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How Firms in Emerging Markets Can Play Catch-Up

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Business strategy has come a long way in the past several decades. In the 1980s, the holy grail of sustainable competitive advantage was thought to stem from positioning the firm against a set of five or so industry-level forces, including returns to scale, switching costs, and other entry barriers. (This view was popularized by Michael Porter at Harvard Business School.) In the 1990s, Jay Barney and others began developing what has become known as the resource-based view (RBV) of the firm. They argued that internal factors—i.e., firm-specific resources that are valuable, rare, inimitable, and non-tradable—were more important in sustaining a competitive advantage than Porter’s external forces.

We now know that the difference between winning and losing is rooted not in the sole existence of resources themselves. Rather, they must be integrated into a coherent capabilities system that transforms them into differentiated products and services—and that ultimately gives a firm its right to win in the marketplace.

However, despite having learned much about the nature of competitive advantage, we still know surprisingly little about how such an advantage arises in the first place. This is a key question for emerging markets, where latecomer firms must somehow overcome the vastly superior capabilities of long-established multinationals. In fact, from the RBV perspective, it’s difficult

to explain how they could catch up at all. Yet, a handful of emerging giants—such as Embraer and Huawei today or Toyota and Samsung in the recent past—have done so. How did they do it, and what can others learn from their experiences?

As I’ve recently argued, all of these companies went through a similar four-stage process of developing specific capabilities. As a result, they successfully transitioned from relying primarily on country-specific advantages, such as ultra-low labor costs, to leveraging their own firm-specific advantages, including superior product design, quality, and innovation.

Stage 1: Seize the moment. Demand for mass-produced products can remain nascent in emerging markets for decades, until conditions change. That shift can happen either through new government policies—such as import substitution, deregulation, or privatization—or when a middle class of newly affluent consumers emerges. The key challenge at this stage is to spot the opportunity and figure out how to exploit it.

Above all, this insight requires prior industry experience, connections with local government officials and other stakeholders, and access to the required startup capital (a significant factor, because the financial sector is invariably still underdeveloped). The overriding objective is to create or acquire the basic lights-on and foundational capabilities to simply get started in the in-

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dustry—or reposition the firm to take advantage of new opportunities. Getting this right means adapting the industry's standard business model to local market conditions and may require some experimentation.

Stage 2: Build strength. Once established, the firm's focus must shift to improving its foundational capabilities first and linking them internally, across functional activities, and externally with supply-chain and channel partners. In fact, significant vertical integration is often crucial to maintain control and deliver acceptable quality levels. In sharp contrast to later stages, the focus at this stage should not yet be on differentiation and creating unique capabilities, but on imitation and developing standard capabilities.

After all, the typical emerging-market firm is not a true startup but a latecomer to an established industry. Given that market position, the new firm still needs to learn the business through an iterative cycle of internal development, contract manufacturing, licensing, selective partnerships, and/or outright acquisitions, while taking advantage of such emerging market and latecomer advantages as low costs and the ability to leapfrog to new technology standards. Contrary to the conventional wisdom, firms that underinvest during this stage tend to run into challenges later when industry growth slows, labor costs rise, competition intensifies, and the country continues its transition to a more market-based economy.

Stage 3: Scale up and consolidate. Once it has developed the required foundational capabilities, the firm must shift its focus to building scale through a combination of organic growth as well as acquiring other local competitors. The goal here is to achieve differentiation first on the cost side, because most emerging markets

firms are still far too weak to compete on demand-side capabilities, such as design and innovation. Instead, the best firms focus on relentless cost improvement in every activity of the business, and they can become truly innovative in such areas as low-cost product design, local sourcing, and “manufacturability”—or designing products so they can be easily mass-produced at ultra-low costs.

At the same time, it is crucial for the domestic market to be large enough and sufficiently difficult to enter (because of natural or regulatory barriers) to enable local firms to make the transition to global standards while they are still relatively protected from world-class multinationals. In addition, the external environment often remains far too uncertain and fluid for the firm to be able to commit to a single development path just yet.

Stage 4: Move up and out. In the final stage, the firm's focus must shift yet again to enable breakout growth by moving up into higher-value segments domestically and out into international markets. If it cannot make this jump, the firm will likely face declining prospects, in that its country-specific cost advantages will eventually migrate to other emerging markets.

To succeed at this level, the firm must develop new, higher-order capabilities and learn how to reconfigure and integrate them into a coherent and differentiated capabilities system. It must also develop a precise understanding of how far to develop each capability (i.e., best-in-class, competitive parity, good enough) and how to fill existing capability gaps (i.e., through internal development, outsourcing them to a more competent third party, or entering into strategic partnerships and acquisitions). Knowing when to embark on each development path is not at all straightforward, and should itself be

come a (dynamic) organizational capability. In other words, the best firms will develop a systematic process for selecting the optimal development path under new or changing circumstances, instead of relying on what has worked well in the past.

Although catching up with entrenched multinationals may appear daunting, today's leading emerging giants have all followed a well-defined capability development path that others can follow. There's no guarantee of success—and some conditions need to be in place at the outset—but companies that choose such a path can put the odds decidedly in their favor. +

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