finance their operations. Like investors, creditors don't have access to accurate information on companies. Businesses can't easily assess the creditworthiness of other firms or collect receivables after they have extended credit to customers. Corporate governance is also notoriously poor in emerging markets. Transnational companies, therefore, can't trust their partners to adhere to local laws and joint venture agreements. In fact, since crony capitalism thrives in developing countries, multinationals can't assume that the profit motive alone is what's driving local firms.

Several CEOs have asked us why we emphasize the role of institutional intermediaries and ignore industry factors. They argue that industry structure, such as the degree of competition, should also influence companies' strategies. But when Harvard Business School professor Jan Rivkin and one of the authors of this article ranked industries by profitability, they found that the correlation of industry rankings across pairs of countries was close to zero, which means that the attractiveness of an industry varied widely from country to country. So although factors like scale economies, entry barriers, and the ability to differentiate products matter in every industry, the weight of their importance varies from place to place. An attractive industry in your home market may turn out to be unattractive in another country. Companies should analyze industry structures–always a useful exercise – only after they understand a country's institutional context.

Applying the Framework

When we applied the five contexts framework to emerging markets in four countries – Brazil, Russia, India, and China – the differences between them became apparent. (See the exhibit "Mapping Contexts in Brazil, Russia, India, and China.") Multinationals face different kinds of competition in each of

continued on page 73

Mapping Contexts in Brazil, Russia, India, and China

The five contexts (below) can help companies spot the institutional voids in any country. An application of the framework to the four fastest-growing markets in the world reveals how different those countries are from developed nations and, more important, from one another.

POLITICAL AND SOCIAL SYSTEM

U.S./EU	Brazil	Russia	India	China
POLITICAL STRUCTURE				
Countries have vibrant democracies with checks and balances. Companies can count on rule of law and fair enforcement of legal contracts.	The democracy is vibrant. Bureaucracy is rampant. There are pockets of corruption in federal and state governments.	A centralized government and some regional fiefdoms coexist. Bureaucracy is stifling. Corruption occurs at all levels of government.	The democracy is vibrant. The government is highly bureaucratic. Corruption is rampant in state and local governments.	The Communist Party maintains a monopoly on political power. Local governments make economic policy decisions. Officials may abuse power for personal gain.
CIVIL SOCIETY				
A dynamic media acts as a check on abuses by both companies and governments. Powerful nongovernmental organizations (NGOs) influence corporate policies on social and environmental issues.	Influential local media serves as a watchdog. The influence of local NGOs is marginal.	The media is controlled by the government. NGOs are underdeveloped and disorganized.	A dynamic press and vigilant NGOs act as checks on politicians and companies.	The media is muzzled by the government, and there are few independent NGOs. Companies don't have to worry about criticism, but they can't count on civil society to check abuses of power.

OPENNESS

U.S./EU	Brazil	Russia	India	China
MODES OF ENTRY				
Open to all forms of foreign investment except when governments have concerns about potential monopolies or national security issues.	Both greenfield investments and acquisitions are possible entry strategies. Companies team up with local partners to gain local expertise.	Both greenfield investments and acquisitions are possible but difficult. Companies form alliances to gain access to government and local inputs.	Restrictions on greenfield investments and acquisitions in some sectors make joint ventures necessary. Red tape hinders companies in sectors where the government does allow foreign investment.	The government permits greenfield investments as well as acquisitions. Acquired companies are likely to have been state owned and may have hidden liabilities. Alliances let companies align interests with all levels of government.

LABOR MARKETS

U.S./EU	Brazil	Russia	India	China
WORKERS MARKET				
The level of unionization varies among countries. Industrial actions take place in Europe, especially in the manufacturing and public sectors, but not in the United States.	Trade unions are strong and pragmatic, which means that companies can sign agreements with them.	Trade unions are present, but their influence is declining except in certain sectors, such as mining and railways.	The trade union movement is active and volatile, although it is becoming less important. Trade unions have strong political connections.	Workers can join the government-controlled All-China Federation of Trade Unions. Historically, there were no industrial actions, but there have been recent strikes at Hong Kong– and Taiwan-owned manufacturing facilities.

CAPITAL MARKETS

U.S./EU	Brazil	Russia	India	China
DEBT AND EQUITY				
Companies can easily get bank loans. The corporate bond market is well developed. The integration of stock exchanges gives companies access to a deep pool of investors.	A good banking system exists, and there is a healthy market for initial public offerings. Wealthy individuals can invest in offshore accounts.	The banking system is strong but dominated by state-owned banks. The consumer credit market is booming, and the IPO market is growing. Firms must incorporate local subsidiaries to raise equity capital.	The local banking system is well developed. Multinationals can rely on local banks for local needs. Equity is available to local and foreign entities.	The local banking system and equity markets are underdeveloped. Foreign companies have to raise both debt and equity in home markets.
VENTURE CAPITAL (VC)				
VC is generally available in urban areas or for specific industry clusters. VC is not as readily available in southern Europe.	A few private equity players are active locally.	Only companies in the most profitable businesses, such as real estate development and natural resources, can access VC.	VC is available in some cities and from the Indian diaspora.	VC availability is limited.
ACCOUNTING STANDARDS				
Apart from off-balance-sheet items, a high level of transparency exists. In the European Union, accounting practices should become more uniform after 2005 because of new norms.	The financial-reporting system is based on a common-law system and functions well.	The modified Soviet system of financial reporting works well. Banks are shifting to international accounting standards.	Financial reporting, which is based on a common-law system, functions well.	There is little corporate transparency. China's accounting standards are not strict, although the China Securities Regulatory Commission wants to tighten disclosure rules.
FINANCIAL DISTRESS				
Efficient bankruptcy processes tend to favor certain stakeholders (creditors, labor force, or shareholders) in certain countries.	Processes allow companies to stay in business rather than go out of business. Bankruptcy processes exist but are inefficient.	Bankruptcy processes and legislation are fully developed. Corruption distorts bankruptcy enforcement.	Bankruptcy processes exist but are inefficient. Promoters find it difficult to sell off or shut down "sick" enterprises.	Companies can use bankruptcy processes in some cases. Write-offs are common.

Key questions for identifying institutional voids: See inside >>

Spotting Institutional Voids

Managers can identify the institutional voids in any country by asking a series of questions. The answers – or sometimes, the lack of them – will tell companies where they should adapt their business models to the nation's institutional context.

POLITICAL AND SOCIAL SYSTEM

1. To whom are the country's politicians accountable? Are there strong political groups that oppose the ruling party? Do elections take place regularly?
2. Are the roles of the legislative, executive, and judiciary clearly defined? What is the distribution of power between the central, state, and city governments?
3. Does the government go beyond regulating business to interfering in it or running companies?
4. Do the laws articulate and protect private property rights?
5. What is the quality of the country's bureaucrats? What are bureaucrats' incentives and career trajectories?
6. Is the judiciary independent? Do the courts adjudicate disputes and enforce contracts in a timely and impartial manner? How effective are the quasi-judicial regulatory institutions that set and enforce rules for business activities?
7. Do religious, linguistic, regional, and ethnic groups coexist peacefully, or are there tensions between them?
8. How vibrant and independent is the media? Are newspapers and magazines neutral, or do they represent sectarian interests?
9. Are nongovernmental organizations, civil rights groups, and environmental groups active in the country?
10. Do people tolerate corruption in business and government?
11. What role do family ties play in business?
12. Can strangers be trusted to honor a contract in the country?

OPENNESS

1. Are the country's government, media, and people receptive to foreign investment? Do citizens trust companies and individuals from some parts of the world more than others?
2. What restrictions does the government place on foreign investment? Are those restrictions in place to facilitate the growth of domestic companies, to protect state monopolies, or because people are suspicious of multinationals?
3. Can a company make greenfield investments and acquire local companies, or can it only break into the market by entering into joint ventures? Will that company be free to choose partners based purely on economic considerations?
4. Does the country allow the presence of foreign intermediaries such as market research and advertising firms, retailers, media companies, banks, insurance companies, venture capital firms, auditing firms, management consulting firms, and educational institutions?
5. How long does it take to start a new venture in the country? How cumbersome are the government's procedures for permitting the launch of a wholly foreign-owned business?
6. Are there restrictions on portfolio investments by overseas companies or on dividend repatriation by multinationals?
7. Does the market drive exchange rates, or does the government control them? If it's the latter, does the government try to maintain a stable exchange rate, or does it try to favor domestic products over imports by propping up the local currency?
8. What would be the impact of tariffs on a company's capital goods and raw materials imports? How would import duties affect that company's ability to manufacture its products locally versus exporting them from home?
9. Can a company set up its business anywhere in the country? If the government restricts the company's location choices, are its motives political, or is it inspired by a logical regional development strategy?
10. Has the country signed free-trade agreements with other nations? If so, do those agreements favor investments by companies from some parts of the world over others?
11. Does the government allow foreign executives to enter and leave the country freely? How difficult is it to get work permits for managers and engineers?
12. Does the country allow its citizens to travel abroad freely? Can ideas flow into the country unrestricted? Are people permitted to debate and accept those ideas?

PRODUCT MARKETS

1. 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?
2. Can consumers easily obtain unbiased information on the quality of the goods and services they want to buy? Are there independent consumer organizations and publications that provide such information?

PRODUCT MARKETS

U.S./EU	Brazil	Russia	India	China
PRODUCT DEVELOPMENT AND INTELLECTUAL PROPERTY RIGHTS (IPR)				
Sophisticated product-design capabilities are available. Governments enforce IPR and protect trademarks, so R&D investments yield competitive advantages.	Local design capability exists. IPR disputes with the United States exist in some sectors.	The country has a strong local design capability but exhibits an ambivalent attitude about IPR. Sufficient regulatory authority exists, but enforcement is patchy.	Some local design capability is available. IPR problems with the United States exist in some industries. Regulatory bodies monitor product quality and fraud.	Imitation and piracy abound. Punishment for IPR theft varies across provinces and by level of corruption.
SUPPLIER BASE AND LOGISTICS				
Companies use national and international suppliers. Firms outsource and move manufacturing and services offshore instead of integrating vertically. A highly developed infrastructure is in place, but urban areas are saturated.	Suppliers are available in the Mercosur region. A good network of highways, airports, and ports exists.	Companies can rely on local suppliers for simple components. The European region has decent logistics networks, but trans-Ural Russia is not well developed.	Suppliers are available, but their quality and dependability varies greatly. Roads are in poor condition. Ports and airports are underdeveloped.	Several suppliers have strong manufacturing capabilities, but few vendors have advanced technical abilities. The road network is well developed. Port facilities are excellent.
BRAND PERCEPTIONS AND MANAGEMENT				
Markets are mature and have strong local and global brands. The profusion of brands clutters consumer choice. Numerous ad agencies are available.	Consumers accept both local and global brands. Global as well as local ad agencies are present.	Consumers prefer global brands in automobiles and high tech. Local brands thrive in the food and beverage businesses. Some local and global ad agencies are available.	Consumers buy both local and global brands. Global ad agencies are present, but they have been less successful than local ad agencies.	Consumers prefer to buy products from American, European, and Japanese companies. Multinational ad agencies dominate the business.

LABOR MARKETS

U.S./EU	Brazil	Russia	India	China
MARKET FOR MANAGERS				
A large and varied pool of well-trained management talent exists.	The large pool of management talent has varying degrees of proficiency in English. Both local and expatriate managers hold senior management jobs.	The large pool of management talent has varying degrees of proficiency in English, and it is supplemented by expatriate managers. Employment agencies are booming.	The country has a highly liquid pool of English-speaking management talent fueled by business and technical schools. Local hires are preferred over expatriates.	There is a relatively small and static market for managers, especially away from the eastern seaboard. Many senior and middle managers aren't fluent in English. A large number of managers are expatriates. Some members of the Chinese diaspora have returned home to work.

More Mapping Contexts: Turn page >>

Source: Media reports and interviews with academics and businesspeople

3. Can companies access raw materials and components of good quality? Is there a deep network of suppliers? Are there firms that assess suppliers' quality and reliability? Can companies enforce contracts with suppliers?

4. How strong are the logistics and transportation infrastructures? Have global logistics companies set up local operations?

5. Do large retail chains exist in the country? If so, do they cover the entire country or only the major cities? Do they reach all consumers or only wealthy ones?

6. Are there other types of distribution channels, such as direct-to-consumer channels and discount retail channels, that deliver products to customers?

7. Is it difficult for multinationals to collect receivables from local retailers?

8. Do consumers use credit cards, or does cash dominate transactions? Can consumers get credit to make purchases? Are data on customer creditworthiness available?

9. What recourse do consumers have against false claims by companies or defective products and services?

10. How do companies deliver after-sales service to consumers? Is it possible to set up a nationwide service network? Are third-party service providers reliable?

11. Are consumers willing to try new products and services? Do they trust goods from local companies? How about from foreign companies?

12. What kind of product-related environmental and safety regulations are in place? How do the authorities enforce those regulations?

LABOR MARKETS

1. How strong is the country's education infrastructure, especially for technical and management training? Does it have a good elementary and secondary education system as well?

2. Do people study and do business in English or in another international language, or do they mainly speak a local language?

3. Are data available to help sort out the quality of the country's educational institutions?

4. Can employees move easily from one company to another? Does the local culture support that movement? Do recruitment agencies facilitate executive mobility?

5. What are the major postrecruitment-training needs of the people that multinationals hire locally?

6. Is pay for performance a standard practice? How much weight do executives give seniority, as opposed to merit, in making promotion decisions?

7. Would a company be able to enforce employment contracts with senior executives? Could it protect itself against executives who leave the firm and then compete against it? Could it stop employees from stealing trade secrets and intellectual property?

8. Does the local culture accept foreign managers? Do the laws allow a firm to transfer locally hired people to another country? Do managers want to stay or leave the nation?

9. How are the rights of workers protected? How strong are the country's trade unions? Do they defend workers' interests or only advance a political agenda?

10. Can companies use stock options and stock-based compensation schemes to motivate employees?

11. Do the laws and regulations limit a firm's ability to restructure, downsize, or shut down?

12. If a company were to adopt its local rivals' or suppliers' business practices, such as the use of child labor, would that tarnish its image overseas?

CAPITAL MARKETS

1. How effective are the country's banks, insurance companies, and mutual funds at collecting savings and channeling them into investments?

2. Are financial institutions managed well? Is their decision making transparent? Do noneconomic considerations, such as family ties, influence their investment decisions?

3. Can companies raise large amounts of equity capital in the stock market? Is there a market for corporate debt?

4. Does a venture capital industry exist? If so, does it allow individuals with good ideas to raise funds?

5. How reliable are sources of information on company performance? Do the accounting standards and disclosure regulations permit investors and creditors to monitor company management?

6. Do independent financial analysts, rating agencies, and the media offer unbiased information on companies?

7. How effective are corporate governance norms and standards at protecting shareholder interests?

8. Are corporate boards independent and empowered, and do they have independent directors?

9. Are regulators effective at monitoring the banking industry and stock markets?

10. How well do the courts deal with fraud?

11. Do the laws permit companies to engage in hostile takeovers? Can shareholders organize themselves to remove entrenched managers through proxy fights?

12. Is there an orderly bankruptcy process that balances the interests of owners, creditors, and other stakeholders?

those nations. In China, state-owned enterprises control nearly half the economy, members of the Chinese diaspora control many of the foreign corporations that operate there, and the private sector brings up the rear because entrepreneurs find it almost impossible to access capital. India is the mirror image of China. Public sector corporations, though important, occupy nowhere near as prominent a place as they do in China. Unlike China, India is wary of foreign investment, even by members of the Indian diaspora. However, the country has spawned many private sector organizations, some of which are globally competitive. It's difficult to imagine a successful business in China that hasn't had something to do with the government; in India, most companies have succeeded in spite of the state.

Brazil mixes and matches features of both China and India. Like China, Brazil has floated many state-owned enterprises. At the same time, it has kept its doors open to multinationals, and European corporations such as Unilever, Volkswagen, and Nestlé have been able to build big businesses there. Volkswagen has six plants in Brazil, dominates the local market, and exports its Gol model to Argentina and Russia. Brazil also boasts private sector companies that, like Indian firms, go head-to-head in the local market with global firms. Some Brazilian companies, such as basic materials company Votorantim and aircraft maker Embraer, have become globally competitive.

Russia is also a cross between China and India, but most of its companies are less competitive than those in Brazil. A few multinationals such as McDonald's have done well, but most foreign firms have failed to make headway there. There are only a few strong private sector companies in the market, such as dairy products maker Wimm-Bill-Dann and cellular services provider VimpelCom. The Russian government is involved, formally and informally, in several industries. For instance, the government's equity stake in Gazprom allows it to influence the country's energy sector. Moreover, administrators at all levels can exercise near veto power over business deals that involve local or foreign companies, and getting permits and approvals is a complicated chore in Russia.

One level deeper, the financial markets in Brazil, Russia, India, and China vary, too. In Brazil and India, indigenous entrepreneurs, who are multinationals' main rivals, rely on the local capital markets for resources. In China, foreign companies compete with state-owned enterprises, which public sector banks usually fund. The difference is important because neither the Chinese companies nor the banks are under pressure to show profits. Moreover, financial reporting in China isn't transparent even if companies have listed themselves on stock exchanges. State-owned companies can for years pursue strategies that increase their market share at the expense of profits. Corporate governance standards in Brazil and India also mimic those of the West more closely than do those in Russia and China. Thus, in Russia and China, multinationals can't count on local partners' internal systems to protect their interests and assets – especially their intellectual property.

The Three Strategy Choices

When companies tailor strategies to each country's contexts, they can capitalize on the strengths of particular locations. Before adapting their approaches, however, firms must compare the benefits of doing so with the additional coordination costs they'll incur. When they complete this exercise, companies will find that they have three distinct choices: They can adapt their business model to countries while keeping their core value propositions constant, they can try to change the contexts, or they can stay out of countries where adapting strategies may be uneconomical or impractical. Can companies sustain strategies that presume the existence of institutional voids? They can. It took decades to fill institutional voids in the West.

Adapt your strategies. To succeed, multinationals must modify their business models for each nation. They may have to adapt to the voids in a country's product markets, its input markets, or both. But companies must retain their core business propositions even as they adapt their business models. If they make shifts that are too radical, these firms will lose their advantages of global scale and global branding.

Compare Dell's business models in the United States and China. In the United States, the hardware maker offers consumers a wide variety of configurations and makes most computers to order. Dell doesn't use distributors or resellers, shipping most machines directly to buyers. In 2003, nearly 50% of the company's revenues in North America came from orders placed through the Internet.

The cornerstone of Dell's business model is that it carries little or no inventory. But Dell realized that its direct-sales approach wouldn't work in China, because individuals weren't accustomed to buying PCs through the Internet. Chinese companies used paper-based order processing, so Dell had to rely on faxes and phones rather than online sales. And several Chinese government departments and state-owned enterprises insisted that hardware vendors make their bids through systems integrators. The upshot is that Dell relies heavily on distributors and systems integrators in China. When it first entered the market there, the company offered a smaller product range than it did in the United States to keep inventory levels low. Later, as its supply chain became more efficient, it offered customers in China a full range of products.

Smart companies like Dell modify their business model without destroying the parts of it that give them a competitive advantage over rivals. These firms start by identifying the value propositions that they will not modify, whatever the context. That's what McDonald's did even as it comprehensively adapted its business model to Russia's factor markets. In the United States, McDonald's has outsourced most of its supply chain operations. But when it tried to move into Russia in 1990, the company was unable to find local suppliers. The

fast-food chain asked several of its European vendors to step up, but they weren't interested. Instead of giving up, McDonald's decided to go it alone. With the help of its joint venture partner, the Moscow City Administration, the company identified some Russian farmers and bakers it could work with. It imported cattle from Holland and russet potatoes from America, brought in agricultural specialists from Canada and Europe to improve the farmers' management practices, and advanced the farmers money so that they could invest in better seeds and equipment.

Then the company built a 100,000 square-foot McComplex in Moscow to produce beef; bakery, potato, and dairy products; ketchup; mustard; and Big Mac sauce. It set up a trucking fleet to move supplies to restaurants and financed its suppliers so that they would have enough working capital to buy modern equipment. The company also brought in about 50 expatriate managers to teach Russian employees about its service standards, quality measurements, and operating procedures and sent a 23-person team of Russian managers to Canada for a four-month training program. McDonald's created a vertically integrated operation in Russia, but the company clung to one principle: It would sell only hamburgers, fries, and Coke to Russians in a clean environment – fast. Fifteen years after serving its first Big Mac in Moscow's Pushkin Square, McDonald's has invested $250 million in the country and controls 80% of the Russian fast-food market.

Change the contexts. Many multinationals are powerful enough to alter the contexts in which they operate. The products or services these companies offer can force dramatic changes in local markets. When Asia's first satellite TV channel, Hong Kong–based STAR, launched in 1991, for example, it transformed the Indian marketplace in many ways. Not only did the company cause the Indian government to lose its monopoly on television broadcasts overnight, but it also led to a booming TV-manufacturing industry and the launch of several other satellite-based channels aimed at Indian audiences. By the mid-1990s, satellite-based TV channels had become a vibrant advertising medium, and many organizations used them to launch products and services targeted at India's new TV-watching consumer class.

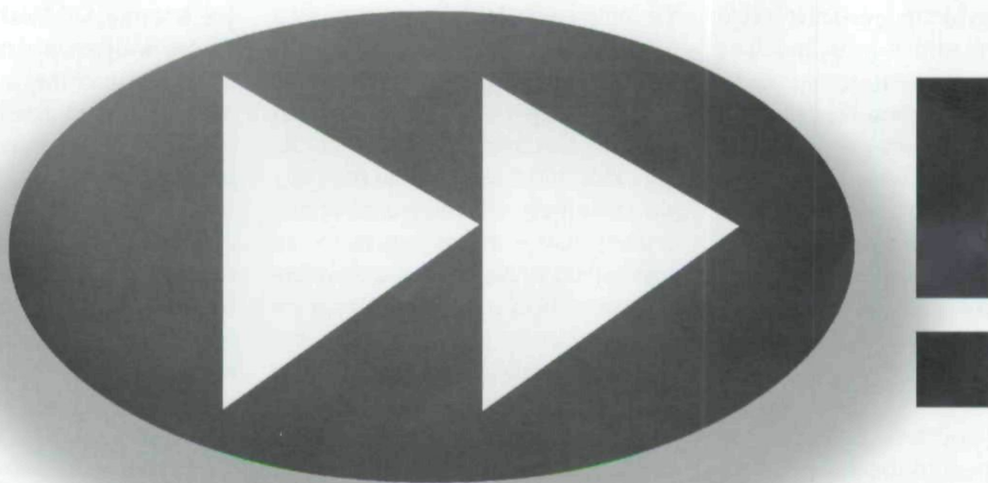
The entry of foreign companies transforms quality standards in local product markets, which can have far-reaching consequences. Japan's Suzuki triggered a quality revolution after it entered India in 1981. The automaker's need for large volumes of high-quality components roused local suppliers. They teamed up with Suzuki's vendors in Japan, formed quality clusters, and worked with Japanese experts to produce better products. During the next two decades, the total quality management movement spread to other industries in India. By 2004, Indian companies had bagged more Deming prizes than firms in any country other than Japan. More important, India's automotive suppliers had succeeded in breaking into the global market, and several of them, such as Sundram Fasteners, had become preferred suppliers to international automakers like GM.

Companies can change contexts in factor markets, too. Consider the capital market in Brazil. As multinationals set up subsidiaries in those countries, they needed global-quality audit services. Few Brazilian accounting firms could provide those services, so the Big Four audit firms – Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers – decided to set up branches there. The presence of those companies quickly raised financial-reporting and auditing standards in Brazil.

In a similar vein, Knauf, one of Europe's leading manufacturers of building materials, is trying to grow Russia's talent market. During the past decade, the German giant has built 20 factories in Russia and invested more than $400 million there. Knauf operates in a people-intensive industry; the company and its subsidiaries have roughly 7,000 employees in Russia. To boost standards in the country's construction industry, Knauf opened an education center in St. Petersburg in 2003 that works closely with the State Architectural and Construction University. The school acts both as a mechanism that supplies talent to Knauf and as an institution that contributes to the much-needed development of Russian architecture.

Indeed, as firms change contexts, they must help countries fully develop their potential. That creates a win-win situation for the country and the company. Metro Cash & Carry, a division of German trading company Metro Group, has changed contexts in a socially beneficial way in several European and Asian countries. The Düsseldorf-based company – which sells everything to restaurants from meats and vegetables to napkins and toothpicks – entered China in 1996, Russia in 2001, and India in 2003. Metro has pioneered business links between farmers and small-scale manufacturers in rural areas that sell their products to small and midsize urban companies.

Multinationals may have to adapt to the voids in a country's product markets, its input markets, or both. But companies must retain their core business propositions even as they adapt their business models.



Fast-forward your company and your career with IMD. More than a consultant, more than a teacher, IMD is your learning and problem-solving partner.

- Global perspectives
- Practical, stimulating, leading-edge learning
- Insights, skills and confidence to succeed

Achieve with IMD,
a world leader
in executive development.

www.hbr.imd.ch
+41 21 618 06 64

Real World. Real Learning®

For instance, Metro invested in a cold chain in China so that it could deliver goods like fish and meats from rural regions to urban locations. That changed local conditions in several important ways. First, Metro's investment induced farmers in China to invest more in their agricultural operations. Metro also lobbied with governments for quality standards to prevent companies from selling shoddy produce to hapless consumers. By shifting transactions from roadside markets to computerized warehouses, the company's operations brought primary products into the tax net. Governments, which need the money to invest in local services, have remained on the company's side. That's a good thing for Metro since, in developing markets, the jury is always out on foreign companies.

While companies can't use the same strategies in all developing countries, they can generate synergies by treating different markets as part of a system.

Stay away. It may be impractical or uneconomical for some firms to adapt their business models to emerging markets. Home Depot, the successful do-it-yourself U.S. retailer, has been cautious about entering developing countries. The company offers a specific value proposition to customers: low prices, great service, and good quality. To pull that off, it relies on a variety of U.S.-specific institutions. It depends on the U.S. highways and logistical management systems to minimize the amount of inventory it has to carry in its large, warehouse-style stores. It relies on employee stock ownership to motivate shop-level workers to render top-notch service. And its value proposition takes advantage of the fact that high labor costs in the United States encourage home owners to engage in do-it-yourself projects.

Home Depot made a tentative foray into emerging markets by setting up two stores in Chile in 1998 and another in Argentina in 2000. In 2001, however, the company sold those operations for a net loss of $14 million. At the time, CEO Robert Nardelli emphasized that most of Home Depot's future growth was likely to come from North America. Despite that initial setback, the company hasn't entirely abandoned emerging markets. Rather, it has switched from a greenfield strategy to an acquisition-led approach. In 2001, Home Depot entered Mexico by buying a home improvement retailer, Total Home, and the next year, it acquired Del Norte, another small chain. By 2004, the company had 42 stores in Mexico. Although Home Depot has recently said that it is exploring the possibility of entering China, perhaps by making an acquisition, it doesn't have retail operations in any other developing countries.

Home Depot must consider whether it can modify its U.S. business model to suit the institutional contexts of emerging markets. In a country with a poorly developed capital market, for example, the company may not be able to use employee stock ownership as a compensation tool. Similarly, in a country with a poorly developed physical infrastructure, Home Depot may have difficulty using its inventory management systems, a scenario that would alter the economics of the business. In markets where labor costs are relatively low, the target customer may not be the home owner but rather contractors who serve as intermediaries between the store and the home owner. That change in customer focus may warrant an entirely different marketing and merchandising strategy – one that Home Depot isn't convinced it should deploy yet.

• • •

While companies can't use the same strategies in all developing countries, they can generate synergies by treating different markets as part of a system. For instance, GE Healthcare (formerly GE Medical Systems) makes parts for its diagnostic machines in China, Hungary, and Mexico and develops the software for those machines in India. The company created this system when it realized that the market for diagnostic machines was small in most low-income countries. GE Healthcare then decided to use the facility it had set up in India in 1990 as a global sourcing base. After several years, and on the back of borrowed expertise from GE Japan, the India operation's products finally met GE Healthcare's exacting standards. In the late 1990s, when GE Healthcare wanted to move a plant from Belgium to cut costs, the Indian subsidiary beat its Mexican counterpart by delivering the highest quality at the lowest cost. Under its then-CEO, Jeff Immelt, GE Healthcare learned to use all its operations in low-income countries – China, Hungary, Mexico, and India – as parts of a system that allowed the company to produce equipment cheaply for the world market.

Parent company GE has also tapped into the talent pool in emerging markets by setting up technology centers in Shanghai and Bangalore, for instance. In those centers, the company conducts research on everything from materials design to molecular modeling to power electronics. GE doesn't treat China and India just as markets but also as sources of talent and innovation that can transform its value chain. And that's how multinational companies should engage with emerging markets if they wish to secure their future.

Andy Klump, Niraj Kaji, Luis Sanchez, and Max Yacoub provided research assistance for the Dell and McDonald's examples in this article.

Reprint R0506C
To order, see page 151.

Harvard Business Review Notice of Use Restrictions, May 2009

Harvard Business Review and Harvard Business Publishing Newsletter content on EBSCOhost is licensed for the private individual use of authorized EBSCOhost users. It is not intended for use as assigned course material in academic institutions nor as corporate learning or training materials in businesses. Academic licensees may not use this content in electronic reserves, electronic course packs, persistent linking from syllabi or by any other means of incorporating the content into course resources. Business licensees may not host this content on learning management systems or use persistent linking or other means to incorporate the content into learning management systems. Harvard Business Publishing will be pleased to grant permission to make this content available through such means. For rates and permission, contact permissions@harvardbusiness.org.