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Rethinking emerging market strategies:

From offshoring to strategic expansion

BY VIKRAM MAHIDHAR, CRAIG GIFFI AND AJIT KAMBIL
WITH RYAN ALVANOS
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Ron Donald knows that good deeds seldom go unpunished. As the head of emerging market business at a major manufacturer, he has received many accolades pertaining to cost savings. His last review with the executive committee was no different; he highlighted, with careful detail, the formidable challenges associated with meeting new cost targets while managing risks. Nonetheless, the committee saw significant growth potential and decided to double its investment in his region. Ron worries that something has to give, but it's his job to come up with a plan.

For more than a decade now, manufacturers have flocked into emerging markets under the banner of globalization to access low-cost sourcing in high-growth economies. Many of these organizations have established fairly successful operations and realized significant cost arbitrage. Just below the surface, however, sizable sourcing risks—from contaminated pet food to lead-based paint in toys—fill headlines with dramatic falls from operational grace, leaving a wake of bludgeoned brand names and skeptical consumers to question the wisdom of offshoring.

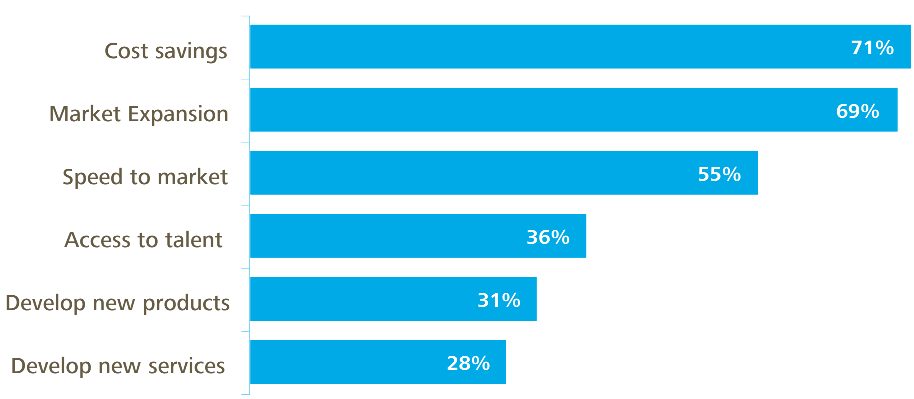
STRATEGIC EXPANSION IN EMERGING MARKETS

Perhaps these alarming headlines reveal only a partial story. If offshoring is the sole culprit of such operational demise, manufacturers would inevitably seek safer harbor somewhere else. Indeed, there's no shortage of risk when it comes to ensuring quality. A mid-2007 study found that only 40 percent of respondents felt they could trust a major retailer to protect them from safety problems in products coming from China.[1] Similarly, European Union consumers rank food safety alongside terrorism as a key concern.[2]

The underlying reality of the situation may be somewhat rosier based on a study Deloitte performed involving interviews with several executives and a survey of 247 executives from consumer and industrial product companies with presence in emerging markets Our study revealed that companies are increasingly making emerging geographic markets a centerpiece of their global business model. Over the next three years, upwards of 88 percent of companies plan to expand their presence in emerging markets. In fact, nearly half of these organizations expect 20 percent or more of their global revenues to have their origins in emerging markets. Furthermore, a third of these companies plan to place more than 20 percent of their investments in these regions. None of these figures suggest an imminent end to offshoring as we know it, but rather a renewed interest in its pursuit.

That's not to say manufacturers would call their endeavors business-as-usual in emerging markets. Forward thinking companies have not been content to simply increase their presence in low-cost centers. They have become more strategic in their operations by establishing core functions of their value chains in these regions. While cost savings is still a key motivator for nearly three-quarters of

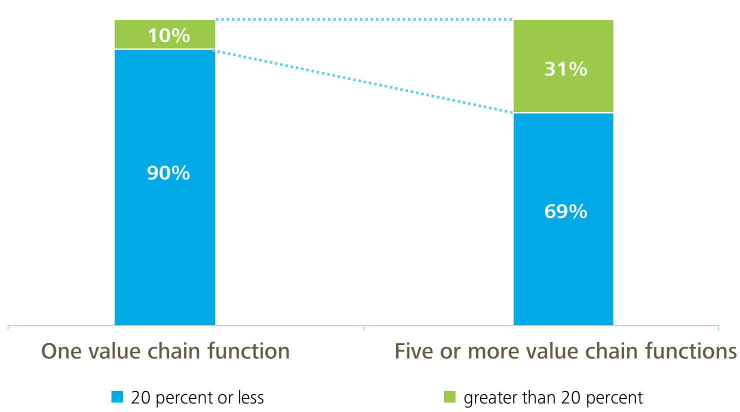
Figure 1: Top three strategic objectives for establishing functions in emerging markets



manufacturing companies, it's no longer the sole reason to set up shop abroad. Almost seventy percent of the manufacturers in our study consider market expansion an important factor (see figure 1). In fact, over two-thirds of companies think it's equally important to cost savings. Similarly, 55 percent of manufacturing companies reported that they establish operations in emerging markets to improve their speed to market. Nokia has been in India since 1995, an early investment that earned it 50 percent of a mobile phone market – one that adds 8–10 million new users every month. D. Shivakumar, managing director of Nokia India, attributes this success to the company's completely localized value chain. Indian operations for everything from R&D to manufacturing, marketing and sales give Nokia the power to launch new phones in a matter of weeks, rather than months, with designs that cater directly to the needs of its local customers.[3]

Increasingly, organizations are broadening the scope of their pursuits in emerging economies. Nearly 40 percent of the companies in our study have established commercial operations in addition to their manufacturing endeavors that cater to global as well as local markets. After-sales service, material sourcing, and sales and marketing – relative newcomers to low-cost centers – are becoming increasingly prevalent. Forward thinking companies are beginning to realize that future returns will depend on emulating global business models in emerging markets. Intuitively, a strong correlation exists between the number of functions a company establishes in emerging markets and the percentage of global profits that come from these regions. A third of the organizations in our study with five or more functions in emerging markets earn 20 percent or more of their global profits from these operations (see figure 2). By comparison, the majority of manufacturers with only

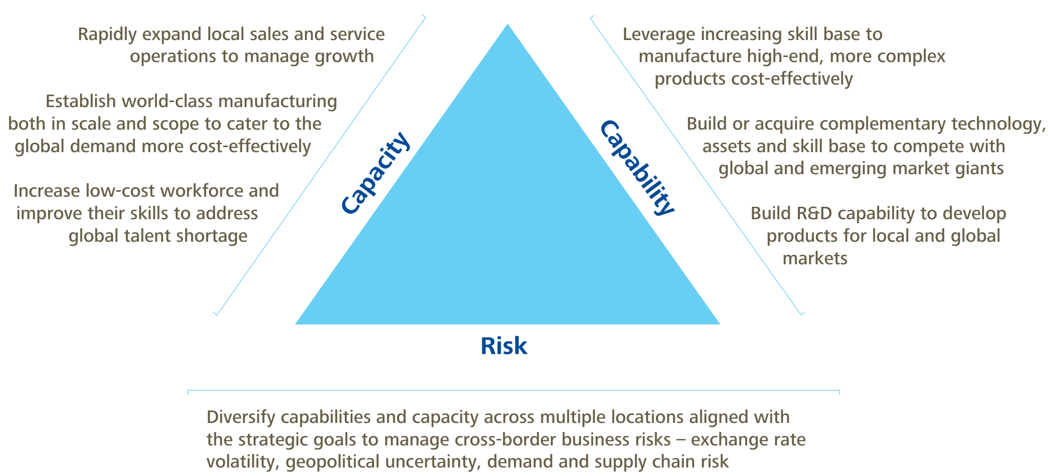
Figure 2: Number of functions in emerging markets vs. percentage of global profits from emerging markets



a single operation in these low-cost centers reported that they derive 10 percent or less of their global profits from their endeavors.

But these numbers don't paint a complete picture, either. Many manufacturers reported that they are increasing their expectations along with their investments in emerging markets. As a result, operational and financial performance goals can become as elusive as they are lofty. In fact, raw materials and manufacturing have become more expensive over the last three years for over 40 percent of the companies who cited cost savings as a key objective in their emerging market strategies. Likewise, only 13 percent of the companies that cited market expansion as their key objective have realized a significant increase in their global market share. The problem is a fundamental one: companies' endeavors in developing countries haven't kept pace with the evolving capacity and capabilities of these regions, and they're not part of a global business model. As a result, performance in these countries pale by comparison to other parts of their global business.

Figure 3: New strategies for emerging markets



When companies were content merely to outsource low-complexity work to low-cost centers, strategies were narrow and straightforward. This simplicity has evaporated as companies begin to strategically shift specific functions of their value chains to account for new objectives pertaining to growth, innovation and sustainability. From a strategy standpoint, three factors determine the emerging market business model: capacity, capability and risk (see figure 3).

CAPACITY

Even though the global economic growth has slowed, developing economies like India and China will continue to be the pillars of global GDP growth. Companies are aggressively targeting these economies to achieve their growth targets, but selling in developing countries is no easy task. It requires a deep understanding of the market, culture and local constraints, in addition to sufficient sales forces and support structures for introducing products to new regions. For some consumer and industrial product companies, it has taken several decades to successfully achieve this capacity. However, companies are rapidly expanding their commercial operations and transforming their revenue models in emerging markets to tap into current demand growth and compete with local emerging giants. For example, after manufacturing and selling in India for 10 years, Volvo recently formed a joint venture with Eicher Motors, a local commercial vehicle manufacturer. Volvo plans to use Eicher's sales and service infrastructure and manufacturing prowess to increase its sales from 5,000 vehicles to 100,000 by 2015. With $225 million invested so far, Volvo plans to gain a 15 percent market share of heavy commercial vehicles.[4]

To date, more than 63 percent of the companies in our study with a presence in emerging markets have manufacturing operations there, and almost two-thirds of these companies plan to continue their expansion over the next three years. From a capacity perspective, they are doing this with good reason. Operations in low-cost centers allow companies to take advantage of favorable currency arbitrage and build capacity for local and international markets. For instance, the combined vehicle assembly capacity of Brazil, Russia, India and China (BRIC) will climb to 20 million vehicles this year, surpassing the 17.4 million currently produced by Canada and the United States.[5]

Companies are expanding both the scale and the scope of their production capacity. In the last few years, the demand for consumer and industrial products in BRIC countries has grown exponentially. Customers in these markets now demonstrate a larger appetite for a wider range of products. Over the last two years, other emerging markets like Poland, Vietnam, Turkey and Thailand have experienced increased demand that's expected to grow exponentially in the years to come. As demand in emerging markets becomes more similar to the developed world, companies will need to grow their capacity for product development and manufacturing to account for increased local demand. Furthermore, these new markets will require suitable price points. High-end, established companies are turning facilities in emerging markets into export hubs by increasing manufacturing capacity to account for both local and international consumers. For instance, WABCO, a global technology leader for commercial vehicles, is investing $35 million in its Qingdao operations in China to increase workforce from 240 to over 1,000 by 2012, making the Qingdao factory WABCO's third largest in the world. The Qingdao production base will continue its commitment to serving China's commercial vehicle industry, and at the same time, it will be an export platform for the entire Asia Pacific region, North America and Europe.[6]

Talent shortage consistently appears on top of the list of challenges in emerging markets. Workforce abounds, but demand for specialized skills is outstripping supply. Of the 70 million skilled workers in urban China, only four percent are specialized.[7] Companies in our study reported that, as a result, they are expanding their human resources capacities in emerging markets and training local talent in the specialized skills they need to complete the work. Despite increasing expenses associated with workforce, companies are still able to hire large numbers of people because the cost differential between the U.S. and emerging economies is still favorable — one U.S. worker to three or more in an emerging economy — and this figure is likely to persist for the next few decades.

CAPABILITY

A second factor that companies need to build their strategies around is capability. After years of mastering low-cost parts and assemblies, a slew of manufacturers and suppliers in emerging markets are ready to move up the engineering value chain. In fact, some of them already support local giants like Tata Motors, that are now beating competition at the global level. Multinational companies are tapping into low-cost, high-end manufacturing abilities to build more complex, engineered products for local and global markets. For example, South Korean Hyundai Motor Co. recently started commercial production at its second engine plant in India in an attempt to drive up small-car sales in one of the world's fastest-growing auto markets. Hyundai, the world's sixth-largest automaker, aims to make its India plants the global hub of its compact car production. Similarly, Ford India plans to make India its strategic manufacturing hub for exporting both diesel and petrol engines to Asia Pacific and Africa.

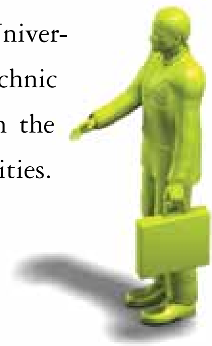
Companies enter emerging markets with an acute awareness of local features that could expand their product or service offerings. For example, many companies use emerging markets to supplement their capabilities in research and development. ArcelorMittal, the world's largest steel company, is setting up a state-of-the-art R&D facility in Kolkata, India. This R&D hub will not only bolster the company's R&D capacity, it will also build the capabilities they need to enter the fast-growing, lucrative field of engineering consultancy. Additionally, the new facility will take advantage of the huge gap between supply and demand for consultancy jobs in that part of India. Already, the company has recruited some 300 people to occupy the 25,000 square foot facility.[8]

CISCO HAD NO PRESENCE IN INDIA BEFORE 2005, BUT BURGEONING MARKET OPPORTUNITIES IN THE EASTERN HEMISPHERE HAVE PROMPTED A SECOND HEADQUARTERS IN BANGALORE THAT WILL SERVE INDIAN CONSUMERS AS WELL AS OTHER EMERGING MARKETS SUCH AS DUBAI. IN ESSENCE, THE COMPANY IS DE-WESTERNIZING ITS U.S.-CENTRIC CORPORATE CULTURE AND PLANS TO HOUSE 20 PERCENT OF ITS TOP LEADERSHIP IN BANGALORE.

Increased R&D investments are having a profound impact on patent filing. The number of U.S. patent applications from India, China, South Korea, Singapore, and Taiwan grew by 759 percent between 1981 and 2001, compared to 116 percent growth in the U.S. during the same period.[9] Between 2000 and 2006, the number of patents granted to applicants from China and the Republic of Korea grew by 26.5% and 23.2% a year, respectively (average annual growth rate).[10] This is the result of companies growing their innovation capabilities in these markets.

Capability extends beyond R&D to other parts of the value chain. Many companies access emerging markets to enhance their product or service offerings, either through acquisitions or alliances with local companies.

Capability also encompasses access to the right talent pools in emerging markets. Companies are expanding their capabilities by accessing a new pool of skilled workers in low-cost centers. Sweden's Saab has entered into a relationship to establish an Aeronautical Design and Development Centre in India and develop its Indian talent pool.[11] Similarly, a large producer of metals established an Innovation Center of Excellence with leading universities in Russia to supplement research and development projects on innovative mining, refining and smelting technologies. These relationships involve Moscow State University, St. Petersburg State Mining Institute, and Ural Polytechnic University to support university-level technical education in the regions where the company has offices and production facilities.



RISK

The third salient factor that companies need to consider in their strategic expansion involves cross-border business risks. Companies need to carefully choose the concentration of activities and locations to create a sustainable cost and revenue structure across geographies.

Cross-border business risk has several faces, each of which can lead to dramatic stumbles and larger-than-usual headline type. One of these is exchange rate volatility, which has a nasty habit of wipingout global profits and tightening cash flow. For many multinational companies that sell in emerging markets, imports from their foreign affiliates or suppliers account for a significant portion of their cost. Fluctuating exchange rates may not allow companies to remain competitive in these highly price-sensitive markets. Moreover, the uncertain future of emerging market currencies adds risk to projected profits and cash flow over the long term.

Political, and increasingly geopolitical, stability can also have a hand in the successes and failures of manufacturers' endeavors in other countries. Car makers in India, for example, face higher levels of risk at the hands of increased reliance on oil, vulnerability to spikes in crude prices, and slowdowns in global expansion.[12] Alternatively, opportunities can offset risks associated with a given location. For example, companies might choose to set up shop in Turkey and benefit from inherent economic growth when that country eventually enters the European Union.

Additionally, operational stability is a prevalent concern among companies in emerging markets. Quality and supply chain lapses – think Chinese pet food and lead-based paint – can be corrosive to hard-won corporate reputations. Simply abandoning emerging markets due to such risk factors is clearly not a viable solution, but companies will need to manage these risks more proactively.

Variety is more than just the spice of life. To hedge against these myriad risks and complications, companies can spread the various parts of their value chains across different countries. Intel, for example, already had significant holdings in China when it was deciding where to establish a new multi-billion-dollar integrated circuit plant. It created this facility in Vietnam to diversify its holdings and hedge its operational bets.[13] More distributed models can offset the risks associated with placing too many value chain chips in a single economic basket.

LOCATION, LOCATION, LOCATION

Emerging market strategy begins, and perhaps also ends, when deciding where to establish the various functions of the value chain. As one of the most complex decisions a business can make, it needs to be aligned with the strategy rather than country rankings by macro-level indicators.

Companies need to do more with less to stay competitive and improve products and speed to market. They must align their strategic objectives with the capabilities and market potential that locations can offer. India and China, for instance, have been among the preferred offshoring venues since companies first explored possibilities in developing countries. In the days when success boiled down to simple cost savings, these countries were the logical choice for low-complexity work. Even though costs are creeping up in these markets, the manufacturing capabilities that these countries have to offer are also changing. China is demonstrating its ability to parlay its prowess in low-end manufacturing to become a major producer of sophisticated, high-tech goods. Companies are choosing locations like India, China and Thailand to expand high-end manufacturing operations. Chinese growth in high-end manufacturing doubled to 48 percent between 1997 and 2007 as a result,[14] and supplier networks from surrounding countries are becoming centers for low-cost sourcing.

These popular destinations are no longer the only offshoring options for prudent expansion. Organizations are beginning to establish operations in other emerging markets that better address the new challenges and complexities of offshoring. Saddled by saturated car markets and ever-increasing competition, manufacturers are scraping for competitive advantages and finding them in Eastern Europe. This relative newcomer among emerging markets boasts low-cost labor, shorter lead times, and attractive tax incentives to manufacturers on the lookout for expansion opportunities. The region, as a result, is poised to increase its production to the 4 million mark by 2015, a 100 percent increase since 2004.[15] Likewise, Latin America, Russia and a host of Asian countries beyond the usual suspects are emerging as attractive options for offshoring.

Moreover, some of the high-growth emerging economies offer significant opportunities for revenue growth in the local markets. Many companies are establishing their commercial operations in markets such as Brazil and Russia. Additionally, companies with manufacturing bases in these markets are establishing research and development units to localize and develop new products.

While companies tweak their strategies to create new value in the emerging markets, leaders of the pack also strategize to protect value. Our study indicated that companies choose multiple locations for product development and manufacturing to reduce development time and access a wider range of local talent. They also spread their investments across multiple locations to diversify their investments across geographies.

As emerging markets grow in number and productive abilities, careful consideration of strategic objectives that account for capability, capacity and risk can go a long way in choosing the right region. Experience is another critical factor when entering emerging markets: companies with more experience tend to do a better job of extending their value chains in emerging markets because they have deeper business relationships and understanding of local markets and cultures. Caterpillar Inc., the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, and industrial gas turbines, has been in China for 30 years. It has an evolved business model and Chinese operations in manufacturing, product design, distribution, research and development, sourcing, and product support. The company's planned expansion of its R&D operations will increase technical support for both local markets and the rest of the Asia Pacific region.[16]

Companies with less experience are also expanding their presence in emerging markets. Cisco had no presence in India before 2005, but burgeoning market opportunities in the Eastern hemisphere have prompted a second headquarters in Bangalore that will serve Indian consumers as well as other emerging markets such as Dubai. In essence, the company is de-Westernizing its U.S.-centric corporate culture and plans to house 20 percent of its top leadership in Bangalore.

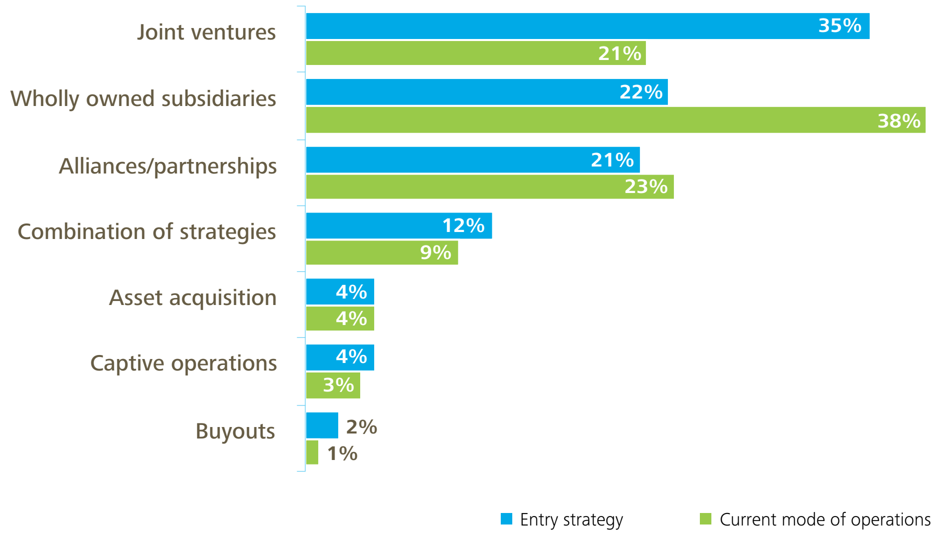
Companies also enter emerging markets to take advantage of newfound financial benefits. Many countries are opening up for trade with the West and reducing tariffs, which in turn invites greater volumes of work from abroad. Morocco, for example, established itself as an export gateway by entering a free trade agreement with the United States, European Union and several other countries including Tunisia, Egypt, Jordan and Turkey. In its efforts to compete with India as a low-cost center, it also offers a number of attractive fiscal incentives, including a five-year tax holiday followed by marginal corporate tax rates of 35 percent on half of the revenue earned thereafter to all export oriented companies.[17]

GETTING THE OPERATING MODEL RIGHT

In recent years, the rate of IJV (international joint venture) formation has continued to increase steadily, especially among emerging markets in Asia, Eastern Europe and Latin America. These emerging markets account for about 70 percent of all IJV entries by multinational corporations.[18] As companies deepen their business activities in low-cost centers and incorporate these endeavors into global value chains, their existing operating models may not be effective in emerging markets. According to our survey, 35 percent of companies used joint ventures to enter emerging markets, but only 21 percent still use them.

The type of business activities, market opportunities, country regulations, tax advantages, and experience in emerging markets are the key determinants of operating model (see figure 4). Thirty-eight percent of manufacturing companies in our study reported that they currently use wholly owned subsidiaries in emerging

Figure 4: Operating model



markets. As they build complete product lines and develop new products, companies require a significant level of control over strategic business activities. For example, Sweden's Volvo group, the world's second largest truck manufacturer, owns a subsidiary in India that builds trucks to sell in India, Myanmar, Indonesia, Vietnam and China. Volvo India has also established a product development center in Bangalore, India that employs over 200 people. The wholly owned subsidiary model allows companies to take advantage of global brands and existing business processes and protects intellectual property by keeping development effectively in-house.

Similarly, companies expanding sales activities in emerging markets need access to deeper knowledge of local customers, support networks, distribution and advertising. In many cases, companies choose joint ventures with experienced players in a local market, as noted earlier with Volvo's recently formed joint venture with Eicher Motors in India to sell heavy vehicles and leverage its network of over 200 service centers across the country.

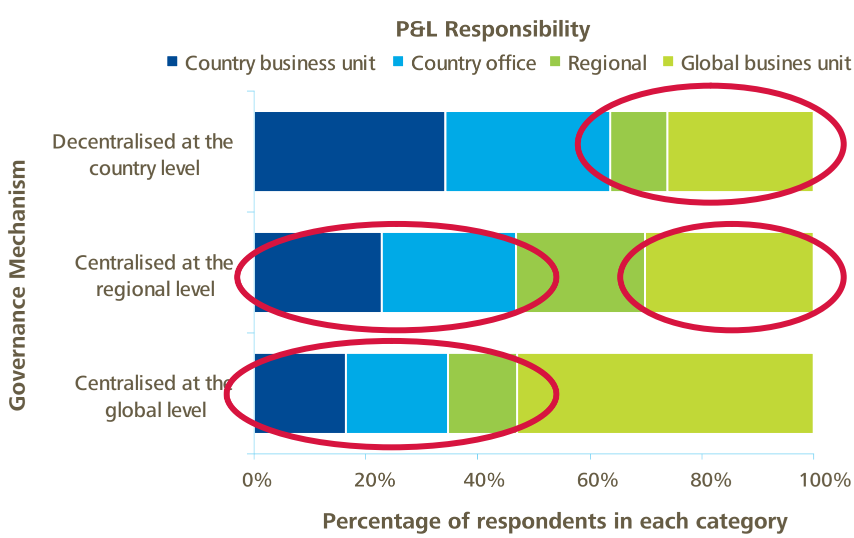
In many cases, market opportunities also drive the choice of operating models in emerging markets. Multinational companies that struggle to stay competitive and innovative sometimes find emerging market companies with a new line of products that has potential to add significant cash flow. In such cases, the choice of operating model depends on size of investment, risk appetite, competition and expected return on the investment. Companies should choose between joint ventures and acquisitions only after thorough due diligence, depending on how these factors play out.

Country regulations and experience in specific countries also drive decisions about operating models. The types of operating model vary significantly by country. For example, in new and comparatively smaller emerging markets like Brazil, Czech Republic and Mexico, more companies prefer wholly owned subsidiaries compared to China and India. Many countries have strict regulations on operating models for foreign direct investment to support protectionism and growth of domestic industries. However, as many countries are committed to becoming open market economies, these regulations are loosening. For instance, just a few years ago, China required all automotive companies to enter Chinese markets via joint venture. Over the years, as countries become economically stronger, they tend to ease such regulations on the operating model. However, to stay competitive over the long run, wholly owned subsidiaries might not be the best model for building an understanding of local markets.

Based on our study, companies with more experience in emerging markets tend to choose wholly owned subsidiaries to expand their presence. With the spotlight on emerging markets, thousands of studies have been commissioned by governments, private companies and academia that now provide deep know-how of these markets. Based on our survey, more than half the companies that have been in the emerging markets for more than ten years choose "wholly owned subsidiary."

In addition to choosing the right operating model, alignment to the global governance model is also a critical success factor. Global governance models and P&L responsibilities are misaligned in over a third of manufacturing companies in our study (see figure 5). For instance, almost 50 percent of the companies that have

Figure 5: Disconnected governance model



a governance model centrally managed by their global headquarters reported that they hold their local or regional businesses responsible for managing profit and loss. As a consequence, local or regional businesses do not have much flexibility to change policies that will favorable to their region. Organizations that have misaligned governance models lose out on operational efficiencies and the chance to take advantage of emerging markets on a global scale.

FROM OFF-SHORING TO THE RIGHT ONE

For manufacturers, maybe the term "emerging market" is misleading. Emergence, after all, suggests a singular, upward path, but many companies are quick to call their operations a two-way street. If companies are to evolve along with host countries that are already becoming highly developed in their own right, they must take a closer look at how to adapt their operating models and global value chains and how to offset the risks and challenges associated with these locations, mindful of the fact that the competition is doing the same thing.

Vikram Mahidhar *is Senior Research Manager and Director of Operations at Deloitte Research, Deloitte Services LP*

Craig Giffi *is Vice Chairman and U.S. Consumer & Industrial Products Leader - Deloitte LLP*

Ajit Kambil *is Global Research Director for the CFO Program, Deloitte Services LP*

Ryan Alvanos *is a writer and editor in Deloitte Research, Deloitte Services LP*

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