WINNING THE $30 trillion DECATHLON

Going for gold in emerging markets

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$30 trillion

DECATHLON

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Illustration by Daniel Hertzberg

Winning the $30 trillion decathlon:
Going for gold in emerging markets

By 2025, annual consumption in emerging markets will reach $30 trillion—the biggest growth opportunity in the history of capitalism. To compete for the prize, companies must master ten key disciplines.

Yuval Atsmon, Peter Child, Richard Dobbs, and Laxman Narasimhan

The Industrial Revolution is widely recognized as one of the most important events in economic history. Yet by many measures, the significance of that transformation pales in comparison with the defining megatrend of our age: the advent of a new consuming class in emerging countries long relegated to the periphery of the global economy.

The two shifts bear comparison. The original Industrial Revolution, hatched in the mid-1700s, took two centuries to gain full force. Britain, the revolution's birthplace, required 150 years to double its economic output per person; in the United States, locus of the revolution's second stage, doubling GDP per capita took more than 50 years. A century later, when China and India industrialized, the two nations doubled their GDP per capita in 12 and 16 years, respectively. Moreover, Britain and the United States began industrialization with populations of about ten million, whereas China and India began their economic takeoffs with populations of roughly one billion. Thus the two leading emerging economies are experiencing roughly ten times the economic acceleration of the Industrial Revolution, on 100 times the scale—resulting in an economic force that is over 1,000 times as big.

CEOs at most large multinational firms say they are well aware that emerging markets hold the key to long-term success. Yet those same executives tell us they are vexed by the complexity of seizing

this opportunity. Many acknowledge that despite greater size, larger capital bases, superior product technology, and more sophisticated marketing tools, they are struggling to hold their own against local upstarts. That anxiety is reflected in their companies' performance in emerging markets. In 2010, 100 of the world's largest companies headquartered in developed economies derived just 17 percent of their total revenue from emerging markets—though those markets accounted for 36 percent of global GDP (Exhibit 1) and are likely to contribute more than 70 percent of global GDP growth between now and 2025.

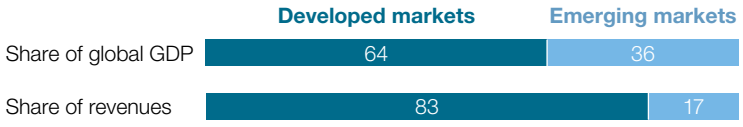
This essay and the compendium of articles that follow describe, for senior executives, the most important priorities in emerging markets. It builds on an extraordinary foundation of research and experience. For more than a decade—starting with the 2001 McKinsey Global Institute (MGI) study of India's economy—McKinsey has put emerging markets at the forefront of its research agenda. Special issues of the *McKinsey Quarterly* have focused on Africa, China, India, and Latin America. We have created more than 60 databases and conducted longitudinal studies on the behavior of consumers in Africa, Brazil, China, India, and Indonesia. McKinsey consultants also have been deeply engaged in helping clients address the business implications of the emerging markets' rapid rise.

We wish there were a secret formula or key capability that could easily transform a company's emerging-market efforts. In fact, our experience

Exhibit 1

Leading companies in the developed world earn just 17% of total revenues from emerging markets, even though these markets represent 36% of global GDP.

Markets' contribution to global GDP vs leading global companies' share of total revenues[1] from given markets, 2010, %



	North America	Western Europe	Asia-Pacific (developed)[2]	Asia (excluding Japan)	Latin America	Eastern Europe	Middle East, Africa
% of global GDP	26	25	13	16	8	7	6
% of revenues	39	28	15	8	4	4	2

[1] For 100 of the world's largest companies headquartered in developed economies; figures for GDP do not sum to 100%, because of rounding.
[2] Asia-Pacific (developed) includes Australia, Japan, New Zealand, and South Korea.

Source: Company financials; McKinsey analysis

Just as winning a decathlon requires an athlete to master ten events, we believe winning in emerging markets requires companies to master these ten capabilities.

suggests the challenge in emerging markets more closely resembles a decathlon, where success comes from all-around excellence across multiple sports. Sitting out an event isn't an option; competing effectively means mastering a variety of different capabilities in a balanced way. As with a decathlon, there's no single path to victory. In emerging markets, companies, like athletes, must learn to make trade-offs, taking into account their own capabilities and those of competitors. They must choose where it makes sense to differentiate themselves through world-class performance and where it is wiser to run with—or, ideally, a little ahead of—the pack. Both the rewards for success and the costs of failure will be large.

The $30 trillion opportunity

For centuries, less than 1 percent of the world's population enjoyed sufficient income to spend it on anything beyond basic daily needs. As recently as 1990, the number of people earning more than $10 a day,[1] the level at which households can contemplate discretionary purchases of products such as refrigerators or televisions, was around one billion, out of a total world population of roughly five billion. The vast majority of those consumers were based in developed countries in North America, Western Europe, or Japan.

But over the past two decades, the urbanization of emerging markets—supported by long-term trends such as the integration of peripheral nations into the global economy, the removal of trade barriers, and the spread of market-oriented economic policies—has powered growth in emerging economies and more than doubled the ranks of the consuming class, to 2.4 billion people. By 2025, MGI research suggests, that number will nearly double again, to 4.2 billion consumers out of a global population of 7.9 billion people.[2] For the first time in world history, the number of people in the consuming class will exceed the number still struggling to meet their most basic needs.

By 2025, MGI estimates, annual consumption in emerging markets will rise to $30 trillion, up from $12 trillion in 2010, and account for nearly 50 percent of the world's total, up from 32 percent in 2010 (Exhibit 2).[3] As a result, emerging-market consumers will become the dominant force in the global economy. In 15 years' time, almost 60 percent of the roughly one billion households with earnings greater than $20,000 a year[4] will live in the developing world. In many product categories, such as white goods and electronics, emerging-market consumers will account for the overwhelming majority of global demand. China already has overtaken the United States as the world's largest market for auto sales. Even under the most pessimistic scenarios for global growth, emerging markets are likely to outperform developed economies significantly for decades.

Leading the way is a generation of consumers, in their 20s and early 30s, who are confident their

[1] On a purchasing-power-parity basis.
[2] See *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012, available at mckinsey.com/mgi.
[3] Our estimate of $30 trillion reflects private consumption in emerging-market regions in 2025. We define these regions to include Africa, Central Asia, China (with Hong Kong and Taiwan), Eastern Europe, Latin America, the Middle East, and South and Southeast Asia. We estimate emerging-market consumption in 2025 by applying the private-consumption share of GDP per country to our national GDP estimates of 2025, calculated on the basis of consensus GDP growth projections from the Economist Intelligence Unit, Global Insight, Oxford Economics, and McKinsey's long-term growth model. Our approach implicitly assumes that private consumption as a share of GDP will remain constant through 2025. Past evidence from developed economies suggests the share of private consumption in many countries will increase with income, which would lead to a higher projected level of emerging-market consumption in 2025.
[4] On a purchasing-power-parity basis.

incomes will rise, have high aspirations, and are willing to spend to realize them. These new consumers have come of age in the digital era. Already, more than half of all global Internet users are in emerging markets. Brazilian social-network penetration, as early as 2010, was the second highest in the world. And a recent McKinsey survey of urban African consumers in 15 cities in ten different countries found that almost 60 percent owned Internet-capable phones or smartphones. As e-commerce and mobile-payment systems spread to even the most remote hamlets, emerging consumers are shaping, not just participating in, the digital revolution and leapfrogging developed-market norms, creating new champions like Baidu, mPesa, and Tencent.

The preferences of emerging-market consumers also will drive global innovation in product design, manufacturing, distribution channels, and supply chain management, to name just a few areas. Companies failing to pursue consumers in these new markets will squander crucial opportunities to build positions of strength that, history suggests, could be long lasting. In 17 major product categories in the United States, the market leader in 1925 remained the number-one or number-two player for the rest of the century.[5]

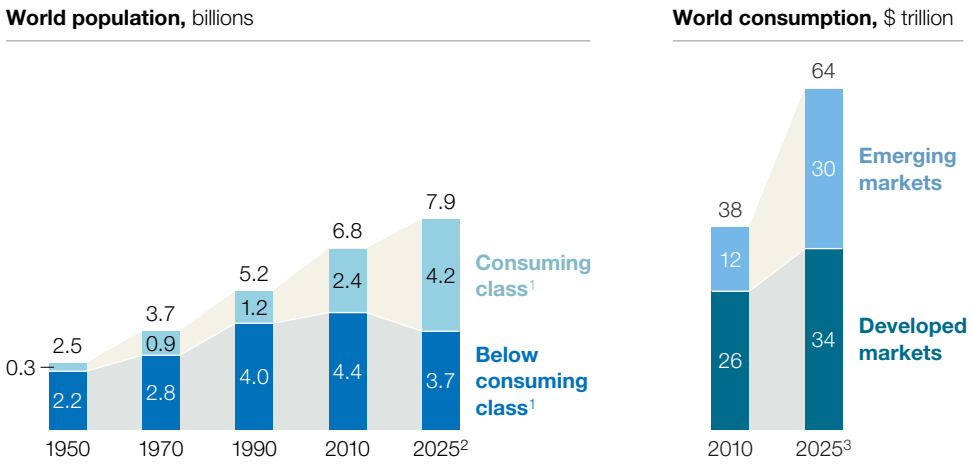
Ten crucial capabilities

For developed-market companies, winning consumers in these new high-growth markets requires a radical change in mind-set, capabilities,

[5]These companies include Kraft Foods (Nabisco), which led in biscuits; Del Monte Foods, in canned fruit; and Wrigley, in chewing gum.

Exhibit 2

By 2025, the consuming class will swell to 4.2 billion people. Consumption in emerging markets will account for $30 trillion—nearly half of the global total.



[1]Consuming class: daily disposable income is ≥$10; below consuming class, <$10; incomes adjusted for purchasing-power parity.
[2]Projected.
[3]Estimate based on 2010 private-consumption share of GDP per country and GDP estimates for 2010 and 2025; assumes private consumption's share of GDP will remain constant.

Source: Angus Maddison, founder of Groningen Growth and Development Centre, University of Groningen; Homi Kharas, senior fellow at Wolfensohn Center for Development at Brookings Institution; McKinsey Global Institute analysis

and allocation of resources. The value consciousness of emerging-market consumers, the diversity of their preferences, and their sheer numbers mean companies must rethink every aspect of operations, including product portfolios, research and development, marketing, supply chain management, and talent development. They must learn to place big bets on new markets and technologies, invest with speed and at scale, and manage risk and cultural diversity at a whole new level.

Changes of such magnitude must be implemented in a thoughtful, systematic way. With the help of colleagues who, in aggregate, have spent centuries applying their diverse expertise to the challenges of emerging-market competition, we've distilled a set of ten capabilities global corporations need in emerging markets. Just as winning a decathlon requires an athlete to master ten events, we believe winning in emerging markets requires companies to master these ten capabilities. Like the events in a decathlon, they can be grouped into three types of activities:

- *Throwing accurately.* Companies must aim their emerging-market activities at the right opportunities. That involves surgically targeting urban growth clusters, anticipating moments of explosive growth, and carefully balancing local relevance and global scale. The digitization of the emerging world is generating increasingly rich data sources that can guide such efforts.

- *Jumping in.* As multinationals leap into action in the emerging world, they face the potential for big gains or losses. The next four capabilities reflect these moments of truth: aggressively redeploying resources to seize nascent opportunities, creating product portfolios, crafting brands, and building a go-to-market system that delivers what emerging-market consumers

need, where they want it. Success in these markets demands cutting-edge technology and aggressive investment in processes tailored to local conditions.

- *Running the distance*. The final three capabilities underscore the fact that competing effectively in emerging markets is a long-term challenge. Global organizations must rethink structures and management processes to move nimbly in unfamiliar environments while retaining scale advantages. They must fashion new models to attract, retain, and develop scarce emerging-market talent and forge new relationships with stakeholders to build sustainable businesses.

Finally, as in a decathlon, companies must sharpen their skills in all these areas at the same time.

1 Surgically target urban growth clusters

The scale of the modern exodus from farms to cities has no precedent. In emerging-market economies today, the population of cities grows by 65 million people a year—the equivalent of seven cities the size of Chicago. Over the next 15 years, just 440 emerging-market cities will generate nearly half of global GDP growth and 40 percent of global consumption growth.

Most of those are midsize cities with unfamiliar names, like Ahmedabad, Huambo, Medan, or Viña del Mar. These "middleweights," as opposed to tier-one megacities, frequently offer the best opportunities. In Brazil, the big metro market is São Paulo state, with a GDP larger than Argentina's. But competition in São Paulo is brutal and retail margins razor thin. For new entrants to the Brazilian market, there might be better options in the northeast, Brazil's populous but historically poorest region, where boomtowns like Parauapebas are growing by as much as 20 percent a year.

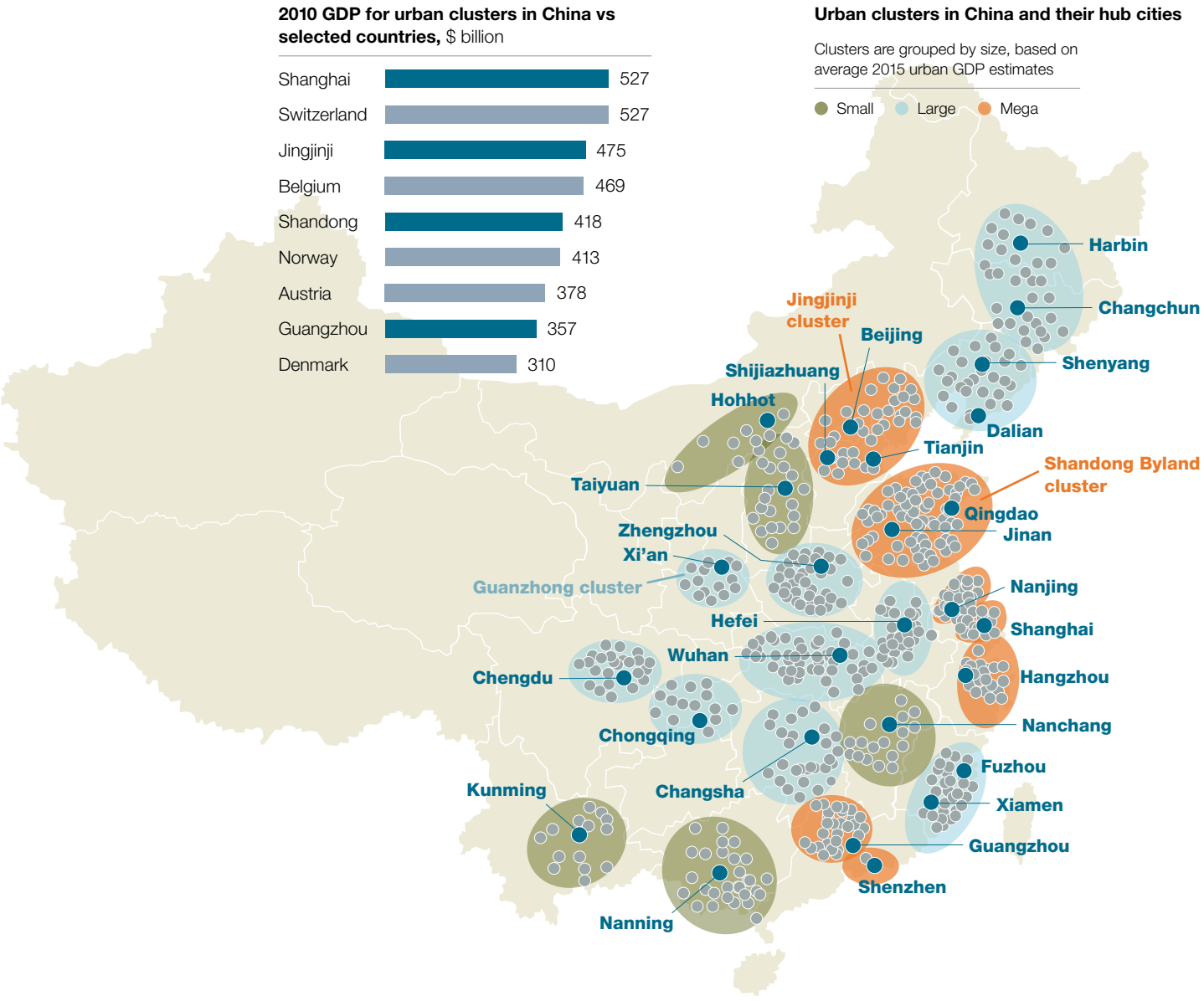
The notion that smaller cities can offer bigger opportunities isn't new. Fifty years ago, Wal-Mart opened its first store, in Rogers, Arkansas, and proceeded to build one of the world's largest businesses by avoiding highly competitive metropolitan markets. Yet four out of five executives queried in a recent McKinsey survey of major multinational firms said that, in emerging markets, their companies make decisions at the country rather than the city level. Three in five said their companies perceive cities as "an irrelevant unit of strategic planning."[6]

Given the diversity of consumer preferences, purchasing power, and market conditions in emerging societies, this failure to acknowledge the importance of cities in business planning is a fundamental strategic error. China has 56 different ethnic groups, who speak 292 distinct languages; India embraces about 20 official languages, hundreds of dialects, and four major religious traditions; Brazil's citizens are among the

[6] See *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012, available at mckinsey.com/mgi.

Exhibit 3

A clustering approach can help companies target consumers more effectively in Chinese cities, some of which are economically larger than entire European countries.



world's most ethnically and culturally diverse; the residents of Africa's 53 countries speak an estimated 2,000 different languages and dialects. Even geographically proximate tier-one cities can be radically different. Consider Guangzhou and Shenzhen, two southern Chinese metropolitan centers of comparable size, separated by a distance of just 100 kilometers. In the former, the majority of consumers are locally born Cantonese speakers. In the latter, more than 80 percent are migrants who communicate in Mandarin and, reflecting their disparate regional origins, have far more diverse tastes in consumer electronics, fashion, and food.

Many multinationals nonetheless pursue country-based approaches or hybrid ones that include tweaks for megacities. They assume that efforts to develop local strategies for middleweight cities can come only at the expense of economies of scale. To minimize that trade-off, global companies should group multiple smaller cities into clusters with common demographics, income distributions, cultural characteristics, media regions, and transportation links (Exhibit 3). By running operations through a common management hub and pursuing a strategy of gradual, cluster-by-cluster expansion, companies can gain scale efficiencies in all aspects of their operations, including marketing, logistics, supply chain management, and distribution. For all but a handful of high-end product and service categories, the emphasis should be on "going deep" before "going wide."

In our experience, cluster-based strategies are far more effective than attempts to achieve blanket coverage of an entire country or region or to chase growth in scattered individual cities. The results of switching to a cluster focus can be dramatic: in India, one leading consumer goods company recently cut costs in half by concentrating on eight large urban clusters rather than attempting to plot strategy for 200 different cities.

2 Anticipate moments of explosive growth

In emerging markets, timing matters as much as geography in choosing where to compete. Demand for a particular product or category of products typically follows an S-curve rather than a straight line: there is a "warm-up zone" as growth gathers steam and consumer incomes begin to rise, a "hot zone" where consumers have enough money to buy a product, and a "chill-out zone" in which demand eases (Exhibit 4).

In plotting consumption S-curves, per capita income is the critical variable. But the takeoff point

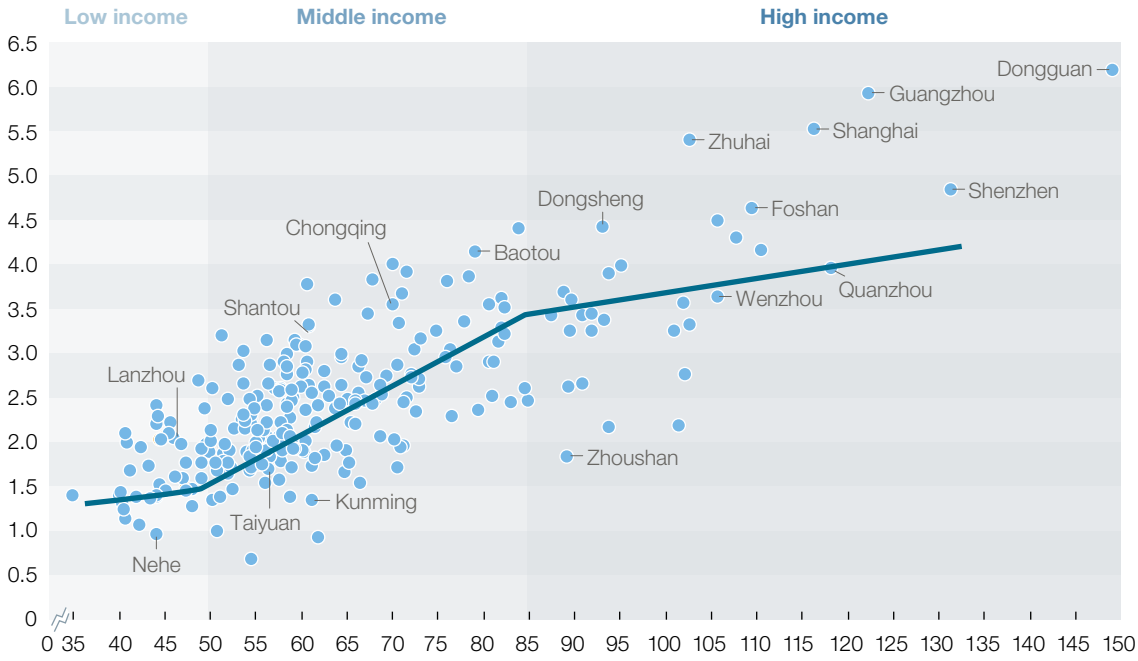
Cluster-based strategies are far more effective than attempts to achieve blanket coverage of an entire country or region or to chase growth in scattered individual cities.

and shape of consumption curves will vary by product or service. Purchases of products with low unit costs, such as snacks and bottled drinks, accelerate at a relatively early stage of the income curve, beauty products somewhat later, and luxury products, such as fashion and fine wines, later still. Services tend to take off at higher income levels. Refrigerators tend to have a steep adoption curve that flattens out once a market reaches saturation, while spending on clothing, a necessity, displays a more sustained growth pattern. The adoption patterns of products within the same general category can vary widely. While refrigerators and washing machines are often lumped together as white goods, consumption data show that in Beijing, purchases of the former start to take off at annual incomes of $2,500 a year and slow above $6,000, while the

Exhibit 4

In China, consumption of household products takes off at middle-income levels, following an S-curve.

Annual consumption of household products[1] by city in 2010,
thousand renminbi per household[2]



Annual household disposable income by city in 2010,
thousand renminbi per household[2]

[1] Includes white goods, furniture, and home accessories.
[2] In 2010 real renminbi; 6.77 renminbi = $1 in 2010.

Source: National Bureau of Statistics of China; McKinsey analysis

take-up for the latter doesn't begin until incomes approach $10,000 a year.

Predicting when and where consumers will move into the hot zone also requires a granular understanding of technological, demographic, cultural, geographic, and regulatory trends, as well as a thorough knowledge of local distribution networks. Because many of India's households are vegetarian, for example, meat consumption in that country is much lower than the global average. In Nigeria, where more than one-third of the population is 14 years of age or younger, sales of baby food are far above the global average at similar income levels.

3 Devise segmentation strategies for local relevance and global scale

Identifying high-growth hot spots and anticipating when consumers there will be ready to buy isn't enough. Multinationals also must determine how to refine their product or service offerings so that they will appeal to (or even shape) local tastes, be affordable, and give the company an opportunity to achieve reasonable scale in a timely way.

Deciding how and how much to cater to local preferences requires a deep understanding of consumer demographics, preferences, and behavior within target segments. In some segments—for instance, many kinds of breakfast cereal in China and India—companies may find that their core offerings aren't even relevant. In others, they will discover opportunities to realize economies of scale by leveraging products across markets.

Too often, multinationals attempt to make sense of the diversity of emerging-market consumers by ordering them in polar caricatures: at one extreme, the "nouveau riche," eager to flaunt their wealth and emulate the West; at the other, the "penny-pinching" poor at the "bottom of the pyramid," for whom the overriding purchase criterion is getting the lowest price. Marketers who succumb to this false dichotomy are drawn into debating flawed strategic alternatives. Should they pursue a niche strategy, targeting rich customers with essentially the same products they sell to developed-market consumers? Or should they go for the mass market by offering cheap products that would never sell back home?

With the number of mainstream consumers on the rise in emerging markets—more than half of all Chinese urban households, for example, will be solidly middle class by 2020, up from 6 percent in 2010—companies are learning to craft more nuanced product strategies that balance scale and local relevance.[7]

A careful segmentation strategy helped Frito-Lay capture more than 40 percent of the Indian branded-snacks market. The company tailored global products, such as Lays and Cheetos, to local tastes. Frito-Lay also created Kurkure, a cross between traditional Indian-style street food and Western-style potato chips that represented a new category in India and is now being sold in other countries. Critical to Kurkure's success: attractive pricing and combining local feel with scalable international packaging. In China, Audi introduced A6 models with a longer wheelbase for extra legroom, while adding backseat entertainment systems and extendable tray tables.

Leading companies also look for opportunities to scale ideas across emerging markets. Unilever, for example, has begun marketing its Pureit water filter, first launched in India in 2005, to con-

[7] We define mainstream consumers in China as members of relatively well-to-do households with annual disposable income of $16,000 to $34,000. For more on China's mainstream consumers, see Yuval Atsmon and Max Magni, "Meet the Chinese consumer of 2020," page 42.

Exhibit 5

Across the board, emerging-market companies grow faster than those from developed economies.

Revenue growth rates segmented by geographic market,[1] compound annual growth rate, %

By location of company headquarters	Overall growth	Growth in home market	Growth in developed markets (for developed, other than home)	Growth in emerging markets (for emerging, other than home)
Emerging-market companies	23.9	17.9	22.4	30.7
Developed-market companies	10.7	7.5	11.7	12.6
Difference = emerging-market companies' growth advantage	**13.2**	**10.4**	**10.7**	**18.1**

[1]Based on growth-decomposition analysis of 2,229 market segments for 720 companies, spanning a number of time frames from 1999 to 2008.

sumers in Asia, Eastern Europe, and South Africa. Telecommunications providers operating in emerging markets have learned to replicate successful marketing programs across multiple geographies.

4 Radically redeploy resources for the long term

To win in emerging markets, developed-market companies must be willing to embrace big changes fast; those unable to reallocate resources radically risk a drubbing by local competitors. Our research shows that emerging-market companies redeploy investment across business units at much higher rates than companies domiciled in developed markets. Emerging-market firms are growing faster than their developed-market counterparts, even when both operate in neutral third markets where neither is based. The emerging players' growth advantage persists even after controlling for the smaller base from which they start, and it also exists in developed markets (Exhibit 5).

In part, the agility of emerging-market companies reflects the fact that majority shareholders tend to have more power in them than in their developed-market counterparts. But it also reflects different management mind-sets. Emerging-market companies are built for speed. They are designed to serve the rapidly changing needs of middle-class consumers in their home markets and other emerging societies. They know that they must innovate or die. It helps too that these upstarts aren't burdened by legacy issues; they can focus on what works in emerging markets without having to straddle both the rich and developing worlds. By contrast, CEOs at many developed-

market companies, who live in fear that even a fleeting dip in domestic earnings, market shares, or stock prices could put their jobs at risk, must protect their flank at home as they are pursuing emerging markets that carry significant near-term risks.

Yet there's no escaping the importance in emerging markets of making big bets and riding them for the long term. The investment profile of global consumer products giants that have established a successful presence in emerging markets indicates an interval of approximately four or five years until investments pay off. M&A can accelerate progress. Consider Danone's purchase in Russia of Unimilk, which allowed the French food giant to offer more competitive products at a wider variety of prices. Similarly, Diageo's acquisition of a majority stake in China's Shuijingfang boosted the British beverage company's distribution reach and ability to supply Chinese consumers with the white liquor that is so popular there.

5
Innovate to deliver value across the price spectrum

Emerging markets offer greenfield opportunities to design and build products and services with innovative twists on best-in-class equivalents in established markets. South Korea's LG Electronics, for instance, struggled in India until the 1990s, when a change in foreign-investment rules enabled the company to invest in local design and manufacturing facilities. Local developers, recognizing that many Indians used their TVs to listen to music, urged LG to introduce new models with better speakers. To keep prices competitive, the company swapped expensive flat-panel displays for less costly conventional cathode tubes.

Today, LG markets many other original products in India, including appliances with programming menus in local languages, refrigerators with brighter colors and smaller freezers, large washing machines for India's big families, and microwaves with one-touch "Indian menu" functions. LG's product innovation center in Bangalore is its largest outside South Korea, and the company is India's market leader in air conditioners, refrigerators, TVs, and washing machines. Other global firms are following LG's lead, in India and elsewhere; over the past 12 years, the number of multinational firms with major research centers in China has risen to nearly 1,000, from less than 20.

Local players too are proving nimble innovators. For rural customers, China's Haier makes extra-durable washing machines that can wash vegetables as well as clothes, and refrigerators with protective metal plates and bite-proof wiring to ward off mice. The company is no less ingenious in developing products for urban users, such as smaller washing machines and refrigerators designed for tiny, cramped apartments. Dabur, an Indian consumer health company, is combining Western science with Indian Ayurvedic medicine to offer innovative consumer health products in India and Africa. Meanwhile Tanishq, part of the Tata Group, has built a fast-growing jewelry business with heavily localized design and payment options that cater to the needs of different Indian communities and regions.

Whether a company sells basic products or services to challenge low-cost local players or seeks to entice consumers to adopt new products and services comparable to global offerings, competing effectively often requires innovating and localizing, while redesigning product lines, service operations, and supply chains.

6
Build brands that resonate and inspire trust

The outlook of consumers in emerging markets differs from those in developed ones in many ways. On average, emerging consumers are younger—with 63 percent aged 35 or under in 2010, versus 43 percent in developed countries—and more optimistic than their more affluent counterparts. And unlike developed-market consumers, whose purchases are informed by a lifetime of exposure to products and brands, emerging consumers are novice shoppers for whom buying a car, a television, or even a box of diapers may be a first-time experience. Emerging consumers wrestle with these new choices in a cluttered marketing environment and highly fragmented retail landscape offering little consistency in how products are presented or promoted. As emerging consumers move from rural villages to cities, they embrace new ideas and ways of living, placing in flux not just their buying preferences but also their very identities. They are highly receptive to effective branding efforts, but also far more likely than developed-market consumers to dump one brand for the next new thing.

These characteristics have significant implications for brand and marketing strategies. In emerging markets, it is critical for products to be included in the initial consideration sets of consumers—the short list of brands they might purchase. Our research indicates that Chinese consumers, for example, consider an average of three brands and end up purchasing one of them about 60 percent of the time. In the United States and Europe, by contrast, consumers consider at least four brands and end up selecting one from their initial consideration sets only 30 to 40 percent of the time.

The intensity of emerging consumers' focus on the initial consideration set favors brands with high visibility and an aura of trust. Multinationals can build visibility with a cluster-by-cluster strategy that achieves top-of-mind recognition in a handful of selected cities before moving to the next batch. Locally focused campaigns have the added advantage of accelerating network effects and making it easier for firms to generate positive word of mouth—a critical prerequisite for emerging-market success. McKinsey surveys find that positive product recommendations from friends or family are twice as important for consumers in China and nearly three times as important for consumers in Egypt as for those in the United States or Britain.

Building trust also requires careful scrutiny of brand messages and delivery. Acer, the Taiwanese computer maker, tested messages emphasizing simplicity with Chinese customers. This theme had resonated with consumers in Taiwan and other affluent markets, but the company discovered that it risked causing mainland buyers to question the quality of Acer products. A new campaign emphasizing reliability proved highly effective.

Mobile and digital channels, including e-commerce, offer additional opportunities to build trust and brand awareness and to engage with customers. In China, more than half the urban population is online, and surveys indicate Chinese consumers are more likely to trust online recommendations than television advertisements. By 2010, a quarter of Brazilians using the Internet had opened Twitter accounts, making Brazilians the world's most enthusiastic tweeters. In India, consumers are leapfrogging traditional media and the PC to embrace mobile devices, while low literacy rates spur the development of voice-

Our research underscores the importance in emerging markets of managing how consumers encounter products at the point of sale.

activated Web sites and services. Of course, digital-marketing efforts must be part of integrated campaigns across a range of channels, including, for reasons we examine below, in-store promotions and educational campaigns.

7
Control the route to market

Our research underscores the importance in emerging markets of managing how consumers encounter products at the point of sale. In China, 45 percent of consumers make purchasing decisions inside shops, compared with just 24 percent in the United States. Almost a quarter of the Chinese consumers we surveyed said in-store promoters or salespeople greatly influence their decisions. In one study, we found that Chinese who purchased high-end consumer electronics items visited stores up to ten times before deciding what to buy.

Managing the consumer's in-store experience is an enormous challenge, especially in middleweight cities where the biggest growth opportunities lie. Part of the problem is the fragmented nature of the retail landscape in emerging markets; e-commerce penetration currently lags behind Western levels, supermarkets remain a relative novelty, and consumers still make most purchases from ubiquitous mom-and-pop shops. In China, the 50 largest retailers have only a tenth of the market share of the 50 largest US retailers.

Reaching these small outlets often means negotiating bad roads and a byzantine, multitiered network of distributors and wholesalers. In these locations, local champions have clear advantages, including long-standing alliances with distributors and armies of low-paid salesmen. Multinationals—many of which now struggle just to get products into emerging-market stores—should be prepared to build a much larger in-house sales operation in these countries. They should also devote far more time and energy than they do in their home markets to categorizing and segmenting sales outlets and to devising precise routines and checklists for monitoring the quality of the in-store experience.

In India, Unilever distributes directly to more than 1.5 million stores by deploying thousands of people for sales and in-store merchandising, many equipped with handheld devices to book replenishment orders anywhere, anytime. For priority outlets, it is often essential to deploy a heavy-control model, using supervisors, "mystery shoppers," and sophisticated IT support to maximize margins while ensuring enough visibility to assess the performance of stores.

Coca-Cola, long active throughout the developing world, goes to great lengths in those markets to analyze the range of retail outlets, identify the highest-priority stores, and understand differences in service requirements by outlet type. For each category of outlet, Coca-Cola generates

a "picture of success"—a detailed description of what the outlet should look like and how Coke products should be placed, displayed, promoted, and priced. The company employs a direct-sales delivery model to serve high-priority outlets, while relying on distributors and wholesalers when direct delivery isn't cost effective. It scrutinizes everything from service levels and delivery frequencies to the positioning of coolers.

In China, Coca-Cola sells directly to over 40 percent of its two million retail outlets and monitors execution in an additional 20 to 30 percent through regular visits by Coca-Cola salesmen and merchandisers. In Africa, where infrastructure is less developed, Coca-Cola has built a network of 3,200 "microdistributors" by recruiting thousands of small entrepreneurs who use pushcarts and bicycles to deliver Coke products to hard-to-reach outlets. There's no substitute in emerging markets for this sort of hands-on approach to managing distributors and key accounts.

8
Organize today for the markets of tomorrow

In a series of surveys and structured interviews with more than 300 executives at 17 of the world's leading multinationals, chosen from a range of sectors and geographies, we learned that local companies struggle with a host of problems. Strategy planning, risk management, talent development, and operating efficiency frequently disappoint global leaders. In related research, we also found that high-performing companies often suffered from a "globalization penalty": they consistently scored lower than more locally focused ones on key dimensions of organizational health.[8]

In theory, global players should enjoy substantial advantages over local rivals in emerging markets, including shared infrastructure and the protection that a more geographically diverse business portfolio offers against country and currency risks. In practice, however, we found that as global companies grow bigger and more diverse, the costs of coping with complexity rise sharply. Less than 40 percent of the executives at the firms we surveyed said they were better than local competitors at understanding the operating environment and customers' needs. Furthermore, the need to adhere to globally standard policies and risk-management practices sometimes hinders managers of global companies in emerging markets from moving quickly to lock in early opportunities.

[8] See Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, "Understanding your 'globalization penalty,'" page 114.

Large multinationals can reduce their globalization penalty by rethinking organizational structures and processes. IBM, for instance, radically revamped its functions in Asia, moving human resources to Manila, accounts receivable to Shanghai, accounting to Kuala Lumpur, procurement to Shenzhen, and customer service to Brisbane. Other global firms have moved core activities closer to priority markets. ABB shifted the global base of its robotics business from Detroit to Shanghai. Dell created regionwide functional centers in Singapore.

Underpinning these moves are some important principles. For example, we've found that multinationals can boost their effectiveness by focusing on a few key management processes for which global consistency is advantageous, while allowing variability and local tailoring in others. It may be useful to group high-growth countries together (even when not geographically proximate) to help top management assess their needs. Clarifying the role of the corporate center is critical; too often headquarters assumes functions that add complexity but little value. New communication technologies can help, but management must ensure that they do not ensnare employees in an ever-expanding web of teleconferences in disorienting time slots, with hazy agendas and ill-defined decision rights. The farther flung the organization, the greater the virtue of simplicity.

9
Turbocharge the drive for emerging-market talent

Unskilled workers may be plentiful in emerging societies, but skilled managers are scarce and hard to retain. In China, barely two million local managers have the managerial and English-language capabilities multinationals need. A recent McKinsey survey found that senior managers working for the China divisions of multinational firms switch companies at a rate of 30 to 40 percent a year—five times the global average. Increasingly, local stars prefer working for local employers that can offer them more senior roles. In 2006, the top-ten ideal employers in China included only two locals—China Mobile and Bank of China—among the well-known global names. By 2010, seven of the top ten were Chinese firms.

Barely half of the executives at the 17 global companies we studied thought their organizations effectively tailored recruiting, training, and development processes across geographies. In a recent survey of leading global companies, we found that just 2 percent of their top 200 employees hailed from key Asian emerging markets. Some global companies have tried to address their emerging-market talent problem by throwing money at it; one leading bank reports paying senior staff in Brazil, China, and India almost double what it does in the United Kingdom.

But beefing up salaries is, at best, a partial solution. In emerging markets, global firms must develop clear talent value propositions—an employer brand, if you will—to differentiate themselves from local competitors. In South Korea, L'Oréal established itself as the top choice for female sales and marketing talent by creating greater opportunities for brand managers, improving working hours, expanding the child care infrastructure, and adopting a more open communications style. Other Western firms, such as Motorola and Nestlé, have burnished their employer brands by building relationships with employees' families.

Deepening ties between key corporate functions and emerging markets can create opportunities for

local talent while enhancing organizational effectiveness. Western firms, including Cisco, HSBC, and Schneider Electric, have benefited from strengthening links between headquarters and high-growth regions and offering emerging-market managers global career paths and mobility programs. Similarly, in 2010, about 200 managers from Unilever's Indian subsidiary were assigned global roles with the parent company; indeed, two former senior executives in the company's Indian operations now are members of the global parent company's core leadership team. At Yum Brands, the India head reports directly to the global CEO.

Given the leadership requirements of emerging markets, global companies need bold talent-development targets. We think many players should aspire to multiply the number of leaders in emerging markets tenfold—and to do that in one-tenth of the time they would take back home. The strategies of emerging-market players merit careful study. In India, Reliance Group, the largest private employer, addressed a leadership gap—a need for as many as 200 new functional leaders to support growth initiatives—by recruiting a new wave of 28- to 34-year-old managers and enlisting help from local business schools and management experts to design new development programs.

10 Lock in the support of key stakeholders

No matter where successful businesses operate, they need the support of key stakeholders in government, civil society, and the local media (increasingly shaped by online commentators). Managing these relationships effectively can have a huge impact on a company's market access, ability to engage in merger or acquisition activity, and broader reputation. We believe global companies must devote far more time and effort to building such support in emerging markets than they would in developed ones. Such efforts should include cultivating relationships with local business allies—customers, joint-venture partners, investors, and suppliers.

Such recommendations may sound like common sense, yet it is surprising how few multinationals take them seriously. Companies must set and monitor rigorous performance targets to measure their commitment to relationship building in

In theory, global players should enjoy substantial advantages over local rivals in emerging markets. In practice, however, we found that as global companies grow bigger and more diverse, the costs of coping with complexity rise sharply.

emerging markets. Senior executives should make a systematic effort to identify key regulators, community leaders, and business partners and to understand their needs. They should attend meetings and events in which key stakeholders participate, and seek inclusion in government advisory bodies. They must also ensure that public-affairs and external-relations teams in emerging markets are as well staffed as operations back home.

Amway's success in China illustrates the benefits of effective stakeholder management. In the early 2000s, the US-based direct-sales giant was almost declared an illegal business in China for violating a 1998 ban on direct selling. Amway's senior executives made numerous visits to Beijing to get to know senior leaders and explain the company's business model. The company also demonstrated its commitment to China by opening stores countrywide, while investing more than $200 million in China-based manufacturing and R&D centers. In 2006, the Chinese government reshaped the regulation of direct sales. Today Amway is China's second-largest consumer product business.

Finally, don't neglect financial stakeholders. Domestic shareholders must be persuaded that the pursuit of long-term growth in emerging markets is worth short-term reductions in returns on capital and won't necessarily weaken performance in core markets. Furthermore, as emerging markets contribute a greater proportion of the global savings pool, investors there could offer a crucial new source of funding.

• • •

Over the last 100 years, the title of "world's greatest athlete" has been given to the winner of the Olympic decathlon. This has been true since the Stockholm Olympics, in 1912, when King Gustav V of Sweden used those words to describe Jim Thorpe, winner of the newly reintroduced decathlon competition. The rise of the emerging world's new consumer class is the greatest competition of our age for businesses—one no truly global company can ignore. For all the complexity of emerging markets, they offer multinationals and their shareholders the best hope for future prosperity. Consumers in those markets hold the key to a $30 trillion prize that lies just over the horizon. During the next 100 years, the title of "world's greatest companies" will surely be given to those that win in emerging markets. Business leaders and their boards need to ask themselves whether they are making the changes required to win or risk being overtaken by competitors with bolder ambitions.

The authors would like to thank Sambit Sathapathy and Jeongmin Seong for their contributions to this article.

Yuval Atsmon (Yuval_Atsmon@McKinsey.com), who was based in McKinsey's Shanghai office from 2006 to 2012, is a principal in the London office, where **Peter Child** (Peter_Child@McKinsey.com) is a director; **Richard Dobbs** (Richard_Dobbs@McKinsey.com) is a director of the McKinsey Global Institute and a director in the Seoul office; **Laxman Narasimhan** (Laxman_Narasimhan@McKinsey.com) is a director in the Delhi office.

THROWING ACCURATELY

Global companies striving for the $30 trillion prize should start by determining where their most promising emerging-market opportunities lie. Many will need to change their current strategies, which rely on a national view to choose targets for global growth, sometimes with an overlay that emphasizes “megacities.” Instead, as detailed in “Unlocking the potential of emerging-market cities,” the greatest potential lies in about 400 emerging-market “middleweight cities” whose rapid expansion is driven by the new consuming class.

Understanding these cities’ distinct cultures and buying patterns can appear daunting. But as the authors explain in “Is your emerging-market strategy local enough?”, targeting city clusters can help a company find an attractive balance between localization and economies of scale. Indeed, to Zeinal Bava, CEO of Portugal Telecom (PT), “There’s no such thing as an effective countrywide strategy.” That’s particularly true for a market as large and diverse as Brazil, a country PT knows well through its investments in leading local players, and where it has looked beyond averages to find the right openings.

Within emerging-market cities, consumer behaviors are evolving rapidly. “Meet the Chinese consumer of 2020” analyzes the largest of the emerging markets, where by the end of the decade the number of midmarket “mainstream consumer” households is

In this section

Illustration by Daniel Hertzberg

expected to explode, rising from fewer than 14 million now to around 167 million—or some 400 million people—by the end of the decade. At the same time, China will also have about 126 million more consumers aged 65 and over, many of them more willing to spend than today's elderly.

Behavioral shifts are being accompanied by profound technology changes. The effects will likely be even greater in emerging markets, which have a golden opportunity to leapfrog mature economies in embracing the digital world. As noted in "Riding Asia's digital tiger," Internet usage is still skyrocketing across Asia, not just in India and China but even in countries where penetration rates are already comparatively high, such as Malaysia. India may have a particular opportunity, suggests a related article, "Can India lead the mobile-Internet revolution?", provided it has sufficient commitment and cooperation from the private and public sectors. Finally, the rise of social media will have far-reaching implications for how companies engage consumers, even in places where the top developed-market platforms are virtually unknown. "Understanding social media in China" describes how companies navigating a world with no Facebook, Twitter, or YouTube can develop authentic, user-oriented content; adopt a test-and-learn approach; and support broader brand goals via sustained social-media efforts.

Unlocking the potential of emerging-market cities

Most companies still take a national or regional view when allocating resources for global growth. They should shift their focus to fast-growing cities.

Richard Dobbs, Jaana Remes, and Fabian Schaer

A massive wave of urbanization is propelling growth across the emerging world. This urbanization wave is shifting the world's economic balance toward the east and south at unprecedented speed and scale. It will create an over-four-billion-strong global "consumer class" by 2025, up from around one billion in 1990. And nearly two billion will be in emerging-market cities. These cities will inject nearly $25 trillion into the global economy through a combination of consumption and investment in physical capital. This is a very significant shot in the arm for a global economy that continues to suffer from pockets of acute fragility.

Yet few business leaders focus on the importance of cities when establishing growth priorities. In a recent survey, we found that fewer than one in five executives makes location decisions at the city (rather than country) level. Few executives expected this approach to change over the next five years, and more than 60 percent regarded cities as "an irrelevant unit of strategic planning."[1] As these new urban-growth zones flourish, there's a cost to companies that lack a clear view of the emerging landscape—chiefly in the potential for resource misallocation.

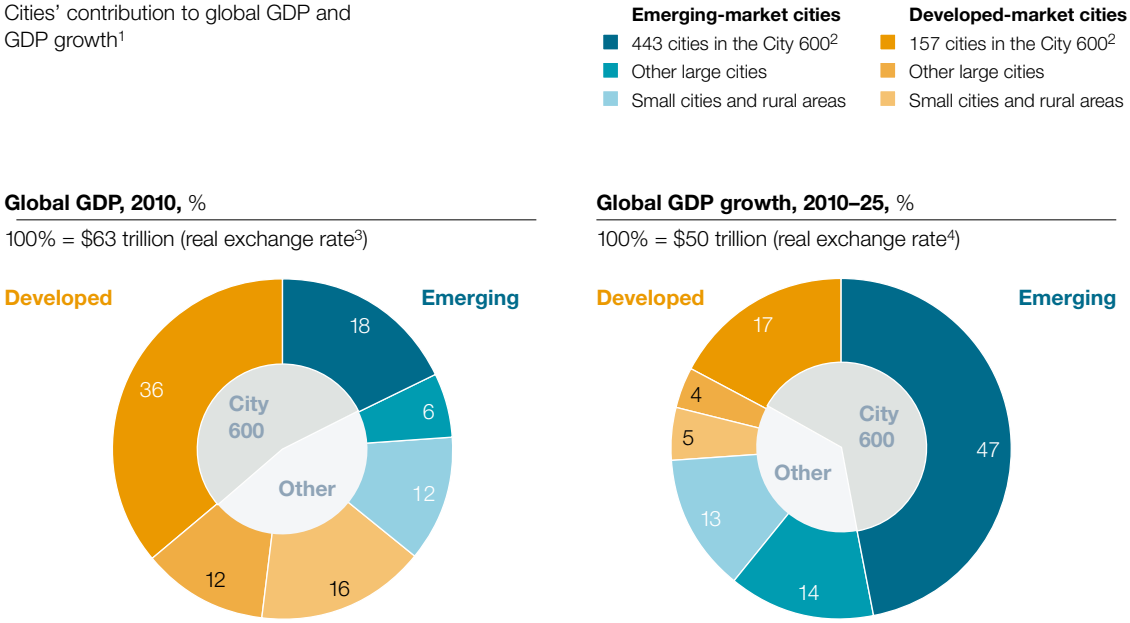
Shifting investment away from established markets to more promising areas can be difficult,

[1] "McKinsey Global Survey results: Relocating for growth" was conducted in February 2012. The survey received responses from 2,962 executives, representing the full range of regions, industries, and company sizes. To adjust for differences in response rates, we weighted the data by the contribution of each respondent's nation to global GDP.

Exhibit 1

Approximately 440 emerging-market cities are poised to deliver close to half of global GDP growth.

Cities' contribution to global GDP and GDP growth[1]



[1]>2,600 cities, including large cities as well as smaller cities and rural areas.
[2]The top 600 cities by their contribution to global GDP growth 2010–25.
[3]Reflects market exchange rate.
[4]Prediction based on differences in per capita GDP growth rates of countries relative to the growth of US per capita GDP.

Source: McKinsey Global Institute Cityscope 2.0

as our colleagues have shown in separate research.[2] Budgets are often "sticky" because companies lock into current rather than future opportunities. And many middle-tier emerging-market cities, however attractive, may be unfamiliar. Take Foshan, Porto Allegre, and Surat—cities that are unlikely to be high on the priority lists of global executives, though each has more than four million inhabitants, fast growth, and a vibrant base of consumers. Indeed, each of these cities will contribute more to global growth than Madrid, Milan, or Zurich.

And they are far from isolated examples. Our research indicates that 440 emerging-market cities, very few of them "megacities," will account for close to half of expected global GDP growth between 2010 and 2025 (Exhibit 1). Crafting and implementing strategies that emphasize such cities will require new attention from senior leaders, new organizational structures that take account of urban rather than just regional or national markets, and potentially difficult choices about which activities to scale back elsewhere to free up resources for new thrusts.

[2]See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinseyquarterly.com, March 2012.

Exhibit 2

A city-specific lens can reveal urban areas with the highest growth potential in a given market.

Top 20 cities by growth in given market, 2010–25

Emerging region
Developed region

Rank	Elderly higher-income[1] consumers (aged 65 and over)	Young entry-level[2] consumers (aged 14 or under)	Consumer spending on laundry care products[3]	Demand for commercial floor space[4]	Municipal water demand
1	Shanghai	Lagos	São Paulo	New York	Mumbai
2	Beijing	Dar es Salaam	Beijing	Beijing	Delhi
3	Tokyo	Dhaka	Rio de Janeiro	Shanghai	Shanghai
4	Tianjin	Ouagadougou	Shanghai	Los Angeles	Guangzhou
5	Mumbai	Khartoum	Mexico City	Tokyo	Beijing
6	São Paulo	Ghaziabad	Moscow	Washington, DC	Buenos Aires
7	Osaka	Sanaa	Bangkok	Dallas	Kolkata
8	Chongqing	Nairobi	Istanbul	São Paulo	Khartoum
9	Delhi	Luanda	Manila	Guangzhou	Dhaka
10	Nanjing	Baghdad	Johannesburg	Chicago	Istanbul
11	Guangzhou	Kampala	Belo Horizonte	Houston	Dallas
11	New York	Ibadan	Porto Alegre	Tianjin	Pune
13	Seoul	Lusaka	Buenos Aires	Moscow	Las Vegas
14	Hong Kong	Kinshasa	Tianjin	Atlanta	Karachi
15	Wuhan	Kano	Tehran	Miami	São Paulo
16	Kolkata	Abidjan	New York	Hong Kong	Hyderabad
17	Shenyang	Abuja	Foshan	Mexico City	Lagos
18	Los Angeles	Bamako	Santiago	Shenzhen	Moscow
19	Toronto	Chittagong	Shenzhen	Phoenix	Wuhan
20	Ahmedabad	Port Harcourt	London	Istanbul	Manila

[1]With household income >$20,000 at purchasing-power parity.
[2]With household income of $7,500–$20,000 at purchasing-power parity.
[3]Based on city-level market-demand-growth model.
[4]Includes replacement floor space.

Source: McKinsey Global Institute analysis

Companies that adopt such a strategic approach may gain early-mover benefits. For some, developing better insights into demographic and income trends—such as an understanding of the urban areas where the population of older, wealthier consumers is growing most rapidly—will be sufficient. Others may need to dig deeper, learning the market dynamics of specific products in target cities. To illustrate the different panoramas of opportunity that appear when companies use a city-specific lens, we looked at five business areas, each with different demand profiles. We then ranked 20 cities with the highest growth potential for each of the areas (Exhibit 2). Among the takeaways:

- Companies marketing health care products to seniors would find Shanghai and Beijing topping the list of cities with growing populations of older consumers whose incomes are sufficiently high (above $20,000 on a purchasing-power-parity basis) to afford these products. Tokyo and Osaka are the only developed-world cities among the top ten—a sign that well-off, aging consumers no longer are found exclusively in developed markets.

- Baby food is at the other end of the age spectrum. Combining income and demographic data—in particular, the numbers of households with young children—we found that cities in Africa offer great potential. More than half of the top ten cities enjoying rapid growth in the number of children[3] who live in households with incomes from $7,500 to $20,000 (on a purchasing-power-parity basis) are in Africa.

- São Paulo, Beijing, Rio de Janeiro, and Shanghai rank highest in a targeted analysis of market growth for laundry products. In fact, over the next decade, São Paulo will experience more growth in the sale of detergents and related cleaning

[3] Individuals aged 14 and under qualify as children for the purposes of this analysis.

products than the national markets of France or Malaysia will. That's just a small shard in the global-consumption mosaic for emerging cities. We project that urban consumers in developing countries will spend an additional $14 trillion annually by 2025.

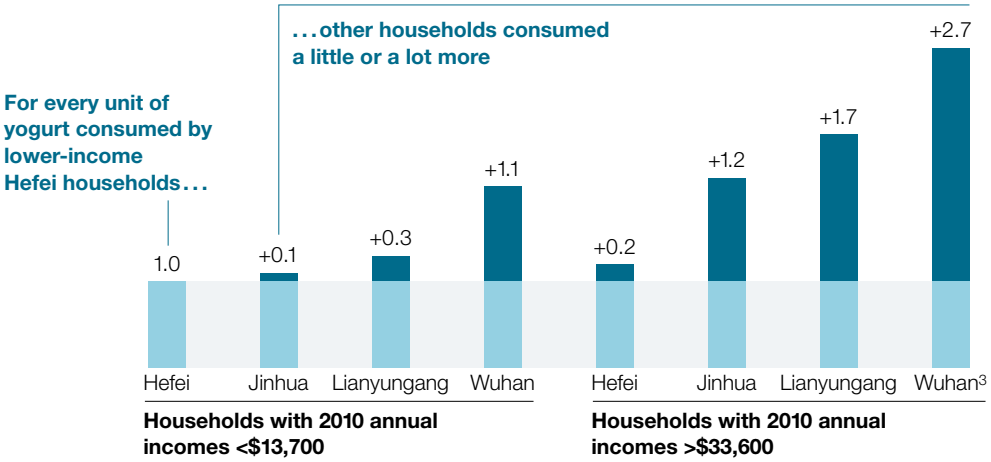
- By 2025, cities worldwide will need to spend at least $10 trillion more per year on physical capital—everything from office towers to new port facilities—than they do today. In building construction, the new floor space required will be equivalent to 85 percent of today's entire residential and commercial building stock; 40 percent of that growth will be in Chinese cities.
- Urban water-related infrastructure, another pressing need, will require $480 billion in global investment by 2025, with 80 percent of that flowing to emerging-market cities. Mumbai and Delhi will be the leaders in that spending.

In addition to supporting geographic priority setting, a city-level view can help companies sharpen their marketing strategies. Product adoption rates often are tied to local preferences that can vary across different cities within the same country—preferences that marketers may miss when they follow the time-honored approach of plotting adoption curves that trace purchases by levels of household income

Exhibit 3

Awareness of cities' different spending patterns across products can sharpen a company's marketing focus.

Example: average yogurt consumption per household in 2010, by cities in China[1]; index: consumption in Hefei households with incomes <$13,700 = 1.0[2]



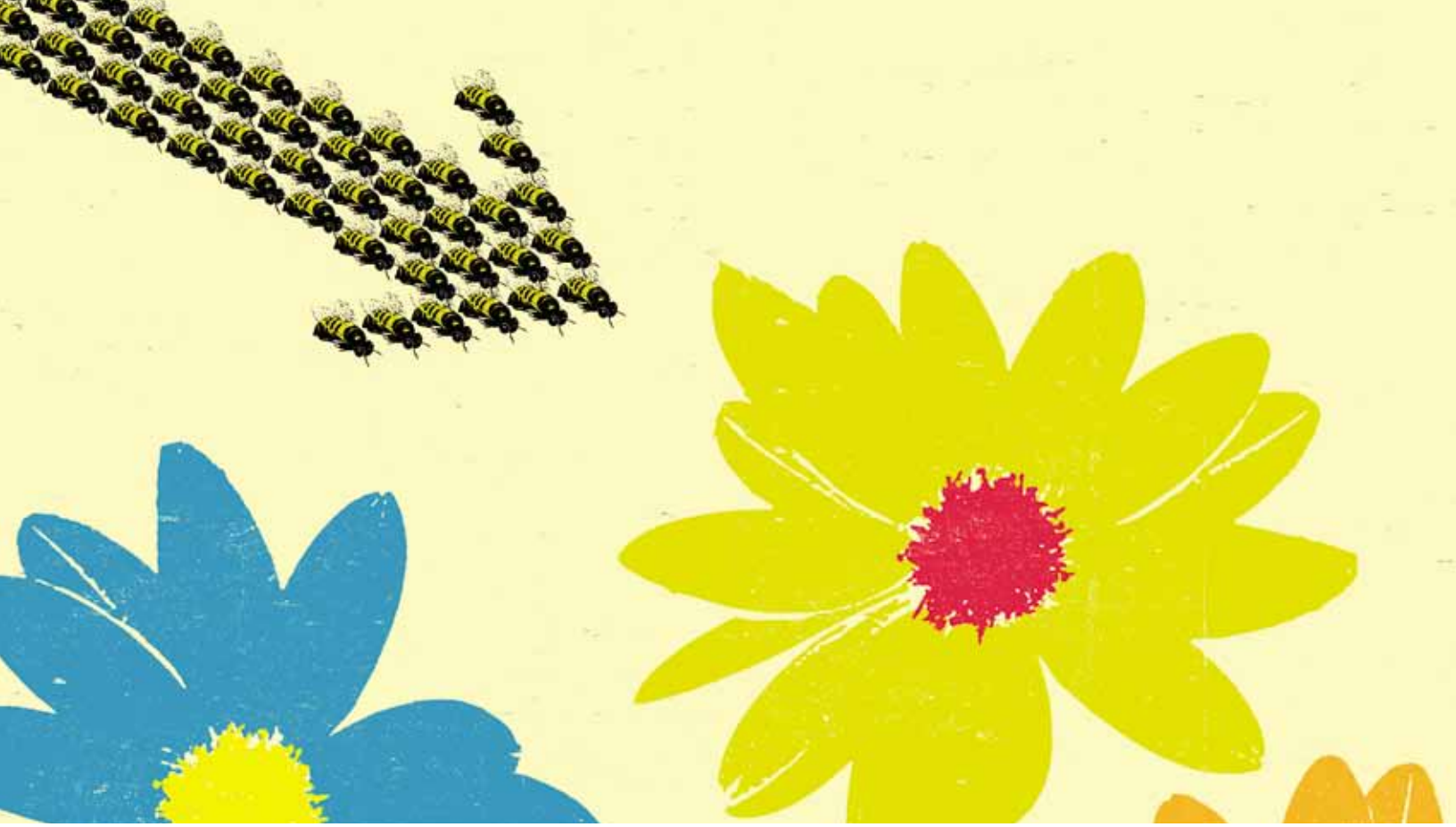
[1]With 2010 populations between 1.1 million (Lianyungang) and 9.7 million (Wuhan).
[2]Income levels adjusted for purchasing-power parity (PPP); $1 at PPP = 3.9 renminbi.
[3]For households earning >$51,900, since data for households earning $33,600–$51,900 not available.

Source: 2010 McKinsey survey of 15,000 Chinese consumers; McKinsey Global Institute analysis

and by product types within categories. Yogurt consumption shows the types of variations that a national view might not pick up: we found, even after adjusting for income levels, that typical households in Wuhan spent significantly more on yogurt than their counterparts in three comparable Chinese cities did (Exhibit 3). Awareness of different spending patterns by city across products should give companies a better basis for allocating marketing and distribution resources.

As the locus of global economic activity shifts to developing nations, companies should be aware of the growth dynamic that's playing out in cities. Leaders who give their strategies an urban dimension could find themselves positioned to allocate investments more effectively and to seize more readily the many opportunities at hand.

Richard Dobbs (Richard_Dobbs@McKinsey.com) is a director of the McKinsey Global Institute (MGI) and a director in McKinsey's Seoul office; **Jaana Remes** (Jaana_Remes@McKinsey.com), based in the San Francisco office, is a senior fellow at MGI; **Fabian Schaer** (Fabian_Schaer@McKinsey.com) is a consultant in the Zurich office.



Artwork by Dan Page

Is your emerging-market strategy local enough?

The diversity and dynamism of China, India, and Brazil defy any one-size-fits-all approach. But by targeting city clusters within them, companies can seize growth opportunities.

Yuval Atsmon, Ari Kertesz, and Ireena Vittal

Creating a powerful emerging-market strategy has moved to the top of the growth agendas of many multinational companies, and for good reason: in 15 years' time, 57 percent of the nearly one billion households with earnings greater than $20,000[1] a year will live in the developing world. Seven emerging economies—China, India, Brazil, Mexico, Russia, Turkey, and Indonesia—are expected to contribute about 45 percent of global GDP growth in the coming decade. Emerging markets will represent an even larger share of the growth in product categories, such as automobiles, that are highly mature in developed economies.

Figures like these create a real sense of urgency among many multinationals, which recognize that they aren't currently tapping into those growth opportunities with sufficient speed or scale. Even China, forecast to create over half of all GDP growth in those seven developing economies, remains a relatively small market for most multinational corporations—5 to 10 percent of global sales; often less in profits.

To accelerate growth in China, India, Brazil, and other large emerging markets, it isn't enough, as many multinationals do, to develop a country-

[1] In terms of purchasing-power parity.

level strategy. Opportunities in these markets are also rapidly moving beyond the largest cities, often the focus of many of these companies. For sure, the top cities are important: by 2030, Mumbai's economy, for example, is expected to be larger than Malaysia's is today. Even so, Mumbai would in that year represent only 5 percent of India's economy and the country's 14 largest cities, 24 percent. China has roughly 150 cities with at least one million inhabitants. Their population and income characteristics are so different and changing so rapidly that our forecasts for their consumption of a given product category, over the next five to ten years, can range from a drop in sales to growth five times the national average.

Understanding such variability can help companies invest more shrewdly and ahead of the competition rather than following others into the fiercest battlefields. Consider Brazil's São Paulo state, where the economy is larger than all of Argentina's, competitive intensity is high, and retail prices are lower than elsewhere in the country. By contrast, in Brazil's northeast—the populous but historically poorest part of the country—the economy is growing much faster, competition is lighter, and prices are higher. Multinationals short on granular insights and capabilities tended to flock to São Paulo and to miss the opportunities in the northeast. It's only recently that they've started investing heavily there—trying to catch up with regional companies in what is often described as Brazil's "new growth frontier."

As developing economies become increasingly diverse and competitive, multinationals will need strategic approaches to understand such variance within countries and to concentrate resources on the most promising submarkets—perhaps 20, 30, or 40 different ones within a country. Of course, most leading corporations have learned to address different markets in Europe and the United States. But in the emerging world, there is a compelling case for learning the ropes much faster than most companies feel comfortable doing.

The appropriate strategic approach will depend on the characteristics of a national market (including its stage of urbanization), as well as a company's size, position, and aspirations in it. In this article, we explore in detail a "city cluster" approach, which targets groups of relatively homogenous, fast-growing cities in China. In India, where widespread urbanization is still gaining steam, we briefly look at similar ways of gaining substantial market coverage in a cost-effective way. Finally, in Brazil we quickly describe how growth is becoming more geographically dispersed and what that means for growth strategies.

Targeting the right city clusters in China

By segmenting Chinese cities according to such factors as industry structure, demographics, scale, geographic proximity, and consumer characteristics, we identified 22 city clusters, each homogenous enough to be considered one market for strategic decision making (Exhibit 1). Prioritizing several clusters or sequencing the order in which they are targeted can help a company boost the effectiveness of its distribution networks, supply chains, sales forces, and media and marketing strategies.

More specifically, this approach can help companies to address opportunities in attractive smaller cities cost effectively and to spot opportunities for, among other things, expanding within rather than across clusters (Exhibit 2)—

a strategy that requires a less complex supply chain and fewer partners. Companies that nonetheless want to expand across clusters may find it easier to target 50 to 100 similar cities within four or five big clusters than cities that theoretically offer the same market opportunity but are dispersed widely across the country.

Another major benefit of concentrating resources on certain clusters is the opportunity to exploit scale and network effects that stimulate faster, more profitable growth. Because most brands still have a relatively short history in China, for example, word of mouth plays a much greater role there than it does in developed economies.

Exhibit 1

A recent analysis of China revealed 22 distinct urban clusters.

Urban clusters and their hub cities

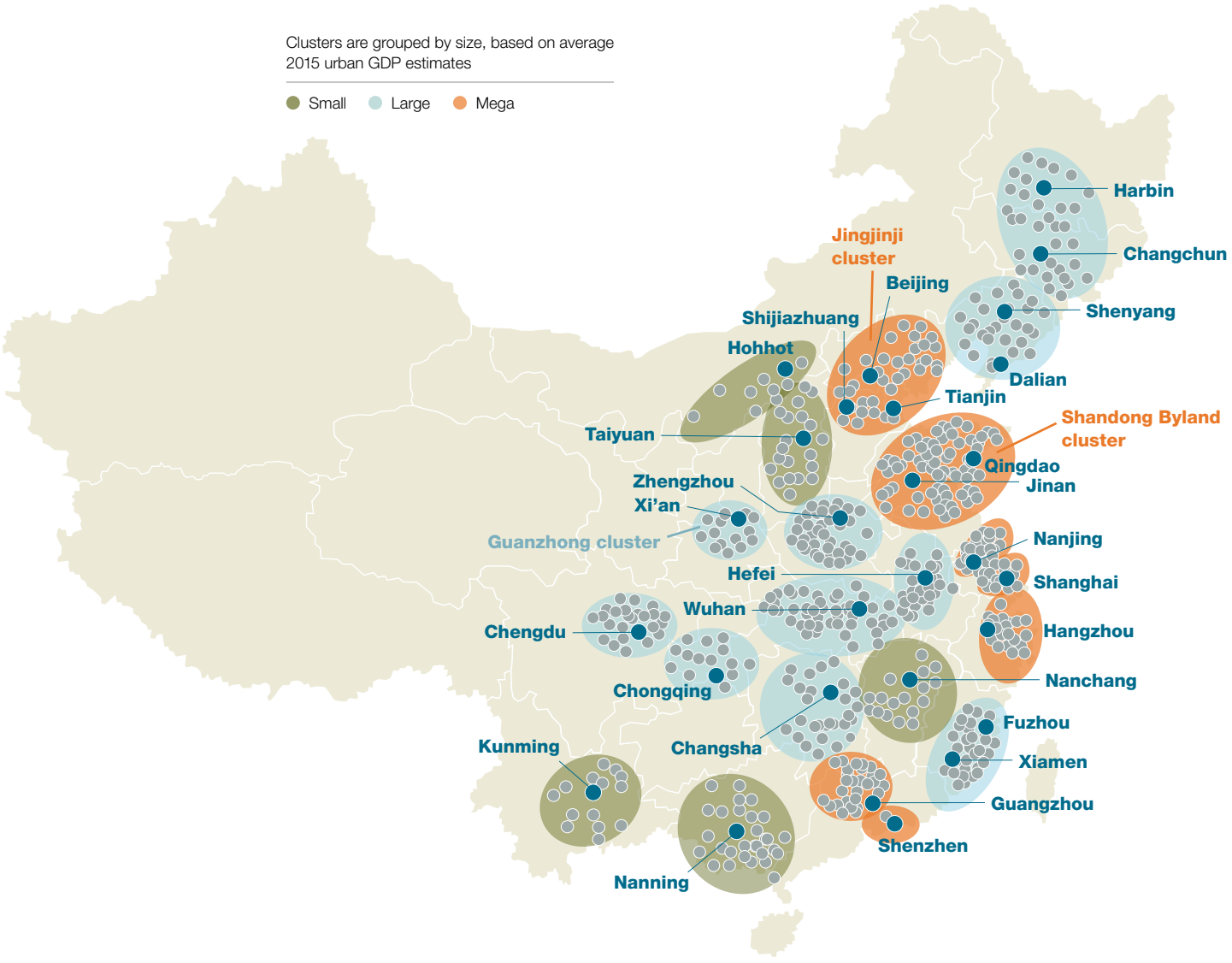
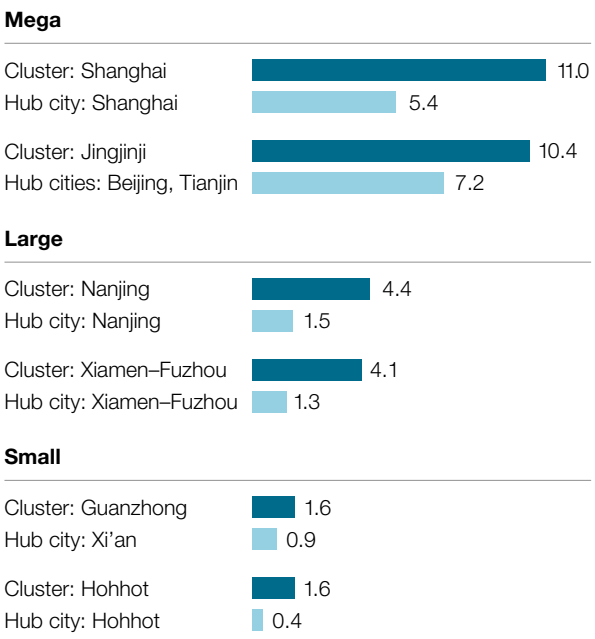


Exhibit 2

Clusters vary considerably in their share of urban GDP and in the relative importance of their hub cities.

Top two clusters in each size category, projected 2015 urban GDP as % of national urban GDP (in 2005 renminbi)



By focusing on attaining substantial market share in a cluster, a brand can unleash a virtuous cycle: once it reaches a tipping point there—usually at least a 10 to 15 percent market share—its reputation is quickly boosted by word of mouth from additional users, helping it to win yet more market share without necessarily spending more on marketing.

Here are four important tips to keep in mind when designing a city cluster strategy for China.

Focus on cluster size, not city size

It's easy to be dazzled by the size of the biggest cities, but trying to cover all of them is less effective for the simple reason that they can be very far from one another. Although Chengdu, Xi'an, and Wuhan, for example, are among the ten largest cities in China, each of them is about 1,000 kilometers away from any of the others. In Shandong province, the biggest city is Jinan, which is barely in the top 20. Yet Shandong has 21 cities among China's 150 largest, which makes the area one of the five most attractive city clusters. Its GDP is about four times bigger than that of the cluster of cities around and including Xi'an, as well as three times bigger than the cluster of cities surrounding Chengdu.

Look beyond historical growth rates

The growth of incomes and product categories is another variable that must be treated in a granular fashion. Extrapolating future trends from

Another major benefit of concentrating resources on certain clusters is the opportunity to exploit scale and network effects that stimulate faster, more profitable growth.

historical patterns is particularly suspect—however detailed that history may be—because consumer spending habits change so rapidly once wealth rises.

In some clusters, many people are starting to buy their first low-end domestic cars; in others, they are upgrading to imports or even to luxury brands. We expect sales of SUVs to increase at a 20 percent compound annual growth rate nationwide in the next four years, for example, but to grow as quickly as 50 percent in several cities and, potentially, even to decline in some where penetration is already deep. Similar or even sharper variance held true in almost every service or product category we analyzed, from face moisturizers to chicken burgers to flat-screen TVs. Yogurt sales in some cities are growing eight times faster than the national average.

The Shenzhen cluster has the highest share (90 percent) of middle-class households—those earning over $9,000 a year. In other clusters, such as Nanchang and Changchun–Harbin, more than half of all households are still poor. As a result, people in the Shenzhen cluster are already active consumers of many categories, and the potential for growth is fairly limited. In the poorer clusters, many categories are just emerging, as larger numbers of people pass the threshold at which more goods become affordable. From a strategic viewpoint, the richer cluster could still be a major growth market for premium goods but not for most mass-market ones.

Don't be fooled by generalities

Talking about Chinese consumers and how they shop is a bit like talking about European consumers. While some generalizations may be fair, certain very strong differences, even within regions, go well beyond the already significant economic variance. Guangzhou and Shenzhen, for example, are both tier-one cities, located in the same province and just two hours apart. But Guangzhou's people mainly speak Cantonese, are mostly locally born, and like to spend time at home with family and friends. In contrast, more than 80 percent of Shenzhen's residents are young migrants, from all across the country, who mainly speak Mandarin and spend most of their time away from their homes. To be effective, marketers will probably have to differentiate their campaigns and emphasize different channels when reaching out to the people in these two cities. That's why we suggest managing them in different clusters, despite their proximity.

The need to localize marketing activities also results from the limited reach of national media. China has over 3,000 TV channels, but just a few are available across the country. In some

areas, only around 5 percent of consumers watch national television. Other media, such as newspapers and radio (and of course billboards), are even more local.

Very few companies can craft their entire strategy at the level of a cluster—those that do are usually its regional champions. But with differences such as the following common, some tailoring is critical:

- Every second consumer in Shandong believes that well-known brands are always of higher quality, and 30 percent are willing to stretch their budgets to pay a premium for the better product. In south Jiangsu, only a quarter of consumers preferred the well-known brands, and only 16 percent were willing to pay a premium for them.

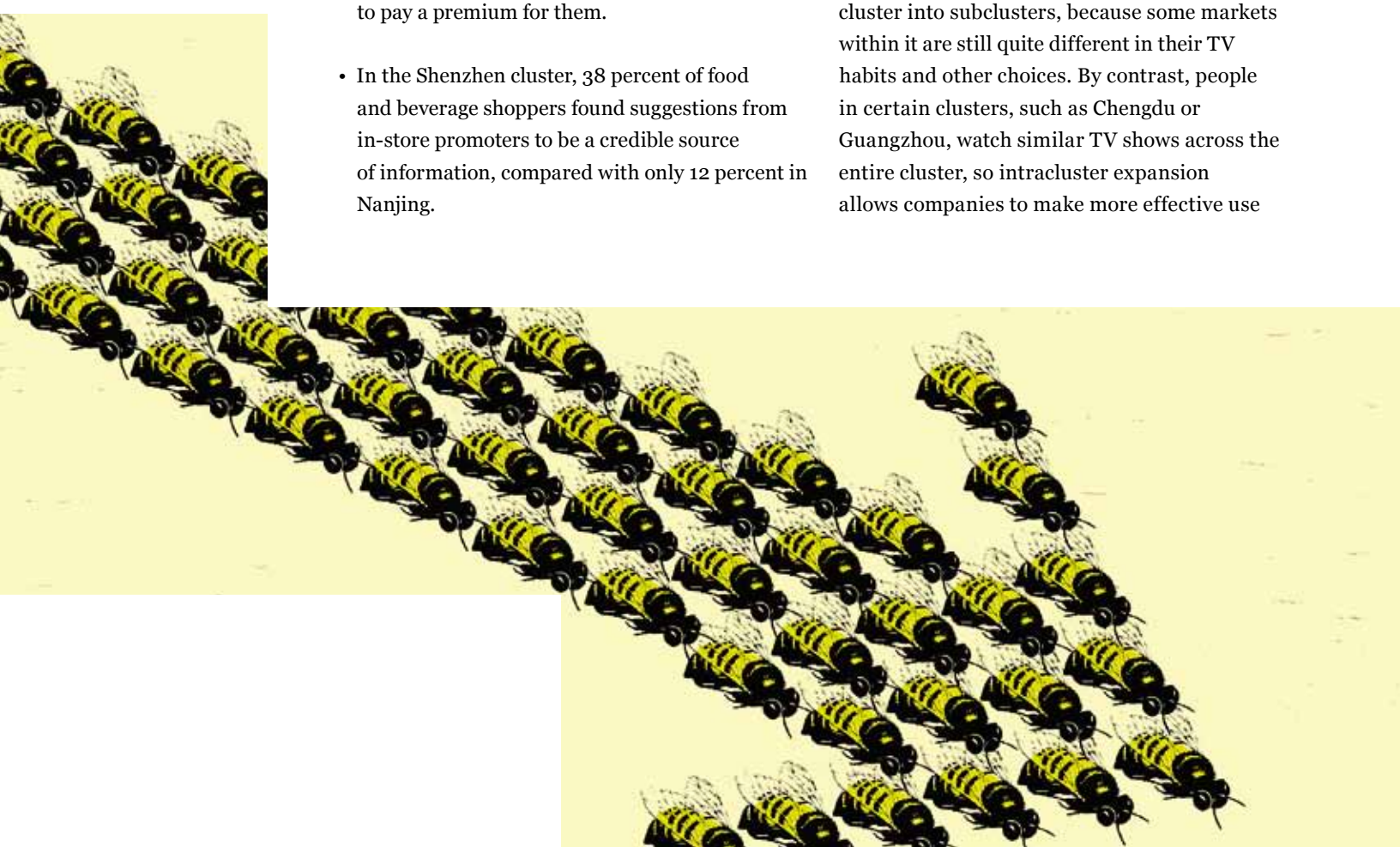
- In the Shenzhen cluster, 38 percent of food and beverage shoppers found suggestions from in-store promoters to be a credible source of information, compared with only 12 percent in Nanjing.

- In Shanghai, 58 percent of residents shop for apparel in department stores, compared with only 27 percent of Beijing residents.

With such diversity common, even merely fine-tuning the marketing mix and channel focus by cluster can pay enormous dividends.

Allow your clusters to be flexible

Some companies may want to merge or divide clusters for strategic-management purposes. A company could, for instance, merge geographically nearby clusters, such as Guangzhou and Shenzhen or Chengdu and Chongqing, if its supply chain was well positioned to manage these proximate clusters as one. Other companies, highly driven by the media market, would find it sensible to split the Shanghai cluster into subclusters, because some markets within it are still quite different in their TV habits and other choices. By contrast, people in certain clusters, such as Chengdu or Guangzhou, watch similar TV shows across the entire cluster, so intracluster expansion allows companies to make more effective use



of the media spending needed to attract consumers in the big cities.

The actual number of submarkets a company opts for will depend in practice on its needs. That number should be manageable—most likely, 20 to 40. Fewer wouldn't be likely to produce the required degree of granularity, though a company might have logistical reasons for taking this approach. More would probably be too many to run effectively.

Cost-effective market coverage in India

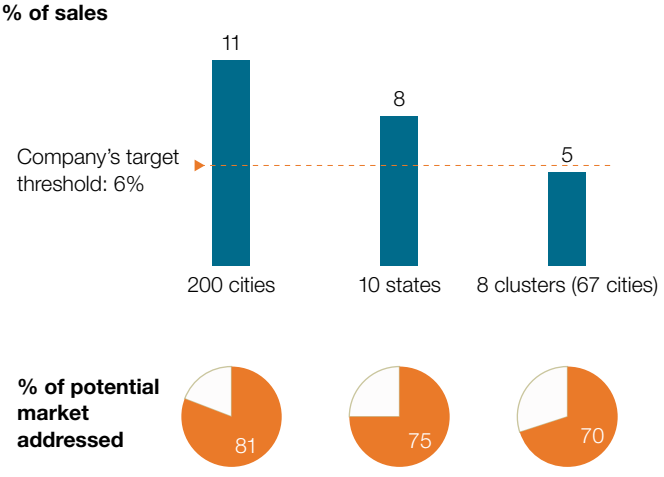
Often, the challenges of accessing consumption growth cost effectively are even greater in India than in China because India is less urbanized and at an earlier stage of its economic development. Companies would need to reach up to 3,500 towns and 334,000 villages, for example, to pursue opportunities in the 10 (of 28) Indian states that by 2030 will account for 73 percent of the country's GDP and 62 percent of the urban population.

To allocate financial and human resources smartly and make things more manageable, companies need to walk away from averages and adopt more granular approaches. Some companies will be well served by focusing on 12 clusters around India's 14 largest cities. Those clusters will provide access to as much as 60 percent of the country's urban GDP by 2030, when the 14 largest cities are likely to account for 24 percent of GDP.

True, India's major clusters won't cover as much of the economy as those in China, where they will encompass 92 percent of urban GDP by 2015. Yet a hub-and-spoke approach in India should provide similar opportunities to optimize supply chains, as well as sales and marketing networks. An established technology player formerly operated in 120 cities all over India, for example. Recently, it shifted to focusing on eight clusters with a total of 67 cities, which still gave it access to 70 percent of its potential market. One benefit: customer service costs fell from a rapidly growing 9 to 10

Exhibit 3

In India, focusing on city clusters helped one technology company reduce its customer service costs dramatically.



percent of sales to a more acceptable 5 percent (Exhibit 3).

Alternatively, a company might improve the economics of its Indian business by focusing on a handful of states, an approach recently adopted by a retailer that had previously been pursuing a national footprint. Another company, this one in the consumer goods sector, recently decided to pursue opportunities in eight cities where consumers earn over $2,500 a year—more than twice the average for India—and the retail infrastructure suits its products nicely. Without this more granular analysis, the multinational would have stayed on the sidelines in the mistaken belief that Indian consumers weren't ready for its products. It would therefore have missed the opportunity to challenge a competitor rapidly gaining the lead in those markets.

Seizing new regional opportunities in Brazil

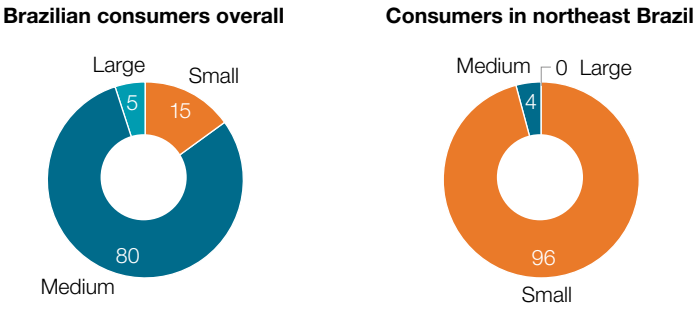
In contrast to China and India, Brazil has been open to multinationals for decades. But during much of that time, most large companies in sectors such as consumer packaged goods focused on the southern (and most affluent) parts of the country. With just over half of the national population, this region includes São Paulo city and state, Brazil's financial and industrial center.

As economic growth accelerated in recent years, many consumers started upgrading to more

Exhibit 4

In Brazil, consumer preferences can vary dramatically across regions.

Example: consumer preference for name-brand detergent's pack sizes,[1] pack size as % of total sales



[1]Small = <500 grams, medium = 1,000 grams, large = >1,000 grams.
Source: LatinPanel

sophisticated products. But growth has also been moving beyond the south and a few large cities, becoming more geographically dispersed. In the populous northeast, for example, income per capita is only half of its level in São Paulo, but the economy is growing faster than it is elsewhere in Brazil. Succeeding in new regions like the northeast requires a fresh approach for many companies. Consider the following:

- Many global companies still make the mistake of doing their consumer research in São Paulo when they are designing new products or national marketing campaigns for Brazil. They don't realize that cosmopolitan São Paulo probably has more in common culturally with New York than with any other city in Brazil.

- Modern-format stores account for 70 percent of retailing in Brazil overall, but for only 55 percent in the northeast. To reach thousands of small (and often capital-constrained) outlets spread all over the region, packaged-goods companies must develop third-party networks specializing in frequent deliveries of goods and small drop sizes. What's more, in Brazil as a whole, many consumer goods companies found that they had focused too much on hypermarkets when designing assortments and promotions. One company, for example, discovered that Brazil's expanding drugstore chains were the fastest-growing channel for personal-care and beauty products. Some leading consumer goods companies have now created specialized organizations that execute distinct channel strategies in different regions and categories, with tailored product portfolios and displays.

- Many packaged-goods companies see detergent powders as a developed category in Brazil. But relatively affluent consumers there are upgrading to larger and more sophisticated washing machines, and many consumers in the northeast are buying their first fully automated machines. New detergent formulas therefore have enormous potential—annual consumption in the northeast

is less than half of what it is in the south. Seizing this opportunity requires an understanding of the regional consumer, however, particularly pack size preferences (Exhibit 4). Consumers in the northeast also want a strong perfume and great quantities of foam but care less about whitening power.

Brazil is distinct from China and India in many respects. But as these examples suggest, there too identifying growth opportunities increasingly requires a detailed understanding of vast regional variations in competition levels, income, product growth rates, consumer preferences, and retail channels.

There is no one-size-fits-all strategy for capturing consumer growth in emerging markets. What's clear, though, is that traditional country strategies and other aggregated approaches will miss the mark because they can't account for the variability and rapid change in these markets. As the battle for the wallet of the emerging-market consumer shifts into higher gear, companies that think about growth opportunities at a more granular level have a better chance of winning.

Yuval Atsmon (Yuval_Atsmon@McKinsey.com), who was based in McKinsey's Shanghai office from 2006 to 2012, is a principal in the London office. **Ari Kertesz** (Ari_Kertesz@McKinsey.com) is a principal in the São Paulo office, and **Ireena Vittal** (Ireena Vittal@McKinsey.com) is a principal in the Mumbai office.

“There’s no such thing as an effective countrywide strategy”

Zeinal Bava

Zeinal Bava became Portugal Telecom’s CEO in 2008, after the company thwarted a hostile-takeover bid. He is widely credited with turning around PT’s domestic and Brazilian operations. A former investment banker, in 2010 and 2011, Bava was named the European telecom sector’s best CEO by *Institutional Investor*.

Portugal Telecom CEO Zeinal Bava set an ambitious goal in early 2008: to raise the international share of PT’s revenues to 66 percent by year-end 2011, from 45 percent in 2007, and almost to double the customer base, to 100 million. These goals appeared more remote in 2010, after Telefónica acquired PT’s half of Brazil’s top mobile operator, Vivo. But PT, determined to revive its Brazil strategy, recently started anew there by acquiring a stake in the country’s largest telecom company, Oi. In this commentary—adapted from a recent interview with Jürgen Meffert, a director in McKinsey’s Düsseldorf office—Bava discusses how to succeed in Brazil.

Portugal Telecom prioritized Brazil in the late 1990s because it has a large and growing population that shares our language and culture. The downside was perceived currency volatility and uneven distribution of wealth. The addressable market was mostly atop the income pyramid.

During the later years of Lula’s presidency,[1] up to 50 million more people became consumers. Consumer demand now underpins Brazil’s economic turnaround. People are leapfrogging in technology. For example, wireless broadband has gone through the roof; today there are more customers using mobile than fixed-line broadband. Pay-TV also offers significant growth prospects, as penetration is low.

[1] Luiz Inácio Lula da Silva, president of Brazil from 2003 to 2011.

Read the full interview, "Remaking Portugal Telecom: An interview with CEO Zeinal Bava," on mckinseyquarterly.com.

A key imperative for development is to improve Brazil's technological infrastructure. Brazil is moving toward becoming one of the planet's seven largest economies. Still, the country ranks only 75th in high-speed Internet. Correcting this imbalance implies fantastic growth opportunities for mobile and for combined landline voice, broadband, and television offers, while improving Brazil's economic competitiveness and its education and health care.

To me, there's no such thing as an effective countrywide strategy. We break the country down into customer segments and then look at different geographies. São Paulo city is very different from São Paulo state, for example; the whole country has around 200 million people. Just the Amazon rainforest covers six million square kilometers.[2] You have to walk away from averages and map out the markets. If you are the leader in a specific market, it might be sufficient to offer customers one month for free. If you're number four, you might have to give three months. When we rolled out 3G, we started in areas where the average revenue per user and spectrum availability supported the business case and service quality underlying the investment.

We also found that you should allow room for pleasant surprises. One state offered incentives for mobile operators to invest in coverage in areas where we didn't see demand. Yet the moment we put up antennas, traffic was immediately well in excess of our estimates. Why? Because lots of people with mobile handsets live in places where there's no coverage. They use their mobiles when they travel to places where there is coverage.

So I think we have to allow ourselves room to imagine different solutions in areas where the numbers don't stack up at first sight. Mobility is a killer attribute for voice, video, or data. In fact, 4G could dramatically change the game because it uses spectrum more efficiently and has the advantage of being a single standard worldwide, so prices will fall very fast. This will have a direct impact on our ability to roll out 4G in places where three years ago we thought the numbers didn't stack up even for 3G.

Also, consider the pace of change in Brazil. Today, a significant portion of the mobile-subscriber base receives but doesn't make calls. Yet buying power is increasing substantially, especially in the north-east. When you earn the minimum wage of roughly 550 reais a month and your income goes up by 100 reais, there's a significant shift in spending patterns. So we may revisit our business model, rerun our numbers, and question our assumptions about penetration levels. This is why we believe Brazil offers scale and growth and why it's such a strategic market for PT.

[2] About 2.3 million square miles.

Meet the Chinese consumer of 2020

Evolving economic profiles will continue to be the most important trend shaping the market.

Yuval Atsmon and Max Magni

Most large consumer-facing companies realize that they will need China to power their growth in the next decade. But to keep pace, these companies will also need to understand the economic, societal, and demographic changes shaping the profiles of consumers and the way they spend. This is no easy task not only because of the fast pace of growth and subsequent changes in the Chinese way of life but also because of the vast economic and demographic differences across the country.

These differences are set to become more marked, with significant implications for companies that fail to grasp them. Since 2005, McKinsey has conducted annual consumer surveys in China, interviewing a total of more than 60,000 people in upward of 60 cities.[1] Our surveys have tracked the growth of incomes, shifting patterns of expenditure, rising expectations—sometimes in line with those of the respondents' Western counterparts and sometimes not—and the development of many different consumer segments. Those surveys now provide insights to help us focus on the future. We cannot, of course, predict it with certainty, and external shocks might confound any forecast. But our understanding of consumer trends to date, coupled with an analysis of the economic and demographic factors that will further shape them in the next decade, serve as a useful lens for contemplating the profile of the Chinese consumer in 2020.

[1] The latest survey, carried out in 2011, gauged Chinese consumers' attitudes and spending behavior for about 60 product types and 300 brands. The respondents—representing a wide range of incomes, ages, regions, and cities—accounted for 74 percent of China's total GDP and 47 percent of the total population.

Changing demographics

Many of the changes taking place in China are common features of rapid industrialization: rising incomes, urban living, better education, postponed life stages, and greater mobility. Japan saw similar changes in the 1950s and 1960s, as did South Korea and Taiwan in the 1980s.

But some unique factors are also at work, such as the government's one-child policy and the marked economic imbalances among regions. Our analysis reveals important insights into the likely demographic and socio-demographic profiles of Chinese consumers at the end of this decade.[2]

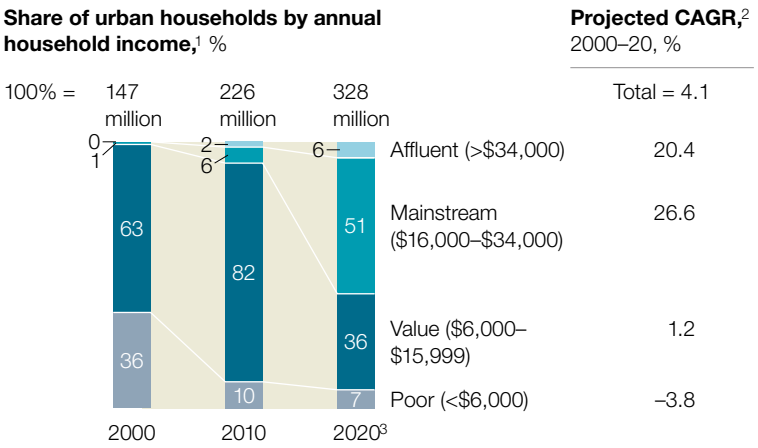
Changes in economic profiles have been and will continue to be the most important trend shaping the consumer landscape. The Chinese are certainly getting richer fast: the per-household disposable income[3] of urban consumers will double between 2010 and 2020, from about $4,000 to about $8,000.[4] That will be close to South Korea's current standard of living but still a long way from its level in some developed countries, such as the United States (about $35,000) and Japan (about $26,000).

The current vast differences in income levels will persist, however, although the numbers at each level will shift dramatically (Exhibit 1). At present, the great majority of the population consists of "value" consumers—those living in households with annual disposable incomes between $6,000 and $16,000 (equivalent to 37,000 to 106,000 renminbi), just enough to cover basic needs. "Mainstream" consumers, relatively well-to-do households with annual disposable income of between $16,000 and $34,000 (equivalent to 106,000 to 229,000 renminbi), form a very small group by comparison. China has fewer than 14 million such

[2] We focus on urban consumers in this report.
[3] Urban-household disposable income—the combined disposable income of all members of a household—is defined as total household income minus income taxes and contributions to social security.
[4] In 2010 real terms for all dollar and renminbi figures in this article, unless stated otherwise.

Exhibit 1

The share of Chinese households in each income level will shift dramatically by 2020.



[1] In real 2010 dollars; in 2010, $1 = 6.73 renminbi.
[2] Compound annual growth rate.
[3] Forecast.

households, representing only 6 percent of the urban population. A tiny group of "affluent" consumers, whose household income exceeds $34,000, accounts for only 2 percent of the urban population, or 4.26 million households.

Until now, these divergences have presented multinational companies operating in China with a choice: to target only mainstream and affluent consumers or to stretch the brand to serve the value segment. Those that took the first course could more or less maintain the same business model they applied in other parts of the world, without needing to de-engineer their products. But in taking that approach, they limited themselves to a target market of 18 million households. Companies that chose to serve the value category benefited from a much bigger market to play in—184 million households—but their products had to be cheaper, they were forced to adapt their business models, and profitability was lower.

This situation is changing. Because the wealth of so many consumers is rising so rapidly, many people in the value category will have joined the mainstream one by 2020. Indeed, mainstream consumers will then account for 51 percent of the urban population. Their absolute level of wealth will remain quite low compared with that of consumers in developed countries. Yet this group, comprising 167 million households (close to 400 million people), will become the standard setters for consumption, capable of affording family cars and small luxury items. Companies will be able to respond by introducing better products to a vast group of new consumers, thus differentiating themselves from competitors and earning higher profits. Nevertheless, value consumers, whose ranks will fall to 36 percent of urban households in 2020, from 82 percent in 2010, will still represent an enormous market for cheaper products: 116 million households, or 307 million consumers.

Affluent consumers will remain an elite minority, making up only 6 percent of the population in 2020. (In the United States in 2010, more than half of the population earned at least $34,000.) But that 6 percent will translate into about 21 million affluent households, with 60 million consumers.

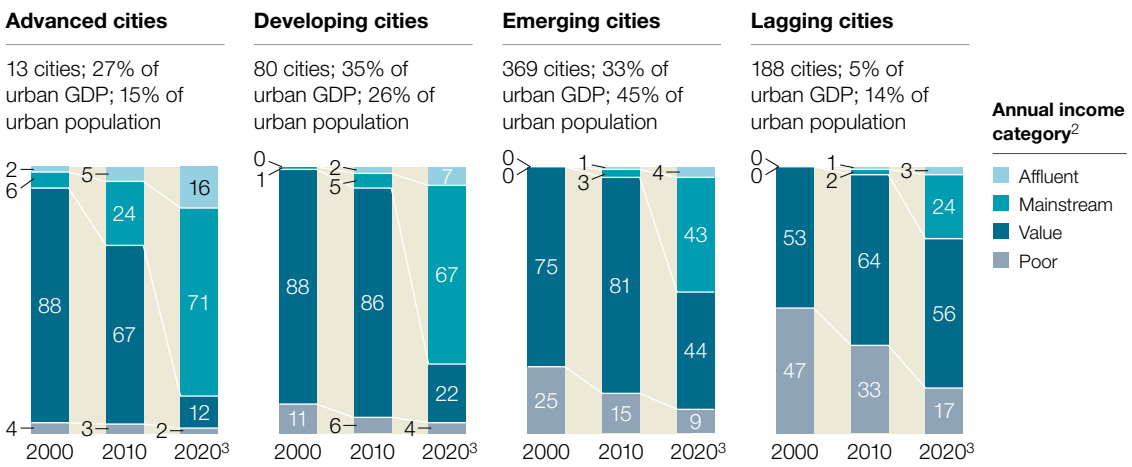
While income is expected to rise across China, some cities and regions are already significantly wealthier than others. Understanding these variations in the rate of development is important because they will affect which categories of goods and services grow most rapidly, and where.

By 2020, almost 400 million Chinese people will have household disposable incomes of between $16,000 and $34,000 per year.

Exhibit 2

The change in income distribution will vary across cities and may suggest new markets.

Income distribution by category,[1] %



[1]Figures may not sum to 100%, because of rounding.
[2]Affluent = >$34,000; mainstream = $16,000–$34,000; value = $6,000–$15,999; poor = <$6,000.
[3]Forecast.

Today, about 85 percent of mainstream consumers live in the 100 wealthiest cities; in the next 300 wealthiest, only 10 percent of consumers are mainstream, but that percentage will rise to nearly 30 percent by 2020. At that point, many families in these cities will be able to afford a range of goods and services (such as flat-screen televisions and overseas travel) that are now largely confined to the wealthiest urban areas. Exhibit 2 explains the distribution of income in four different groups of cities. Some of them (Foshan in Guangdong, for example) are small in terms of absolute GDP or population size. But it's worth noting that the affluence of their populations could make them as attractive to companies as leading tier-one cities, such as Shanghai and Shenzhen.

New spending patterns

An understanding of China's changing economics and its impact on the profiles of consumers helps to identify some key trends in spending patterns in the next decade. We discuss three: high growth in discretionary categories, the tendency to trade up as consumers spend some of their discretionary income on better goods and services, and the emergence of a senior market.

Higher discretionary spending

Bigger incomes and government efforts to increase consumption will benefit all consumer-facing companies, though to varying degrees, depending on their product portfolios. Discretionary categories will show the strongest overall growth—13.4 percent—between 2010 and 2020, as these goods become affordable to growing numbers of consumers. Next come semi-necessities (10.9 percent growth) followed by necessities (7.2 percent). These average figures will of course vary significantly by region and city.

Exhibit 3 shows forecast annual consumption by category for 2020 and the rising importance of discretionary spending. Each broad category includes subcategories, some of which are more discretionary than others and expected to grow faster. For example, a discretionary category within food—dining out—is expected to grow by 10.2 percent a year in the coming decade, against 7.2 percent growth for basic food ingredients.

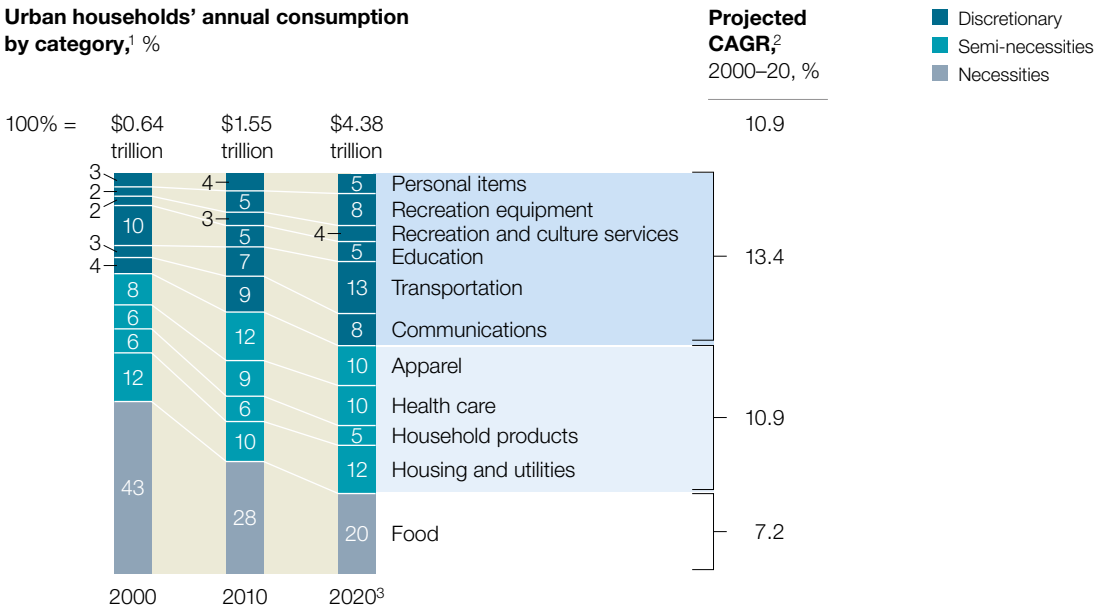
Of course, the wealthiest people—those in our affluent segment—will be the main consumers of discretionary items. Less obvious is the extent to which they will be able to afford more such items in 2020, compared with people in other income groups, as their numbers and wealth grow. Our consumption model suggests that in 2010, average household spending for value, mainstream, and affluent consumers was about $2,000, $4,000, and $12,000, respectively. These figures will jump to $3,000, $6,000, and $21,000, respectively, by 2020. So although all consumers will increase their spending, the gaps between different income groups will widen significantly. Stark disparities in standards of living are emerging in China.

Aspirational trading up

The second noticeable trend in spending is a propensity to trade up, driven increasingly by

Exhibit 3

Discretionary spending is expected to grow considerably by 2020.



[1]In real 2010 dollars; in 2010, $1 = 6.73 renminbi. Figures may not sum to 100%, because of rounding.
[2]Compound annual growth rate.
[3]Forecast.

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consumers aspiring to improve themselves, the way they live, and their perceived social standing. Many Chinese, like their Western counterparts, judge themselves and others by what they buy.

Strong early growth in developing markets comes when large numbers of consumers try products for the first time. As markets mature, growth relies on consumers who buy more goods and services more frequently and trade up to buy pricier versions of items they already have. This pattern explains why some basic-necessity categories have little room for growth: many consumers can already afford such items and probably won't buy a great deal more of them. But that does not mean no growth at all. Take the market for sauces and condiments. Most people can already afford to buy as much as they need of these items. But the increased attention now paid to health and well-being shows that even here, companies have trading-up opportunities.

Such opportunities also exist within semi-necessity categories, such as apparel, health care, and household products: more consumers will be able to afford different outfits for different occasions, for instance, or to buy additional branded products. As a consequence, brands focused on mass-market consumers might need to be repositioned to suit their rising aspirations, while newer, younger brands may be able to leapfrog more established competitors by offering premium products and crafting a premium brand image.

But it is the top end of the market that will benefit most from trading up: growth at the high end of some consumer goods categories already outpaces average growth for those categories as a whole. Sales of premium skin care products, for instance, rose by more than 20 percent a year in the past decade while the industry average was 10 percent.

Annual volume growth rates of more than 20 percent are foreseeable for luxury SUV cars,

An aging China will have about 126.5 million more people above age 65—many of them more willing to spend than today's elderly.

compared with around 10 percent for basic family models. China had already become a leading luxury market by 2010 and could overtake Japan to become the biggest such market by 2015.

Emerging senior market

The aging of China means that as a share of the total population, it will have five percentage points more people above the age of 65 in 2020 than it has today. That is an extra 126.5 million citizens, clearly an important consumer segment. What is equally important is the way the spending patterns of older people in 2020 will differ from those of older people now. In our 2011 survey, the elderly were more inclined to save and less willing to spend on discretionary items such as travel, leisure, and nice clothes. These tendencies will probably be much less apparent in 2020.

Most people in China over the age of 55 experienced the harsh conditions of the Cultural Revolution, in the late 1960s and early 1970s. Not surprisingly, they think it important not to spend frivolously. Among residents of tier-one cities, 55- to 65-year-olds allocate half of their spending to food and little to discretionary categories: only 7 percent goes toward apparel, for example. People who are ten years younger devote only 38 percent of their spending to food but 13 percent to apparel. Indeed, our consumer surveys have revealed that although today's older consumers behave very differently from younger ones, today's 45- to 54-year-olds—the older generation come 2020—have spending patterns similar to those of 34- to 45-year-olds (who allocate 34 percent of their spending to food and 14 percent to apparel). This finding implies that companies will have to rethink their ideas about what older Chinese consumers want.

Implications for companies

The biggest challenge is building and sustaining a leading position in China and, for multinationals, using it to drive global growth. In fact, as the country with the world's largest group of mainstream consumers, it could be an excellent test bed for companies that serve this consumer segment. Our analysis indicates that huge variations in the growth rates of companies operating in China come 2020 are likely, depending on the product category, consumer segment, and geography.

A second challenge is that China is so vast and its regions so diverse it should be treated almost as a collection of separate countries. Companies should redefine the roles of their regional divisions and headquarters, delegating more decision-making power to the former. Many companies already operate with three, five, or even more regional bases, but these tend to function only as sales offices, executing instructions from the top. Consumer needs could become so varied across China's regions that local insight and strategic decision-making

Read *Meet the 2020 Chinese consumer*, the full report on which this article is based, on mckinseychina.com.

power will be vital. Regional offices should therefore receive full responsibility for their own profit-and-loss accounts, strategic planning, consumer research, innovations, portfolios, route-to-market models, and marketing. The corporate center should have a redefined role—serving the individual units and safeguarding the company's brands—with less power and at a lower overhead cost.

A third challenge stems from the fact that undifferentiated mass consumption and the rising cost of ads made the scale of a brand or product crucial to its success in the past decade. Companies provided the same value proposition—usually framed around a product's functional benefits—to all types of consumers, while stretching brands across product categories and price tiers to leverage scale and garner market share. Over the next decade, the game will change to take account of the emergence of different categories of consumers and their own sense of their differences and individuality. Companies will need the crispest value propositions to connect with each group and to stand out from competitors. By 2020, they will have to position brands (or sub-brands) to target narrower consumer segments and offer more tailored value propositions. Brands extended across too many consumer segments and price points may struggle to defend their market position. Hard though the transition could be, at some point companies that have focused on maximizing their brands' scale will have to adopt a model based on a portfolio of more targeted brands or sub-brands to connect with different consumer segments.

No doubt China and its consumers' behavior will take some unexpected turns over the next decade. Nonetheless, our research reveals the clear direction of travel. To be sure of taking part in that journey, companies in the market should start making the acquaintance of China's 2020 consumers today.

The authors would like to thank Lihua Li and Wenkan Liao for their contributions to the report underlying this article.

Yuval Atsmon (Yuval_Atsmon@McKinsey.com), who was based in McKinsey's Shanghai office from 2006 to 2012, is a principal in the London office. **Max Magni** (Max_Magni@McKinsey.com) is a principal in the Hong Kong office.

Illustration by Daniel Hertzberg

Riding Asia's digital tiger

Asia is the world's hottest area of Internet growth, but the dynamics on the ground vary widely by nation.

Vikash Daga, Nimal Manuel, and Laxman Narasimhan

Asia's emerging markets are poised for explosive digital growth. The region's two largest economies—China and India—already boast some 500 million Internet users, and we forecast nearly 700 million more will be added by 2015 (Exhibit 1). Other emerging Asian nations have the potential to grow at a similarly torrid pace. We estimate that within five years, this billion-plus user market may generate revenues of more than $80 billion in Internet commerce, access fees, device sales, and so forth (Exhibit 2).

To better understand the consumers, growth prospects, and problems, we surveyed more than 13,000 individuals across China, India, and Malaysia—countries at very different stages of their digital evolution.[1] The key finding? While there were some notable differences in the types of content consumers favor and the devices they use, significant demand is waiting to be unlocked in all three nations. That could lead to growing markets for digital content and services and to new opportunities around digital marketing, including efforts to reach consumers via Internet sales channels.

Malaysia

Of the three markets we researched, Malaysia is the most advanced. While the country has only around 15 million Internet users, that's close to 55 percent of the total population, and mobile-Internet penetration is close to 30 percent

[1] Field surveys were conducted across 50 cities and in-depth ethnographic profiles developed to form a cross-device, longitudinal view of how the region's digital consumption is evolving.

of it. Given the Malaysian government's push to expand high-speed broadband, we forecast that the country will have up to 25 million Internet users by 2015, or close to 80 percent of the population. As both fixed and wireless broadband grow, we project that more than 50 percent of all users will choose to have both personal-computer and mobile-device options for getting online.

Malaysians consume 35 percent more digital media than Internet users in China and 150 percent more than users in India, particularly on social-networking sites and instant messaging. That may, for example, give handset manufacturers opportunities to build social-network access into their devices. We also found that Malaysians like to multitask across both digital and traditional media. For advertisers, that's problematic, since viewers are paying less attention to traditional media content—and thus advertising.

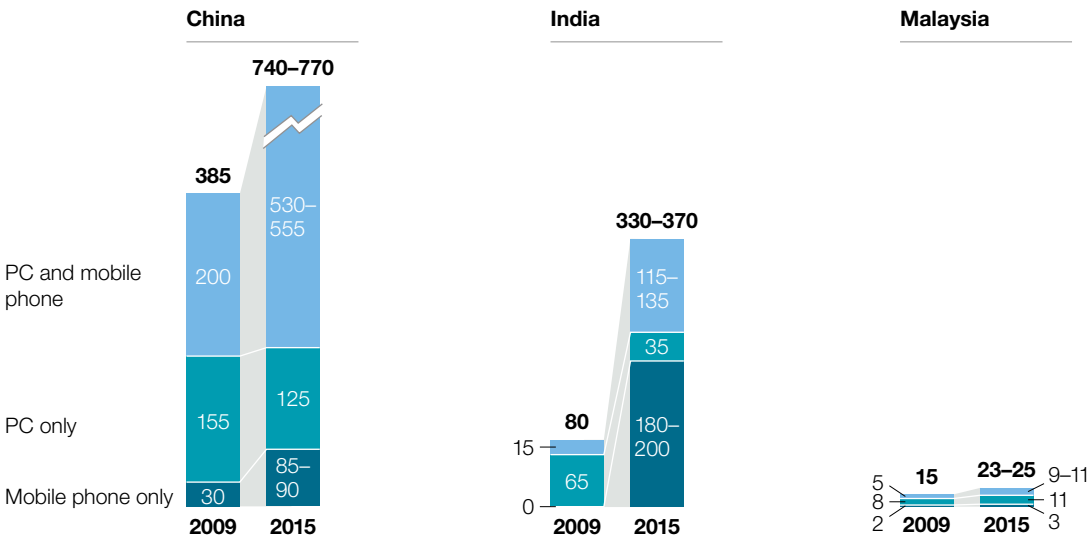
China

China leads the world in sheer numbers of Internet users—more than 420 million people, or close to

Exhibit 1

Over the next five years, nearly 700 million more Asians will start using the Internet.

Penetration,[1] millions of users



Penetration,[2] % of total population

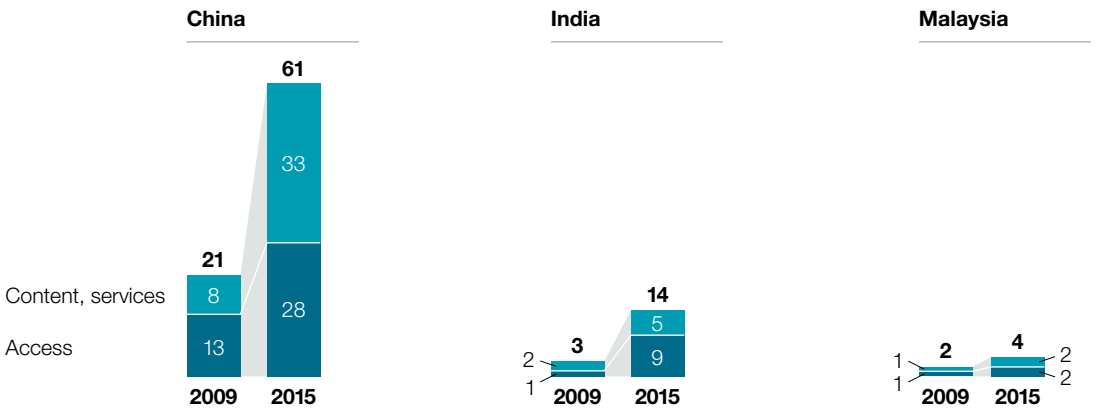
	China		India		Malaysia	
Mobile phone	58	86	30	61	110	141
Internet	29	55	7	28	56	80
Mobile Internet	18	46	1	27	27	44

[1]Figures for 2015 are projected.
[2]Penetration above 100% indicates some users have multiple connected devices.

Exhibit 2

Internet opportunities in emerging Asia could reach approximately $80 billion by 2015.

Revenue,[1] $ billion



[1] Figures for 2015 are projected.

30 percent of the population. Over 80 percent surf the Web from home, while 230 million use mobile devices. We forecast that the number of Internet users will almost double over the next five years, hitting 770 million people, or 55 percent of the population. More than 70 percent will use both PCs and handheld devices.

China's digital usage, which is similar to that of the United States, skews toward instant messaging, social networks, gaming, and streaming video. Increasingly, Internet users in China are substituting digital media for traditional ones, with the potential for further cannibalization as digital consumption grows. This development has stark implications for advertisers and how they allocate future marketing budgets. Consumers, meanwhile, also use the Internet in their purchasing decisions. They are more influenced by recommendations from social-network contacts and friends than by traditional marketing messages or visits to company Web sites.

India

With only 7 percent of the population connected (81 million users), India is Asia's digital sleeper. Yet we believe that it's poised to become a true mobile-Internet society as new users leapfrog PCs altogether. We project that by 2015, the number of Internet users will increase almost fivefold, to more than 350 million—28 percent of the population—with more than half of those accessing the Web via mobile phones. To capture this opportunity, companies will need to roll out wired and wireless broadband networks aggressively, to make smartphones and network access more affordable, and to develop new content types.

Consumer demand clearly is robust. On average, Indians spend more than four hours a day consuming online and offline content. On PCs, often used in cyber cafés, Indians spend much time e-mailing and are heavy consumers of downloaded videos and music, as well as DVD movies. While Indian consumers use mobile

phones predominantly for voice services, they also treat them as offline personal-entertainment devices, listening to radio stations or to downloaded music. There is significant pent-up demand for more convenient and personalized Internet access—a void the mobile Web could fill.

Embracing the opportunity

High hardware costs, inconsistent network quality, and limited access could check these optimistic growth prospects. But the extent of such barriers varies by nation, and there's notable progress overcoming them. Construction of network infrastructure is proceeding apace—companies in India, for example, just spent nearly $25 billion on telecommunications spectrum. Meanwhile, hardware and access costs are declining in most markets. The biggest challenge is to make money while creating a variety of low-cost content. Three issues are especially important:

- Innovators and entrepreneurs must develop content creation and delivery models priced low enough to compete against the pirated options currently available.
- Content and Web services providers need to foster the growth of local and regional advertising markets to help defray the cost of content creation.
- E-commerce platforms, including transaction systems that make purchases more convenient and trusted, must be developed.

At the same time, companies in consumer-facing sectors (for instance, automotive, packaged consumer goods, and retailing) will need to reconsider their marketing and advertising strategies in light of the shift away from traditional media. At stake is a significant competitive advantage in a region that already boasts more than half the world's Internet users—and will only continue to grow.

The authors wish to acknowledge the contributions of Nal Gollagunta to this article.

Vikash Daga (Vikash_Daga@McKinsey.com) is a principal in McKinsey's Delhi office, where **Laxman Narasimhan** (Laxman_Narasimhan@McKinsey.com) is a director; **Nimal Manuel** (Nimal_Manuel@McKinsey.com) is a principal in the Kuala Lumpur office.

Illustration by Gwenda Kaczor

Can India lead the mobile-Internet revolution?

The country could become the world's first truly mobile digital society. But grasping the opportunity requires unprecedented cooperation between the private and public sectors.

Laxman Narasimhan

Almost 1,500 years ago, Indian mathematicians, including Aryabhata, Brahmagupta, and Pingala, transformed mathematics by conceiving the rules of the binary numeral system. While those rules today lie at the heart of the code powering the Internet, India has relatively few Internet users: just 7 percent of its population is connected to the Web, compared with 32 percent in China and 77 percent in the United States.

Yet India has an opportunity to lead the world once again by becoming the first truly mobile digital society. All the elements are in place: the cost of network access and handsets is going down, wireless networks are going up, and Indian consumers already display an insatiable appetite for digital services. In addition, bypassing the personal computer—moving straight to widespread mobile access—simply makes sense. It would sidestep a host of hurdles associated with delivering affordable Internet services to a population that is geographically dispersed and relatively poor, in a country where infrastructure development can be problematic.

Can India actually transform itself from an Internet laggard into a world leader? The trail the country would blaze could serve as a model for other developing markets. But much depends on whether India can rediscover its revolutionary spirit and garner unprecedented cooperation and commitment from both the private and public sectors.

The Indian digital consumer

As of 2010, India's base of 81 million Internet users was the world's fourth largest.[1] Yet this figure is a function of sheer population, not deep adoption: at the time, just 20 percent of India's urban citizens were connected to the Internet, compared with 60 percent in China. And while China had 233 million mobile-Internet users, or 18 percent of its total population, India had just 17 million, or less than 1 percent.

Even though typical Indian consumers have no Internet access, they have a remarkable appetite for digital content. In fact, they consume an average of 4.5 hours of it daily across offline channels such as television, DVDs, and CDs. And while they use mobile phones predominantly for voice services, a whole segment of business has grown around retailers essentially operating as physical iTunes stores, charging fees to load music and other content onto mobile devices. The net result is that while India is a relatively poor country, more than 70 percent of its urban consumers already spend about $1 a month on content and services through offline, unorganized retail channels—a market estimated to be worth more than $4 billion annually.

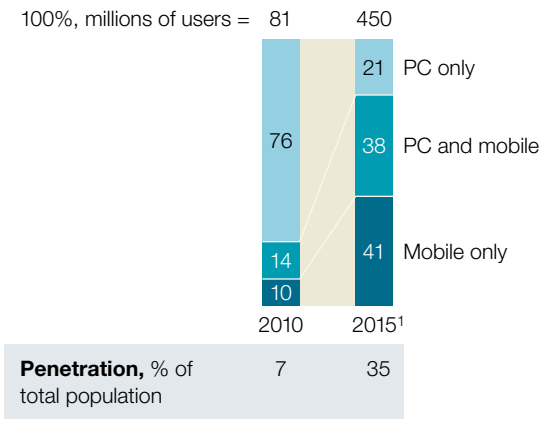
The mobile Internet could deliver the personalized entertainment that Indian consumers crave. If India's latent demand is unleashed, McKinsey research forecasts that the total number of Internet users will increase more than fivefold, to 450 million, by 2015 (exhibit). Total digital-content consumption will double, to as much as $9.5 billion. Including access charges, revenues from total digital consumption could rise fourfold, to $20 billion—twice the expected growth rate of China.

[1] China ranks first, with 420 million users, followed by the United States, with 240 million, and Japan, with 99 million. Source: Internet World Stats, 2010.

Exhibit

India's Internet users will increase fivefold by 2015, and more than three-quarters of them will choose mobile access.

Share of Internet use by channel in India, %



[1] Projected.

Source: 2010 McKinsey digital consumer survey; McKinsey analysis

Development roadblocks

Realizing India's potential won't be easy. The country faces well-known challenges: the cost and ease of access to Internet services, infrastructure development, and the availability of relevant and local-language content. However, these challenges are less worrisome than commonly thought—particularly since the leap to mobile connectivity would allow India to sidestep some of them.

There's enough development in devices, networks, operating systems, and operator strategies to suggest that India is on track to resolving the challenge of affordable, easy Internet access. The average price of smartphones that deliver much richer content, including video, is falling rapidly—already nearing $125, significantly less than the cost of PCs. Mobile devices also are inherently easier to operate than PCs, and the ability to access Web sites with a single touch or a voice command (critical given India's high illiteracy rate) is becoming a reality. Finally, Indian operators are starting to offer innovative rate plans for mobile data use, addressing criticisms of the prices of data plans and their perceived opaqueness. Cheaper, easier access for all is on the cards.

It's no secret that infrastructure development in India is a real challenge. McKinsey research on the country's 11th five-year economic plan[2] suggests that while the government has spent what it intended to, infrastructure (such as electricity connections and road building) is significantly behind schedule. More troubling is the reason: beyond the frequently mentioned issue of land ownership, delays in building "hard" infrastructure often stem from a lack of "soft" infrastructure, such as educated, skilled workers with project-management capabilities. These delays should encourage the leap to mobile-Internet access, perhaps delivered by the private sector. Mobile operators are aggressively rolling out networks across the country, including an impending 3G network, following recent auctions in which companies spent almost $30 billion acquiring telecommunications spectrum.

The government also is making large investments to overcome other hurdles. In particular, it is sponsoring efforts to give citizens unique identification numbers that will, for instance, allow identities to be authenticated with mobile devices. That will facilitate wireless banking and other services, such as e-health care. In addition, the ability to identify all citizens means that subsidies and incentives can be delivered to them efficiently. The National Rural Employment Guarantee Authority, for example, is supposed to distribute $8.5 billion to citizens in 2011. In the past, significant portions of such funds have failed to reach the recipients. The digital opportunity may substantially eliminate this problem, and citizens spurred by the prospect of finally getting what's due to them should make the leap to mobile-Internet services such as e-commerce. Additionally, our research on e-payments has uncovered significant opportunities to drive down costs.

Embracing the digital opportunity

The most formidable hurdle to the realization of India's digital promise is finding a sustainable way to deliver attractive returns for content companies at affordable prices for consumers. India differs from other Asian mobile-Internet leaders, such as Japan and even China, where access charges generate enough revenue for operators to finance the ongoing creation of value-added services. India's telecom industry structure and poorer population are putting pressure on access

[2] India's Planning Commission develops, executes, and monitors five-year plans for the country's economic development. The 11th such plan covers the period from 2007 to 2012.

revenue, and it's unclear whether telecommunications companies will be able to extract sufficient profits from their mobile value-added services and entertainment or from their nascent local-advertising-driven networks to warrant continued large investments. To overcome this issue, private and public companies, as well as India's government, must address two priorities.

Mobile content and services

The first step toward generating more profits from content and services is the creation of offerings that are compelling and easy to access and use, much like iPhone applications. That will require companies to raise their game in editing, visual merchandising, and marketing. More local-language content also is required, and it should be presented in new ways: voice and single-touch mobile-Internet access are essential, particularly to overcome illiteracy and a lack of familiarity with the Internet.

Making money from content

Financial institutions and regulators must promote the next phase of payment systems, a critical enabler that will affect the pace of development of revenue streams beyond consumer access and services. Selling regional and local advertising on mobile devices is essential: it's the fastest-growing form of advertising in India, and there's a desperate need for local content, given the country's 23 official languages. Meanwhile, content providers should think about new ways of making money from the Internet—for example, by balancing free and priced material to reflect the value of content delivered in real time and in specific contexts, such as shopping coupons received by mobile devices as consumers pass certain stores.

All participants—public and private—have a role in unleashing the digital revolution's true potential. Governments can promote access, undertake thoughtful regulation and oversight, and deliver public services such as information, health care, subsidies, and incentives. Banks and financial-services companies can enhance their online presence to build real-time, personalized relationships with customers. Insurance companies can address their high-cost, multi-layered business systems and examine opportunities—for example, using the Internet to deliver product information and training more effectively. Advertising agencies can adopt new approaches to developing concepts, pricing, and measurements of effectiveness. And marketers can better address the way consumers now make purchasing decisions, finding new analytical approaches to the allocation of spending and the management of "buzz" and word of mouth.

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Binary mathematics lies behind the technology that underpins the Internet. After more than 1,500 years, India could again lead the world in a technological revolution. The consumer demand exists. The opportunity is real. Is India up to the challenge?

The author wishes to acknowledge the contributions of Vikash Daga, Nal Gollagunta, and Nimal Manuel, who co-led the research that underpins this article.

Laxman Narasimhan (Laxman_Narasimhan@McKinsey.com) is a director in McKinsey's Delhi office.

Understanding social media in China

The world's largest social-media market is vastly different from its counterpart in the West. Yet the ingredients of a winning strategy are familiar.

Cindy Chiu, Chris Ip, and Ari Silverman

No Facebook. No Twitter. No YouTube. Listing the companies that don't have access to China's exploding social-media space underscores just how different it is from those of many Western markets. Understanding that space is vitally important for anyone trying to engage Chinese consumers: social media is a larger phenomenon in the world's second-biggest economy than it is in other countries, including the United States. And it's not indecipherable. Chinese consumers follow the same decision-making journey as their peers in other countries, and the basic rules for engaging with them effectively are reassuringly familiar.

Surveying the scene

In addition to having the world's biggest Internet user base—513 million people, more than double the 245 million users in the United States[1]—China also has the world's most active environment for social media. More than 300 million people use it, from blogs to social-networking sites to microblogs and other online communities.[2] That's roughly equivalent to the combined population of France, Germany, Italy, Spain, and the United Kingdom. In addition, China's online users spend more than 40 percent of their time online on social media, a figure that continues to rise rapidly.

This appetite for all things social has spawned a dizzying array of companies, many with tools more advanced than those in the West: for example, Chinese users were able to embed multimedia content in social media more than

[1] These figures are sourced from Internet World Stats data, as of December 2011 (US figures from March 2011).

[2] A McKinsey survey on Chinese consumers, *China's social-media boom* (available on the McKinsey Greater China Web site, mckinseychina.com), also finds that 91 percent of Internet users in tier-one to tier-three cities use social media. Tier-one cities include Beijing, Guangzhou, Shanghai, and Shenzhen. Tier two comprises about 40 cities, tier three about 170. The tiers are defined by urban population and by economic factors, such as GDP and GDP per capita.

18 months before Twitter users could do so in the United States. Social media began in China in 1994 with online forums and communities and migrated to instant messaging in 1999. User review sites such as Dianping emerged around 2003. Blogging took off in 2004, followed a year later by social-networking sites with chatting capabilities such as Renren. Sina Weibo launched in 2009, offering microblogging with multimedia. Location-based player Jiepang appeared in 2010, offering services similar to foursquare's.

This explosive growth shows few signs of abating, a trend that's at least partially attributable to the fact that it's harder for the government to censor social media than other information channels. That's one critical way the Chinese market is unique. As you shape your own social-media strategy, it's important to fully understand some other nuances of the country's consumers, content, and platforms.

Consumers

China's social-media users not only are more active than those of any other country but also, in more than 80 percent of all cases, have multiple social-media accounts, primarily with local players (compared with just 39 percent in Japan).[3] The use of mobile technologies to access social media is also increasingly popular in China: there were more than 100 million mobile social users in 2010, a number that is forecast to grow by about 30 percent annually.[4] Finally, because many Chinese are somewhat skeptical of formal institutions and authority, users disproportionately value the advice of opinion leaders in social networks. An independent survey of moisturizer purchasers, for example, observed that 66 percent of Chinese consumers relied on recommendations from friends and family, compared with 38 percent of their US counterparts.

Content

The competition for consumers is fierce in China's social-media space. Many companies regularly employ "artificial writers" to seed positive content about themselves online and attack competitors with negative news they hope will go viral. In several instances, negative publicity about companies—such as allegations of product contamination—has prompted waves of microblog posts from competitors and disguised users. Businesses trying to manage social-media crises should carefully identify the source of negative posts and base countermeasures on whether they came from competitors or real consumers. Companies must also factor in the impact of artificial writers when mining for social-media consumer insights and comparing the performance of their brands against that of competitors. Otherwise, they risk drawing the wrong conclusions about consumer behavior and brand preferences.

Platforms

China's social-media sector is very fragmented and local. Each social-media and e-commerce platform has at least two major local players: in microblogging (or weibo), for example, Sina Weibo and Tencent Weibo; in social networking, a number of companies, including Renren and Kaixin001. These players have different strengths, areas of focus, and, often, geographic priorities. For marketers, this fragmentation increases the complexity of the social-media landscape in China and requires significant resources and expertise, including a network of partners to help guide the way. Competition is evolving quickly—marketers looking for partners should closely monitor development of the sector's platforms and players.

Crafting a winning strategy

While these unique Chinese market characteristics often create challenging wrinkles for marketers to

[3] Figures are sourced from *China's social-media boom*.
[4] Figures are sourced from IDC and iResearch.

contend with, they don't invalidate the principles that underpin effective social-media strategy elsewhere. The following few examples illustrate how companies are applying some widespread social-media tenets in China.

Make content authentic and user oriented. Estée Lauder's Clinique brand launched a drama series, *Sufei's Diary*, with 40 episodes broadcast daily on a dedicated Web site. (Viewers also could watch segments on monitors located on buses, trains, and airplanes.) While skin care was part of the story line and products were prominently featured, *Sufei's Diary* was seen as entertainment—not a Clinique advertisement—and has been viewed online more than 21 million times. Clinique's online brand awareness is now 27 percent higher than that of its competitors, although social-media content costs significantly less than a traditional advertising campaign.

Adopt a test-and-learn approach. When Dove China first imported the Real Beauty social-media campaign to promote beauty among women of all looks and body types, Chinese consumers viewed the real women as overweight and unattractive. Dove switched tack and partnered with *Ugly Wudi*, the Chinese adaptation of the US television show *Ugly Betty*, to weave the Real Beauty message into story lines and mount a number of initiatives, including a blog by Wudi and live online chats. The effort generated millions of searches and blog entries, increased uptake of Dove body wash by 21 percent year over year after the show's first season, and increased unaided awareness of Dove's Real Beauty by 44 percent among target consumers. The estimated return on investment from this social-media campaign was four times that of a traditional TV media investment.

Support overarching brand goals with sustained social-media efforts. Starbucks China promotes the same message of quality, social responsibility, and community building across all of its social-media efforts, as well as in its stores. And Durex didn't just establish a corporate account on Sina Weibo: it built a marketing team that both monitors online comments around the clock and collaborates closely with agency partners to create original, funny content. The company's approach is designed to interact meaningfully with fans, generate buzz, and deepen customer engagement with the brand.

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In China, the estimated return on investment for Dove's Real Beauty social-media campaign was four times that of a traditional TV media investment.

The sheer number of the more than 300 million social-media users in China creates unique challenges for effective consumer engagement. People expect responses to each and every post, for example, so companies must develop new models and processes for effectively engaging individuals in a way that communicates brand identity and values, satisfies consumer concerns, and doesn't lead to a negative viral spiral. Another problem is the difficulty of developing and tracking reliable metrics to gauge a social-media strategy's performance, given the size of the user base, a lack of analytical tools (such as those offered by Facebook and Google in other markets), and limited transparency into leading platforms. Yet these challenges should not deter companies. The similarity between the ingredients of success in China and in other markets makes it easier—and well worth the trouble—to cope with the country's many peculiarities.

The authors would like to acknowledge the contributions of TC Chu, Davis Lin, and Yael Taqqu to the development of this article.

Cindy Chiu (Cindy_Chiu@McKinsey.com) is a consultant in McKinsey's Shanghai office, where **Ari Silverman** (Ari_Silverman@McKinsey.com) is a principal; **Chris Ip** (Chris_Ip@McKinsey.com) is a director in the Singapore office.

JUMPING IN

Seriously committing to emerging markets often means reallocating capital and people in dramatic ways. “Parsing the growth advantage of emerging-market companies” reveals that players headquartered in emerging markets have been reinvesting revenues and redeploying assets more flexibly than their counterparts from developed markets—and they have grown faster as well, both at home and abroad.

Job one for many multinationals: making deeper investments in innovative, emerging market–oriented product development. “A CEO’s guide to innovation in China” surveys the scene in the world’s biggest emerging market, where global and local players bring contrasting strengths and weaknesses to the competition ahead. “Three snapshots of Chinese innovation” then shows the rapid progress of three sectors—autos, semiconductors, and pharmaceuticals—in developing new products that are tailored to local conditions.

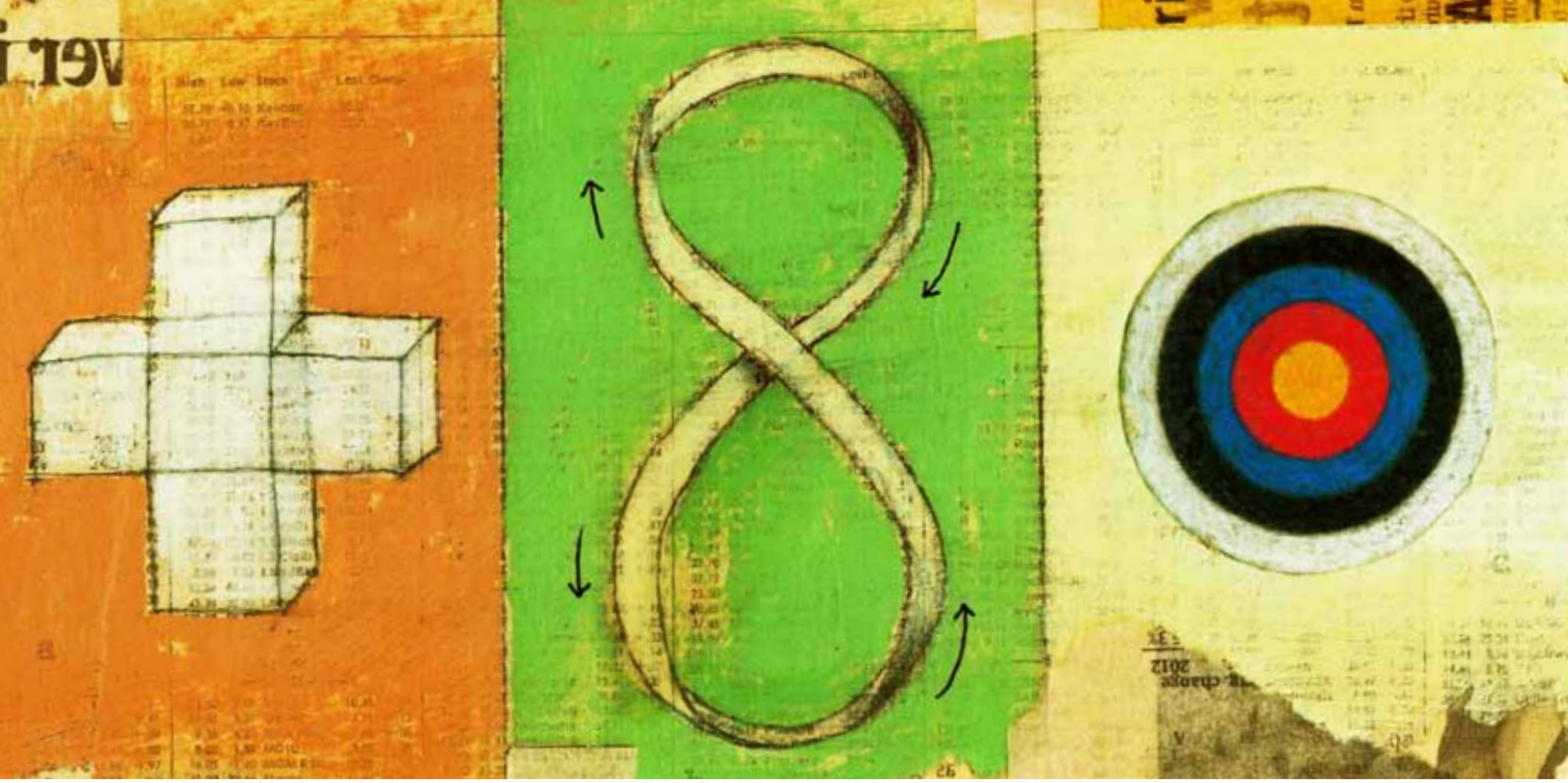
Innovative thrusts aren’t enough, of course: product strategies that strike the right balance between meeting emerging-market needs and preserving global efficiencies are a financial necessity. “Capturing the world’s emerging middle class” lays out four category-specific approaches for developing compelling product offerings quickly and at scale.

In this section

Illustration by Daniel Hertzberg

The process of building brands and engaging emerging-market consumers also requires major investments that differ in crucial respects from established practices. Like consumers everywhere, those in emerging markets are making decisions in a less linear way than in the past—following more iterative journeys involving multiple information sources and feedback loops. And as we explain in "Building brands in emerging markets," brands and channels are in such flux that it's particularly important in these markets to develop positive word of mouth, get into the consumer's initial list of choices, and strengthen in-store merchandising.

That last requirement is more difficult when retail is highly fragmented—as is still the case in many emerging markets, despite pockets of rapid growth for both local and multinational chain retailers. "Selling to mom-and-pop stores in emerging markets" suggests that to keep the traditional retail channel profitable, consumer goods makers should adopt a segmentation approach that allows for greater customization of promotions, displays, and incentives. Fragmented retail is a signature feature of business life in Africa, which is the focus of this section's final feature, "How we do it: Three executives offer advice on competing in Africa." The article illustrates the level of commitment that companies such as Coca-Cola, Standard Bank, and Absa are already making.



Artwork by David Lesh

Parsing the growth advantage of emerging-market companies

Surprisingly little of their edge is attributable to starting from a smaller revenue base. They also seem to invest more, allocate resources more fluidly, and spot fast-growing segments.

Yuval Atsmon, Michael Kloss, and Sven Smit

Leaders of multinational companies are by now well aware of the growth potential that emerging-market consumers represent, an opportunity that we estimate could exceed $20 trillion annually by the end of this decade.[1] Many multinational players, however, don't seem to be capturing that growth as well as their emerging-market counterparts are. That came to light last year as part of ongoing research that began more than five years ago and was the foundation for *The Granularity of Growth*.[2] We examined the growth rates of companies headquartered in developed economies and compared them with those of companies domiciled in emerging markets, examining performance in both developed and emerging markets. One striking finding was that companies headquartered in emerging markets grew roughly twice as fast as those domiciled in developed economies—and two and a half times as fast when both were competing in emerging markets that represented "neutral" turf, where neither company was headquartered.

One potential explanation was that the smaller size of emerging-market business segments would explain a large part of the outperformance. In essence, emerging-market businesses were growing faster from a smaller base. The smaller base point was true: the average revenue for business units of emerging-economy companies in our sample, at $3 billion, was less than half of the $8 billion size for units from developed-

[1] See David Court and Laxman Narasimhan, "Capturing the world's emerging middle class," page 86.

[2] See Mehrdad Baghai, Sven Smit, and Patrick Viguerie, *The Granularity of Growth: How to Identify the Sources of Growth and Drive Enduring Company Performance*, Hoboken, NJ: Wiley, 2008; and Sumit Dora, Sven Smit, and Patrick Viguerie, "Drawing a new road map for growth," mckinseyquarterly.com, April 2011.

economy companies. We've recently done further research, however, to isolate the effects of size on the performance gap. Specifically, we compared the growth rates of $3 billion and $8 billion firms within the developed-market sample and found that $3 billion companies grew at 10.7 percent annually over the period we studied, while $8 billion companies grew by 7.3 percent. On this basis, the smaller size of emerging-market businesses, on average, accounts for 3.4 percentage points of the growth gap, or, at most, a quarter of the overall 13-percentage-point differential (Exhibit 1).

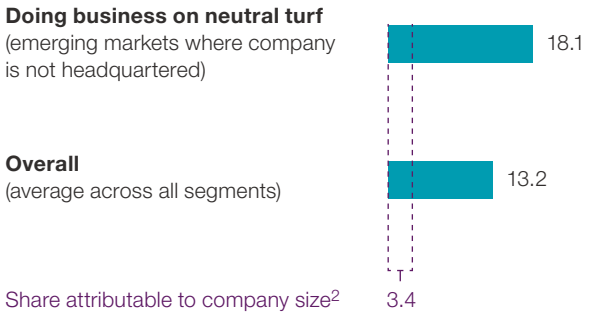
It is impossible to definitively disaggregate the sources of the remaining growth differential. However, the following three factors appear to be materially different for these two classes of companies:

Higher reinvestment rates. Emerging-market companies paid dividends at a lower rate than developed-market companies, returning only 39 percent of earnings to shareholders, while developed-market companies returned close to 80 percent. They also reinvested excess cash to grow fixed assets at a higher rate: 12 percent annually versus 7 percent for developed-market companies (Exhibit 2). The company in our sample with the highest rate of growth in fixed assets—roughly 30 percent annually over the last decade—was South Africa's Mobile Telephone Networks. For most of that period, rapid asset growth accompanied aggressive expansion in the company's Internet and cellular services in Africa and the Middle East. More recently, the company has been moving into mobile-money services, especially in African countries that lack financial infrastructure. This, too, has

Exhibit 1

Companies in emerging markets grew faster than those based in developed economies—and size explained only a fraction of the differential.

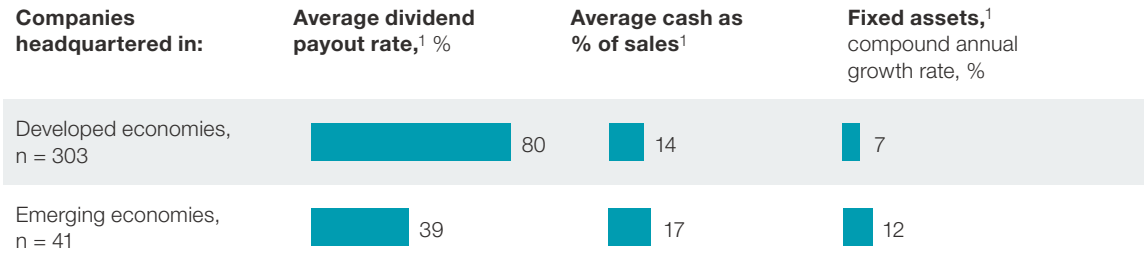
Growth rate advantage for companies with emerging-market headquarters, 1999–2008,[1] percentage points



[1]Based on growth decomposition analysis of 720 companies and their geographic business segments, analyzed on multiple time frames between 1999 and 2008.
[2]Based on difference in growth rate between 2 sets of developed-market companies that mirror the average segment size of emerging- and developed-market companies in our sample.

Exhibit 2

Low dividend payouts and high fixed-asset growth suggest emerging-market companies were reinvesting more aggressively.



[1]Based on results for companies over multiple time frames between 1999 and 2008; fixed assets include net additions to assets from inorganic activities.

required significant investment—for example, $784 million on recent network expansion in Ghana and $1 billion on its Nigerian network.

Agile asset reallocation. Additionally, we found that on average, emerging-market companies have been reallocating capital toward new business opportunities more dynamically than those headquartered in developed economies. Companies in India, for instance, consistently redeployed investments across business units at a higher rate than US companies.[3] India's Kesoram Industries is a notable example, shifting 80 percent of its capital across business units over the seven years we studied. Up until 2005, the company focused most of its capital expenditures on rayon and cement. Beginning in 2007, however, it moved the majority of new investments to the tire business to capture the double-digit growth in India's automobile sector, which has been spurred by improving highway infrastructure. This type of strategic reallocation, our research has shown, is correlated with higher total returns to shareholders over time.[4] Potentially contributing to agility was the fact that majority shareholders comprised a much more influential bloc among emerging-market companies than at developed-economy companies.[5] Although we aren't suggesting this is the ideal governance model under all circumstances, it does create conditions for more effective shareholder alignment and more rapid decisions.

Growth-oriented business models. Emerging-market companies generally serve the needs of fast-growing emerging middle classes around the world with lower-cost products. Developed-economy companies tend to rely more on brand recognition while targeting higher-margin segments, which are relatively smaller and thus less likely to move the needle on the companies' overall growth rates. We found that across a number of product segments—such as soft drinks, telecom services, and mobile phones—emerging-market companies' price points were 10 to 60 percent below those of developed-market counterparts. Even in business segments such as construction equipment, emerging-market players offered more products at lower prices.

Consistent with that growth model has been the focus of many emerging-market players on R&D investments aimed at lower-cost products that fit developing-market conditions (and

[3]Median index of capital expenditure reallocation of companies in India was 42 percent during the period from 2003 to 2010, versus 35 percent for companies in the United States from 1998 to 2005.

[4]See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinseyquarterly.com, March 2012.

[5]In emerging-market companies, the median stake held by a majority shareholder was 40 percent, while at developed-market companies it was 10 percent.

Exhibit 3

Developed-market companies have filed more patents, but emerging-market companies have been gaining ground rapidly.

Companies headquartered in:	Average number of patents filed in 2010		Growth rate of patents filed, 2000–10, CAGR,[1] %		
	In emerging economies	In developed economies	In emerging economies	In developed economies	Overall
Developed economies	153	547	9	4	5
Emerging economies	18	71	22	14	16

[1]Compound annual growth rate; excludes domestic markets.

Source: World Intellectual Property Organization (WIPO); McKinsey analysis

sometimes fuel "reverse innovation," which can make a dent in developed markets). While in aggregate, emerging-market companies file significantly fewer patents than their developed-market counterparts, they are starting to catch up (Exhibit 3), and a few innovation leaders are emerging. Chinese manufacturer Huawei, for example, was among the world's top five companies in terms of international patents filed from 2008 to 2010. Huawei had 51,000 R&D employees in 2010, representing a stunning 46 percent of its total head count, and placed them in 20 research institutes in countries such as Germany, India, Russia, Sweden, and the United States. Efforts such as these could boost the intensity of global competition.

As the locus of future growth continues to shift to emerging markets, companies across regions should be thinking systematically about strategies for pursuing it. For many companies, a clear understanding of where to place their bets will be key, and some will need to grapple with ways to overcome organizational inertia. Business unit leaders, for example, may resist cutting costs in home markets in order to invest more in emerging markets. Many companies, meantime, still find it difficult to convince senior executives to relocate to unfamiliar locations and they may be reluctant to move teams en masse to emerging areas. In the quest to direct resources to regions with the greatest growth potential, it might be time for global players to start thinking more like emerging-market companies.

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Yuval Atsmon (Yuval_Atsmon@McKinsey.com), who was based in McKinsey's Shanghai office from 2006 to 2012, is a principal in the London office, **Michael Kloss** (Michael_Kloss@McKinsey.com) is a director in the Johannesburg office, and **Sven Smit** (Sven_Smit@McKinsey.com) is a director in the Amsterdam office.

A CEO's guide to innovation in China

Dynamic domestic players and focused multinationals are helping China churn out a growing number of innovative products and services. Intensifying competition lies ahead; here's a road map for navigating it.

Gordon Orr and Erik Roth

China is innovating. Some of its achievements are visible: a doubling of the global percentage of patents granted to Chinese inventors since 2005, for example, and the growing role of Chinese companies in the wind- and solar-power industries. Other developments—such as advances by local companies in domestically oriented consumer electronics, instant messaging, and online gaming—may well be escaping the notice of executives who aren't on the ground in China.

As innovation gains steam there, the stakes are rising for domestic and multinational companies alike. Prowess in innovation will not only become an increasingly important differentiator inside China but should also yield ideas and products that become serious competitors on the international stage.

Chinese companies and multinationals bring different strengths and weaknesses to this competition. The Chinese have traditionally had a bias toward innovation through commercialization—they are more comfortable than many Western companies are with putting a new product or service into the market quickly and improving its performance through subsequent generations. It is common for products to launch in a fraction of the time that it would

take in more developed markets. While the quality of these early versions may be variable, subsequent ones improve rapidly.[1]

Chinese companies also benefit from their government's emphasis on indigenous innovation, underlined in the latest five-year plan. Chinese authorities view innovation as critical both to the domestic economy's long-term health and to the global competitiveness of Chinese companies. China has already created the seeds of 22 Silicon Valley–like innovation hubs within the life sciences and biotech industries. In semiconductors, the government has been consolidating innovation clusters to create centers of manufacturing excellence.

But progress isn't uniform across industries, and innovation capabilities vary significantly: several basic skills are at best nascent within a typical Chinese enterprise. Pain points include an absence of advanced techniques for understanding—analytically, not just intuitively—what customers really want, corporate cultures that don't support risk taking, and a scarcity of the sort of internal collaboration that's essential for developing new ideas.

Multinationals are far stronger in these areas but face other challenges, such as high attrition among talented Chinese nationals that can slow efforts to create local innovation centers. Indeed, the contrasting capabilities of domestic and multinational players, along with the still-unsettled state of intellectual-property protection (see sidebar, "Improving the patent process"), create the potential for topsy-turvy competition, creative partnerships, and rapid change. This article seeks to lay out the current landscape for would-be innovators and to describe some of the priorities for domestic and multinational companies that hope to thrive in it.

China's innovation landscape

Considerable innovation is occurring in China in both the business-to-consumer and business-to-business sectors. Although breakthroughs in either space generally go unrecognized by the broader global public, many multinational B2B competitors are acutely aware of the innovative strides the Chinese are making in sectors such as communications equipment and alternative energy. Interestingly, even as multinationals struggle to cope with Chinese innovation in some areas, they seem to be holding their own in others.

The business-to-consumer visibility gap

When European and US consumers think about what China makes, they reflexively turn to basic items such as textiles and toys, not necessarily the most innovative products and rarely associated with brand names.

In fact, though, much product innovation in China stays there. A visit to a shop of the Suning Appliance chain, the large Chinese consumer electronics retailer, is telling. There, you might find an Android-enabled television complete with an integrated Internet-browsing capability and preloaded apps that take users straight to some of the most popular Chinese Web sites and digital movie-streaming services. Even the picture quality and industrial design are comparable to those of high-end televisions from South Korean competitors.

We observe the same home-grown innovation in business models. Look, for example, at the online sector, especially Tencent's QQ instant-

[1] Commercialization differs from *shanzhai*, or "copycat innovation." Many executives in the developed world misunderstand *shanzhai*, believing that it is purely the replication of an innovation developed in another market. Although this does occur, products developed through the *shanzhai* approach incorporate features specifically for the Chinese market. *Shanzhai* is quite prevalent in consumer products categories such as packaged goods and electronics. It can also be found in the business-to-business domain, where local companies produce knockoffs of successful foreign products or business models.

messaging service and the Sina Corporation's microblog, Weibo. These models, unique to China, are generating revenue and growing in ways that have not been duplicated anywhere in the world. QQ's low, flat-rate pricing and active marketplace for online games generate tremendous value from hundreds of millions of Chinese users.

What's keeping innovative products and business models confined to China? In general, its market is so large that domestic companies have little incentive to adapt successful products for sale abroad. In many cases, the skills and capabilities of these companies are oriented toward the domestic market, so even if they want to expand globally, they face high hurdles. Many senior executives, for example, are uncomfortable doing business outside their own geography and language. Furthermore, the success of many Chinese models depends on local resources—for example, lower-cost labor, inexpensive land, and access to capital or intellectual property—that are difficult to replicate elsewhere. Take the case of mobile handsets: most Chinese manufacturers would be subject to significant intellectual property–driven licensing fees if they sold their products outside China.

Successes in business to business

Several Chinese B2B sectors are establishing a track record of innovation domestically and

Improving the patent process

In innovative sectors such as biotechnology, electric vehicles, pharmaceuticals, and solar energy, the number of patent applications from Chinese companies is rising. In fact, Huawei and ZTE ranked among the world's top five corporate patent registrants by volume in 2010. Intensifying patent activity reflects a growing recognition that intellectual property is essential to value. As this mentality takes hold, domestic innovators may pressure the government to create a more modern intellectual-property system.

Currently, China recognizes three categories of patents: invention (what most people elsewhere think of as worthy of a patent), utility (a new use for something that already exists), and design. Invention patents run for 20 years, the others only for 10. Patent reform—such as reducing the duration of design or utility patents and raising the bar for what can be registered in those categories—would be a powerful way for the Chinese government to signal its seriousness about promoting indigenous innovation. If China decides to move ahead with patent reform, a desire for global consistency could well make it a high-priority multilateral issue.

Without patent reform, companies must rely on one of two strategies for protecting intellectual property. The first is to continue to outrun the competition by developing increasingly innovative solutions or building in protection through complex integration that is difficult to reverse engineer. The second is to create easily identifiable technology "signatures" that would be hard to refute in legal proceedings.

A Chinese-built high-speed train at the Wuhan Railway Station, in Wuhan, China.

globally. The Chinese communications-equipment industry, for instance, is a peer of developed-world companies in quality. Market acceptance has expanded well beyond the historical presence in emerging markets to include Europe's most demanding customers, such as France Télécom and Vodafone.

Pharmaceuticals are another area where China has made big strides. In the 1980s and 1990s, the country was a bit player in the discovery of new chemical entities. By the next decade, however, China's sophistication had grown dramatically. More than 20 chemical compounds discovered and developed in China are currently undergoing clinical trials.

China's solar- and wind-power industries are also taking center stage. The country will become the world's largest market for renewable-energy technology, and it already has some of the sector's biggest companies, providing critical components for the industry globally. Chinese companies not only enjoy scale advantages but also, in the case of solar, use new manufacturing techniques to improve the efficiency of solar panels.

Success in B2B innovation has benefited greatly from friendly government policies, such as establishing market access barriers; influencing the nature of cross-border collaborations by setting intellectual-property requirements in electric vehicles, high-speed trains, and other segments; and creating domestic-purchasing policies that favor Chinese-made goods and services. Many view these policies as loading the dice in favor of Chinese companies, but multinationals should be prepared for their continued enforcement.

Despite recent setbacks, an interesting example of how the Chinese government has moved to build an industry comes from high-speed rail. Before 2004, China's efforts to develop it had limited success. Since then, a mix of two policies—encouraging technology transfer from multinationals (in return for market access) and a coordinated R&D-investment effort—has helped China Railways' high-speed trains to dominate the local industry. The multinationals' revenue in this sector has remained largely unchanged since the early 2000s.

But it is too simplistic to claim that government support is the only reason China has had some B2B success. The strength of the country's scientific and technical talent is growing, and local companies increasingly bring real capabilities to the table. What's more, a number of government-supported innovation efforts have not been successful. Some notable examples include attempts to develop an indigenous 3G telecommunications protocol called TDS-CDMA and to replace the global Wi-Fi standard with a China-only Internet security protocol, WAPI.

Advantage, multinationals?

Simultaneously, multinationals have been shaping China's innovation landscape by leveraging global assets. Consider, for example, the joint

venture between General Motors and the Shanghai Automotive Industry Corporation, which adapted a US minivan (Buick's GL8) for use in the Chinese market and more recently introduced a version developed in China, for China. The model has proved hugely popular among executives.

In fact, the market for vehicles powered by internal-combustion engines remains dominated by multinationals, despite significant incentives and encouragement from the Chinese government, which had hoped that some domestic automakers would emerge as leaders by now. The continued strength of multinationals indicates how hard it is to break through in industries with 40 or 50 years of intellectual capital. Transferring the skills needed to design and manufacture complex engineering systems has proved a significant challenge requiring mentorship, the right culture, and time.

We are seeing the emergence of similar challenges in electric vehicles, where early indications suggest that the balance is swinging toward the multinationals because of superior product quality. By relying less on purely indigenous innovation, China is trying to make sure the electric-vehicle story has an ending different from that of its telecommunications protocol efforts. The government's stated aspiration of having more than five million plug-in hybrid and battery electric vehicles on the road by 2020 is heavily supported by a mix of extensive subsidies and tax incentives for local companies, combined with strict market access rules for foreign companies and the creation of new revenue pools through government and public fleet-purchase programs. But the subsidies and incentives may not be enough to overcome the technical challenges of learning to build these vehicles, particularly if multinationals decline to invest with local companies.

Four priorities for innovators in China

There's no magic formula for innovation—and that goes doubly for China, where the challenges and opportunities facing domestic and multinational players are so different. Some of the priorities we describe here, such as instilling a culture of risk taking and learning, are more pressing for Chinese companies. Others, such as retaining local talent, may be harder for multinationals. Collectively, these priorities include some of the critical variables that will influence which companies lead China's innovation revolution and how far it goes.

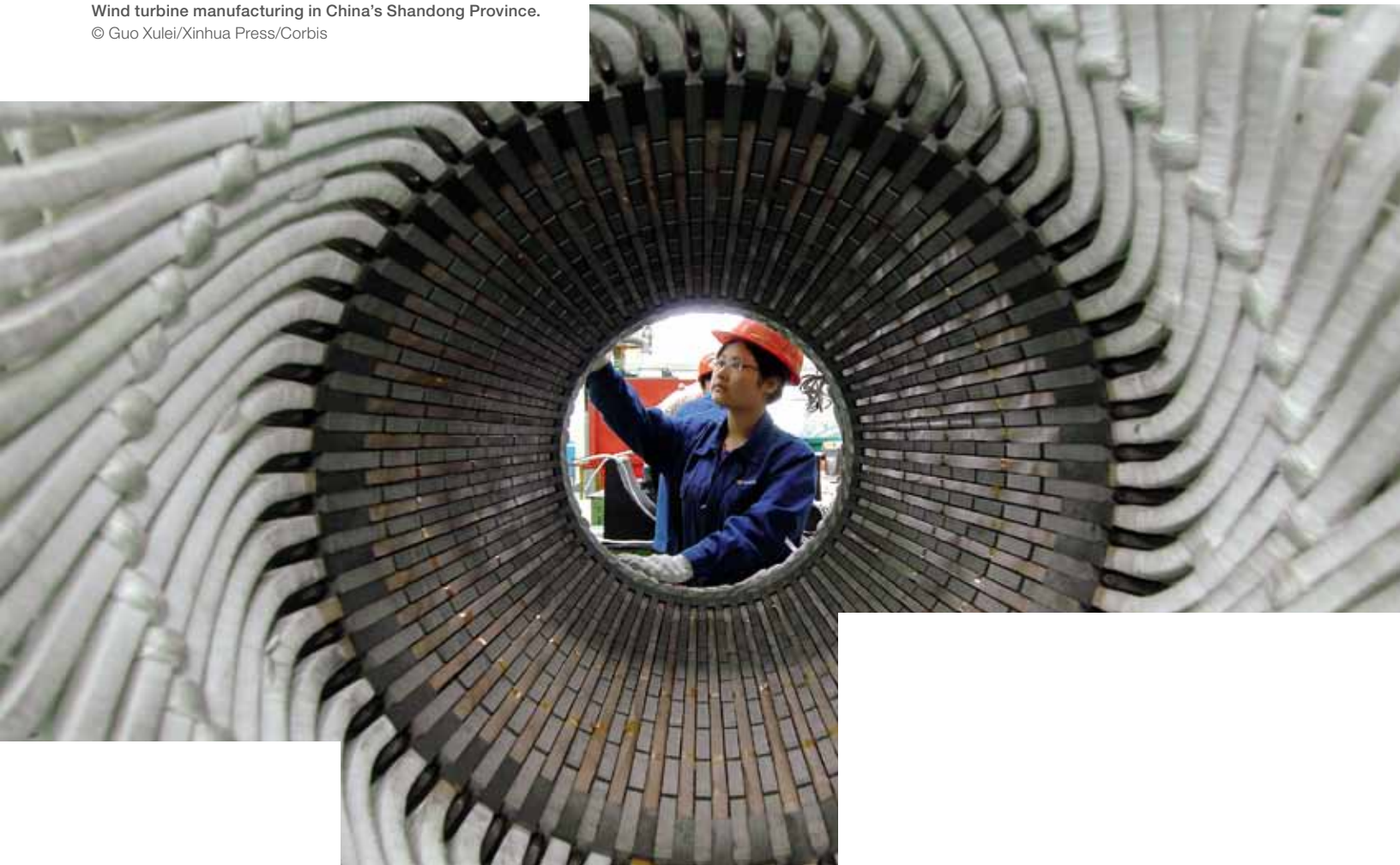
Deeply understanding Chinese customers

Alibaba's Web-based trading platform, Taobao, is a great example of a product that emerged from deep insights into how customers were underserved and their inability to connect with suppliers, as well as a sophisticated understanding of the Chinese banking system. This dominant marketplace enables thousands of Chinese manufacturers to find and transact with potential customers directly. What looks like a straightforward eBay-like trading platform actually embeds numerous significant innovations to support these transactions, such as an ability to facilitate electronic fund transfers and to account for idiosyncrasies in the national banking system. Taobao wouldn't have happened without Alibaba's deep, analytically driven understanding of customers.

Few Chinese companies have the systematic ability to develop a deep understanding of customers' problems. Domestic players have traditionally had a manufacturing-led focus on reapplying existing business models to deliver products for fast-

growing markets. These "push" models will find it increasingly hard to unlock pockets of profitable growth. Shifting from delivery to creation requires more local research and development, as well as the nurturing of more market-driven organizations that can combine insights into detailed Chinese customer preferences with a clear sense of how the local business environment is evolving. Requirements include both research techniques relevant to China and people with the experience to draw out actionable customer insights.

Many multinationals have these capabilities, but unless they have been operating in China for some years, they may well lack the domestic-market knowledge or relationships needed to apply them effectively. The solution—building a true domestic Chinese presence rather than an outpost—sounds obvious, but it's difficult to carry out without commitment from the top. Too many companies fail by using "flyover" management. But some multinationals appear to be investing the necessary resources; for example, we recently met (separately) with top executives of two big industrial companies who were being transferred from the West to run global R&D organizations from Shanghai. The idea is to be closer to Chinese customers and the network of institutions and universities from which multinationals source talent.



Wind turbine manufacturing in China's Shandong Province.

Retaining local talent

China's universities graduate more than 10,000 science PhDs each year, and increasing numbers of Chinese scientists working overseas are returning home. Multinationals in particular are struggling to tap this inflow of researchers and managers. A recent survey by the executive-recruiting firm Heidrick & Struggles found that 77 percent of the senior executives from multinational companies responding say they have difficulty attracting managers in China, while 91 percent regard employee turnover as their top talent challenge.

Retention is more of an issue for multinationals than for domestic companies, but as big foreign players raise their game, so must local ones. Chinese companies, for example, excel at creating a community-like environment to build loyalty to the institution. That helps keep some employees in place when competing offers arise, but it may not always be enough.

Talented Chinese employees increasingly recognize the benefits of being associated with a well-known foreign brand and like the mentorship and training that foreign companies can provide. So multinationals that commit themselves to developing meaningful career paths for Chinese employees should have a chance in the growing fight with their Chinese competitors for R&D talent. Initiatives might include in-house training courses or apprenticeship programs, perhaps with local universities. General Motors sponsors projects in which professors and engineering departments at leading universities research issues of interest to the automaker. That helps it to develop closer relations with the institutions from which it recruits and to train students before they graduate.

Some multinationals energize Chinese engineers by shifting their roles from serving as capacity in support of existing global programs to contributing significantly to new innovation thrusts, often aimed at the local market. This approach, increasingly common in the pharma industry, may hold lessons for other kinds of multinationals that have established R&D or innovation centers in China in recent years. The keys to success include a clear objective—for instance, will activity support global programs or develop China-for-China innovations?—and a clear plan for attracting and retaining the talent needed to staff such centers. Too often, we visit impressive R&D facilities, stocked with the latest equipment, that are almost empty because staffing them has proved difficult.

Instilling a culture of risk taking

Failure is a required element of innovation, but it isn't the norm in China, where a culture of obedience and adherence to rules prevails in most companies. Breaking or even bending them is not expected and rarely tolerated. To combat these attitudes, companies must find ways to make initiative taking more acceptable and better rewarded.

One approach we found, in a leading solar company, was to transfer risk from individual innovators to teams. Shared accountability and community support made increased risk taking and experimentation safer. The company has used these "innovation work groups" to develop everything from more efficient battery technology to new manufacturing processes. Team-based approaches also have proved effective for some multinationals trying to stimulate initiative taking.

Chinese innovation is evolving across a range of industries. Read "Three snapshots of Chinese innovation," page 76, for ground-level views from the automobile, semiconductor, and pharmaceutical industries.

How fast a culture of innovation takes off varies by industry. We see a much more rapid evolution toward the approach of Western companies in the way Chinese high-tech enterprises learn from their customers and how they apply that learning to create new products made for China. That approach is much less common at state-owned enterprises, since they are held back by hierarchical, benchmark-driven cultures.

Promoting collaboration

One area where multinationals currently have an edge is promoting collaboration and the internal collision of ideas, which can yield surprising new insights and business opportunities. In many Chinese companies, traditional organizational and cultural barriers inhibit such exchanges.

Although a lot of these companies have become more professional and adept at delivering products in large volumes, their ability to scale up an organization that can work collaboratively has not kept pace. Their rigorous, linear processes for bringing new products to market ensure rapid commercialization but create too many hand-offs where insights are lost and trade-offs for efficiency are promoted.

One Chinese consumer electronics company has repeatedly tried to improve the way it innovates. Senior management has called for new ideas and sponsored efforts to create new best-in-class processes, while junior engineers have designed high-quality prototypes. Yet the end result continues to be largely undifferentiated, incremental improvements. The biggest reason appears to be a lack of cross-company collaboration and a reliance on processes designed to build and reinforce scale in manufacturing. In effect, the technical and commercial sides of the business don't cooperate in a way that would allow some potentially winning ideas to reach the market. As Chinese organizations mature, stories like this one may become rarer.

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China hasn't yet experienced a true innovation revolution. It will need time to evolve from a country of incremental innovation based on technology transfers to one where breakthrough innovation is common. The government will play a powerful role in that process, but ultimately it will be the actions of domestic companies and multinationals that dictate the pace of change—and determine who leads it.

Gordon Orr (Gordon_Orr@McKinsey.com) is a director in McKinsey's Shanghai office, where **Erik Roth** (Erik_Roth@McKinsey.com) is a principal.

Three snapshots of Chinese innovation

Automobiles:
Kevin Wale
President and managing director, GM China

Semiconductors:
Robert Dvorak, Sri Kaza, and Nick Santhanam
McKinsey & Company

Pharmaceuticals:
Steve Yang
Vice president and head of R&D for Asia and emerging markets, AstraZeneca

Chinese innovation is evolving in diverse ways and at an uneven pace across a range of different industries. Presented here are ground-level views from three of them: automobiles, semiconductors, and pharmaceuticals.

General Motors and its Chinese joint-venture partners sold more cars in 2010 in China (2.35 million units) than in the United States (around 2.2 million units). In an edited version of an interview with McKinsey's Glenn Leibowitz and Erik Roth, GM China president Kevin Wale explains the importance of team-based innovation efforts in China and describes GM's rapidly growing Advanced Technical Center in Shanghai. He also observes that innovation in China's auto industry is more about commercialization models than technical achievements.

While automotive innovation has had years to take hold, innovation on the leading edge of the semiconductor business remains nascent. But barriers that once held back local chip makers now appear to be eroding. This means global players will face some tough trade-offs in the years ahead. The challenge: how to participate in China's growth—which may well require joint ventures with domestic players—without sacrificing valuable intellectual property. McKinsey's Bob Dvorak, Sri Kaza, and Nick Santhanam describe this dilemma and present a few ideas for multinational companies trying to overcome it.

Finally, Steve Yang, head of R&D for Asia and emerging markets for the global drugmaker AstraZeneca, articulates some key differences between pharma development in China and Western markets. The starting point: different disease prevalence (gastric and liver cancer, for example, are more prevalent in China). In an edited version of an interview with McKinsey's Jeremy Teo, Yang describes new models of innovation that could emerge from China, as well as the long-term commitment to talent development that will be needed for AstraZeneca's Chinese research center to reach its innovative potential.

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Kevin Wale

Automotive innovation in China:
The view from General Motors

Innovation through commercialization

There's probably more innovation in going to market and in thinking about new business opportunities than there is in technical innovation. Technical innovation is lagging behind the rest of the world in maturity. The country is trying to get there as quickly as it can but doesn't have the deep graduate research capability that the rest of the world has.

What China does better than any place else in the world is to innovate by commercialization, as opposed to constant research and perfecting the theory, like the West. When the Chinese get an idea, they test it in the marketplace. They're happy to do three to four rounds of commercialization to get an idea right, whereas in the West companies spend the same amount of time on research, testing, and validation before trying to take products to market. The electric vehicle is a good example. The Chinese view is that it's not going to be perfect, and they're not trying to make it perfect from day one. They've got a few more series of improvements to go, and they'll work on them in parallel with finding out what the customer really likes and adapting to that. That's an innovative way of doing innovation, something that the rest of the world is struggling to understand. In our business in China, if we don't innovate through or with commercialization, we're going to lag behind our competitors.

The power of teamwork

We're trying to set up a small unit that is designed to focus on what some people call "innovation," but what I call "predator versus prey." Everyone's coming after us, and we want to stay the predator. The only way to do that is by having people who are focused on who is doing what to us and where the opportunities are.

We find the deployment of small task teams is by far the best approach to drive these innovative ideas. Take OnStar,[1] for instance, which was actually quite innovative for this market. The way we did it was well ahead of others. These systems are released by code, and they're now up to OnStar 8. We deployed the absolute latest and went straight to 8; we didn't start at 1. It was a calculated risk that we could make a business model that could benefit from this technology and cover the significant cost and technical support required to support that. Being out there, it feels like you're in the Wild West. Four to five of you are in a team. You don't have a lot support, but a lot of responsibility.

In our joint ventures, we're happy to take innovation from suppliers any day of the week. We encourage suppliers to come up with new ideas. We have a lot of local technology in our cars. Our people wanted to lead and they worked with suppliers to develop new ways of doing things. Lighting systems and infotainment are pretty much at the cutting edge of what's available.

[1] OnStar, a subsidiary of GM, is a vehicle safety, security, and information service system.

> **"What China does better than any place else in the world is to innovate by commercialization, as opposed to constant research and perfecting the theory, like the West."**

Kevin Wale is the president and managing director of GM China, which he has led since 2005.

R&D and advanced design centers in China

We wanted to take advantage of some of the great talent that's going to be coming out of the universities. They're going to be coming out in droves. They're not at the advanced graduate stage, simply because they don't have the mentors in the system, but they will be coming out, and there's plenty of good talent now that we can staff.

We also want to do research and applied development that is close to the biggest market in the world. It really is very easy to ignore the realities of life when you don't confront them every day. So we want to make sure that we have activity in the market, with people who speak the language, understand the culture, and confront that culture every day. The first building that's going up is a battery lab. With the electric vehicle, there will be a lot of suppliers, a lot of government support; the rules will be different, and the applications will be different. We want to be here, where we will be learning that every day and reacting to it every day. It's the same research capability we have in Detroit, but we're able to do the work here and frame it around real local knowledge.

For the full version of this interview, see "Innovating in China's automotive market: An interview with GM China's president," on mckinseyquarterly.com.

We also will have an advanced design center here for the same reason. It's hard to imagine doing advanced design without taking into account the influence of the largest and fastest-growing market in the world. So we're putting in a starting point where we will have the basis for future creativity in the country.

The leader of our R&D is a local Chinese who has worked in R&D in China and has excellent connections with the local universities. We also have excellent connections with universities, and we run multiple projects through a program called "PACE"[2] and through cooperative development. That will be the starting ground for recruiting.

Also, we're offering more internships than we normally do because we want to take the best young technical talent. Initially, we will supplement them with skilled researchers from the rest of the world, primarily the United States. But at the end of the day, we will use local skilled talent. We don't see a problem for the size of what we're doing here. It's a big site, but it's not a big number of people at a particular time—probably 300 people to start with—among all those areas: design, advanced research, powertrain engineering.

Integration with global product development

I'd say with a fair degree of confidence that we integrate our Chinese operations fully into our global operations better than anyone else in the world. If we're working on a global program, we'll be doing serious work down the road the same way as they're doing it in the United States or Germany.

Our engineering centers two years ago introduced the subcompact Chevrolet Sail, which was completely designed here. The low-cost passenger vehicle was difficult to provide out of a global solution because we were trying to cater to too many global needs. That opened the opportunity for the Sail. We were able to focus on addressing a solution that wasn't going to come out of a global package.

The latest Buick GL8 minivan was introduced here and was done pretty quickly through capability that is built here in China, using a combination of on-the-job mentoring, coaching, and expert assistance from overseas, as well as a very structured development process from our global team. The GL8 is an old GM architecture that no one else wanted, but it's a terrific product for China. It has turned into an unbelievably good-looking and highly desirable car. I can't tell you how many senior executives and CEOs ring me up trying to speed up their provision of the GL8.

The Baojun brand is a lower-priced sedan aimed at consumers who live outside of China's major markets. It's just a massive opportunity in China, and the ability to meet the income needs and transportation needs of that group of people was never going to be met by GM in a traditional sense.

[2] Partners for the Advancement of Collaborative Engineering Education.

Kevin Wale's commentary is drawn from an interview with **Glenn Leibowitz** (Glenn_Leibowitz@McKinsey.com), an editor in McKinsey's Taipei office, and **Erik Roth** (Erik_Roth@McKinsey.com), a principal in the Shanghai office.

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Robert Dvorak, Sri Kaza, and Nick Santhanam

Semiconductors: A new source of Chinese innovation?

The semiconductor industry is a powerful example of the tension surrounding China's potential for innovation. The country's leaders understand the important role silicon plays in product innovation,[3] so for two decades they have sought to create a more potent domestic semiconductor industry—with mixed results. China purchases 33 percent of the world's chips ($100 billion worth), using them both in products sold domestically and in exports. But most of the Chinese industry competes in commoditized areas such as chip assembly and testing, and Chinese semiconductor companies hold 4 percent or less of the most prized segments of the global value chain in chip design and manufacturing.

This article highlights four obstacles that have kept the country in check, the potential for their impact to diminish, and the resulting challenge for global producers that have been reluctant to share key elements of intellectual property (IP) with Chinese players.

Shifting winds

Structural changes in the industry and the marketplace, coupled with new industrial policies that promote next-generation technologies and technology transfers from abroad, are combining to weaken the barriers that have held China back.

Chips designed for China's needs

Chinese players have exerted little influence on semiconductor design, technology standards, or chip selection for major product categories such as mobile phones, laptop computers, and LCD televisions. Most decisions about design and

[3] See André Andonian, Christoph Loos, and Luiz Pires, "Building an innovation nation," whatmatters.mckinseydigital.com, March 2009.

functionality come from global champions and reflect the preferences of consumers in Europe, Japan, and the United States.

But that dynamic is shifting, along with the rising economic power of China's middle class, with its increasingly diverse needs. Some Chinese companies are now moving to the forefront of a "built in China, for China" movement. Their clout is likely to mean that more semiconductor platforms will be designed locally. Consider the fact that in 2010, Chinese consumers purchased 19 percent of all PCs sold throughout the world, 18 percent of the LCD TVs, 14 percent of the mobile phones, and 26 percent of the automobiles (all by unit volume).

China's manufacturers, meanwhile, are leveraging this domestic scale to sell in global markets: Lenovo now ranks second in global PC sales and ZTE fourth in the manufacture of handsets. Huawei ranks among the top three world players in all segments of telecom equipment.

Export controls lose their bite

The home governments of leading semiconductor manufacturers have long banned the sale of leading-edge manufacturing technology to China. Current controls by Taiwan and the United States, for example, bar the export of equipment used to make chips below the 65-nanometer threshold.[4] As a result, Chinese manufacturers are at least two generations behind the highest-performing 32-nanometer chips.

Market changes, however, are eroding the impact of these bans. Leading-edge semiconductors represent only 14 percent of global demand—half the market share of 2003—as fewer devices require the highest levels of processing power.[5] That's particularly true of devices favored by China's new consumers, whose purchases often involve entry-level mobile phones and TVs. The result: a more level playing field for China's players, some of which can now use manufacturing processes that are two generations behind to mass-produce chips that represent sizable markets (for example, analog integrated circuits and microcontrollers).

Reordering China's high-tech zones

China's industrial planners made missteps in early efforts to incubate a semiconductor industry. Rather than concentrate investments and incentives in one geographic area, as the Taiwanese did with Hsinchu Science Park, government officials dispersed their bets, financing fabrication sites in 19 cities. This fragmentation hindered the establishment of a vibrant semiconductor ecosystem with clusters of manufacturing prowess and design talent.

China has corrected its course, however, and now is concentrating more investment in a smaller number of cities—for instance, Chengdu, Dalian, and Shanghai. These centers have a stronger base of expertise, as well as a critical mass of manufacturers and suppliers. They are attracting investment from global leaders and developing more broadly based value chains in areas such as wireless communications systems.

A new regime for technology transfer

Foreign players own most of the IP across the semiconductor value chain, and the lion's share of revenue streams for the design of semiconductors and the processes used to manufacture them goes to non-Chinese companies. While the Chinese have found ways to acquire or piece together IP to build a strong position in many industries, the challenge in semiconductors is uniquely difficult because of the complexity of chip design and manufacturing and the high level of materials science that is required.

[4] A designation of the size of semiconductor processing units or nodes. Lower numbers represent greater processing power, with more nodes per chip. Controls generally apply to the two most recent generations of semiconductors.

[5] At the same time, semiconductor manufacture is reaching the limits of Moore's law, which predicts that the performance of semiconductors will rise rapidly while costs decrease. This phenomenon has allowed China to catch up in trailing-edge technologies.

The full version of this article originally appeared in the inaugural issue of *McKinsey on Semiconductors* (September 2011), available on mckinsey.com.

China, however, has one of world's best-funded and ambitious tech industry policies, and acquiring semiconductor know-how and IP remains a high priority. Increasing China's chances for success is a new, two-pronged initiative that will increase the pressure on global companies to share their IP with Chinese partners. The first part involves stepped-up investments and new policy directives that will advance large, next-generation technology platforms such as cloud computing, the Internet of Things,[6] and hybrid electric vehicles. These three markets represent tens of billions of dollars in opportunities for global and domestic semiconductor companies. The second part sets targets for indigenous innovation, with the goal of reducing dependence on foreign technologies to 30 percent, from the current 50 percent. Government purchases of products and services, from mobile phones to cloud-computing networks, will favor products that incorporate high levels of domestically developed technology.

Strategic choices for global players

For global semiconductor players, the dilemma is clear: how to participate in what will probably be the world's most dynamic technology growth environment while safeguarding core IP and know-how. These companies must remember that China seeks to use transferred IP and manufacturing methods to create its own champions that can compete with global countries around the world, not just in the local market.

The experience of high-speed rail players provides a cautionary tale. Global companies were encouraged to form partnerships with Chinese ones to develop a national high-speed network. Some foreign companies favored a relatively restrictive sharing of IP, but a classic prisoner's dilemma[7] scenario played out: the attractiveness of market access gave global players a powerful incentive to ditch hard-line positions. In the end, industry partnerships were formed on less restrictive terms. Within three years, Chinese companies had absorbed key elements of the core technology, and since 2007 they have won nearly $20 billion in new rail contracts.

Global semiconductor players thus will need to be clear about the terms of engagement with potential partners. China's complex fabric of national, provincial, and local policy makers and companies creates a considerable opportunity for customized strategies. Forming ventures with strictly delineated IP transfer terms is the obvious solution. Global leaders such as GE (in rural health care) and ABB (in electric motors and power transmission) are exploring alternatives.

One option is for foreign companies to launch indigenous R&D centers with Chinese universities and institutes and to focus these facilities on developing technologies for unproven but promising next-generation domestic markets. Multinationals that participate in such ventures align themselves with China's goals while they contain IP risks to markets that are still evolving. Another approach is to focus on local product development in partnership with downstream players such as auto manufacturers. This strategy helps multinationals meet local-technology requirements and provides for more active risk management.

[6] For more, see Michael Chui, Markus Löffler, and Roger Roberts, "The Internet of Things," mckinseyquarterly.com, March 2010.

[7] The prisoner's dilemma, a situation analyzed in game theory, shows why two individuals may fail to cooperate, despite the fact that cooperation would seem to be advantageous for both.

The authors would like to acknowledge the contributions of Rajat Mishra and Sid Tandon to the development of this article.

Bob Dvorak (Bob_Dvorak@McKinsey.com) is a director emeritus in McKinsey's Silicon Valley office, where **Sri Kaza** (Sri_Kaza@McKinsey.com) and **Nick Santhanam** (Nick_Santhanam@McKinsey.com) are principals.

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Steve Yang

Pharmaceutical innovation: AstraZeneca's experience in China

What's different about China

There are many unique disease mechanisms in China. Gastric and liver cancers, for example, have high prevalence and, in many cases, could have different populations or different disease etiologies. That presents a white space on which R&D innovation can focus. We can use what we have learned in the West to understand this situation and to try to develop new medicines against those diseases. I hope that will open up new markets and help us meet unmet medical needs of patients in China and the rest of Asia.

Also very important is that China and, to some extent, India have shown the world the importance of conducting R&D with more resource efficiency, particularly by focusing on externalization. This could mean strategic outsourcing of certain R&D functions. It could also mean collaborating with academics or biotech companies, and that's an area in which I believe China can offer tremendous potential not only for our local R&D operation but also for our global R&D.

Finally, there's China's urbanization. There are consequences to the migration to megacities with populations of more than 20 million. In these environments, people will increasingly have a more sedentary lifestyle. In such an environment, with high-density living, how do we continue to help people live a healthy lifestyle, prevent disease, and improve the quality of living? And the challenges and opportunities go beyond just inventing the next pill or vial for injection, to fundamentally thinking about what, with so many people living together, the best way is to prevent

> **We are giving scientists the mandate not only to do good science but also to become good leaders and good managers.**

Steve Yang is vice president and head of R&D for Asia and emerging markets at AstraZeneca, which he joined in January 2011.

disease or at least slow down disease and some of the chronic disease progressions. That is something I don't think the world has really tackled before. The scale of such innovation is where China can offer ground for experimentation.

Progress to date

We have made great progress and built a solid foundation. Our Innovation Center China was announced in 2006 as part of a $100 million investment we made in China, and it was launched in October 2007. During the four years since then, we have accumulated a lot of data, contributed to global oncology research in the area of biomarkers and translational science, and built credibility and a strong team locally. We are ready to expand our mission to become a drug discovery center, with a special focus on cancers prevalent in Asia, such as gastric and liver cancers.

But the journey has just started. If you use as a measure the time needed to develop a new drug, we still have a long way to go. It takes 10 to 15 years to take an idea all the way from a scientist's hypothesis to products on the market. There is a Chinese saying that you may have a destiny, and that final destiny may be very bright, but the road that leads there is inevitably windy and full of challenges. That's the case at both the strategic and operational levels. On a day-to-day basis, managing turnover and retaining and developing talent can be challenging, although in AstraZeneca R&D we are fortunate to have a turnover rate well below the industry average. Also, AstraZeneca is a multinational company, and the majority of our senior leaders, our resources, and our stakeholders are thousands of miles and many time zones away. Constantly gathering their support and commitment is very important.

Finally, we have seen a significant improvement in the IP environment. But, because of the rapid development of the legislative environment and the regulatory framework, there is a constant flow of amendments to policies on the IP law. In many cases, it took some time for the government, the legislature, and enforcement agencies, as well as industry, to understand fully what those new regulations meant. That's just natural growing pains. In IP law, there has been a recent commitment reflecting the government's increasing understanding of the importance of IP, but we hope to have more clarity around how those new laws will be interpreted and enforced.

The talent situation

There are a large number of scientists available, trained either overseas or locally. We have seen significant quality of talent both in the returnee population and in the locally educated population. There are disciplines—for example, chemistry and general biology—that tend to follow this trend. There are also disciplines that are

For the full version of this interview, see "Innovating in China's pharma market: An interview with AstraZeneca's head of R&D in Asia and emerging markets," on mckinseyquarterly.com.

highly specialized and require decades of training. In those areas, the talent, particularly those with experience, is in short supply. Examples would be toxicologists, pathologists, statisticians, and clinicians. That's one dimension to look at: the technical competency of the talent.

The other dimension, given the fast growth of the markets, includes the leadership and management capabilities of the talent. In many cases, companies like ours need to ramp up our efforts quickly, so we are giving the scientists—particularly the scientific leaders—the mandate not only to do good science and to drive projects but also to become good leaders and good managers. If we use those criteria, the number of individuals who possess all these skills is smaller.

But in general, we are optimistic. From our own experience, we can recruit talent overseas and locally. And to support our portfolio, our mission, and, more important, the Innovation Center China, we have an excellent record in retaining and continuously developing those colleagues.

Steve Yang's commentary is drawn from an interview with **Jeremy Teo** (Jeremy_Teo@McKinsey.com), an associate principal in McKinsey's Shanghai office.

Capturing the world's emerging middle class

Multinational companies need scale and speed to penetrate the developing world's increasingly prosperous consumer markets.

David Court and Laxman Narasimhan

The rapid growth of an emerging, urban middle class represents a powerful opportunity for early winners to gain lasting advantages, just as companies in Europe and the United States did at similar points in their development (Exhibit 1). In 17 product categories in the United States, for example, we found that the market leader in 1925 remained the number-one or number-two player for the rest of the century. These companies include Kraft Foods (Nabisco), which led in biscuits; Del Monte Foods, in canned fruit; and Wrigley, in chewing gum.

Cities are a crucial unit of analysis for multinationals seeking to identify their best opportunities. As companies target those with the greatest potential, they will simultaneously find significant consumer diversity within some cities, and striking points of commonality across them. That complexity holds profound implications for multinationals' product and service offerings—and underscores the fact that many companies' traditional strengths may offer fewer advantages than at home.

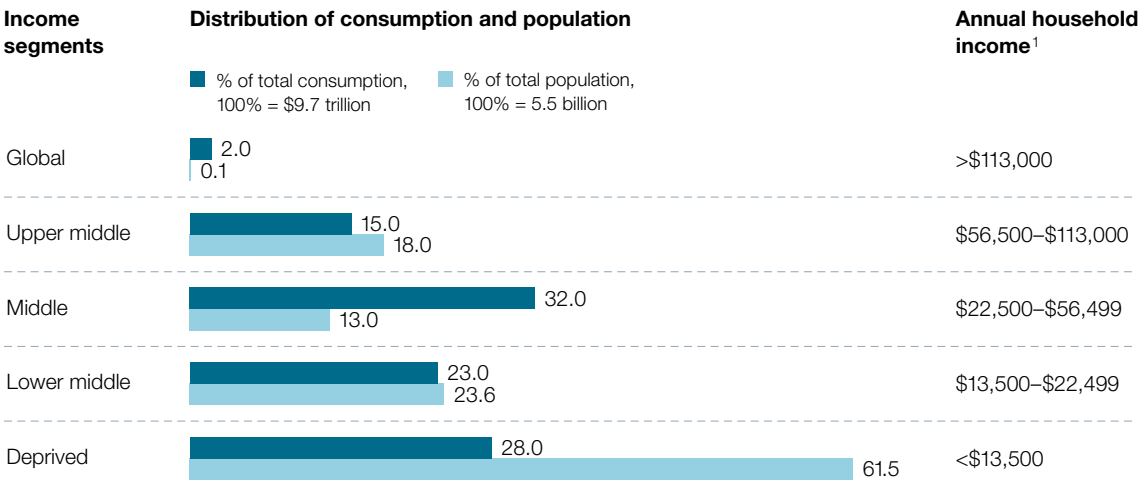
After all, most multinationals' business models are based on practices established in the markets of the developed world, where these days the game is won slowly by finding cost savings and making product improvements that capture single percentage points of market share over time. Among emerging markets, perhaps only China can provide

enough short-term growth to justify that strategy. Meeting the needs of most consumers in emerging markets requires a different course, which often elicits anguished cries in the corridors of the multinationals: "You want me to change my business model and go across the world for $50 million in revenue?" It's an understandable lament for executives who not only fear ending up with little to show for their efforts but also are wary of the battles already under way among emerging-market champions such as Chinese beverage maker Hangzhou Wahaha. The company has built a $5.2 billion business against global competitors like Coca-Cola and PepsiCo by targeting rural areas, filling product gaps that meet local needs, keeping costs low, and appealing to patriotism.

While there are multiple approaches to capturing emerging-market consumers, the two critical factors are speed and scale. Our experience suggests that one way multinationals can quickly gain the scale they need is to identify clusters of similar consumers across multiple markets. That approach allows these companies to build revenue and profit streams that are collectively material and justify significant, ongoing capital investments to fuel growth. Another tack is to work at a more local level, gaining scale in specific regions and categories by teaming up with deeply knowledgeable on-the-ground partners. They can help not only in product development but also in distribution and market positioning—the crucial final steps to reaching highly local consumer markets.

Exhibit 1

In developing countries, the emerging class—nearly two billion strong—spends a total of $6.9 trillion annually.



[1]Based on purchasing-power-adjusted exchange rate.

Note: Developing countries are Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Peru, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, Venezuela, Vietnam.

Source: Economist Intelligence Unit, June 2009; Euromonitor, June 2009; World Bank, April 2009; McKinsey analysis

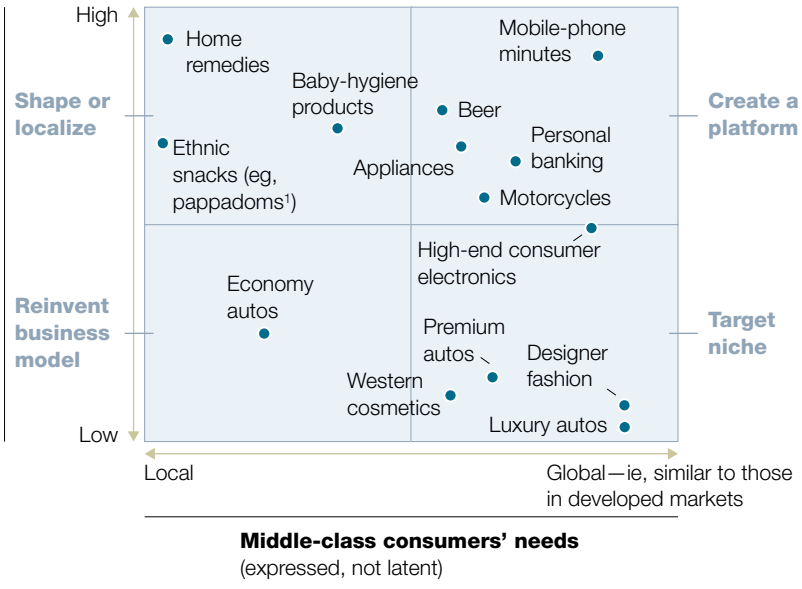
All of this is easier said than done, of course, precisely because consumers in emerging markets are so diverse. In some ways, they resemble those in developed nations: they are aware of and have a fondness for brands and want access to a variety of products at different prices, including products they aspire to but can't currently afford. Yet their tastes are often localized, and while they are middle-class in regional terms,[1] they are still not wealthy enough to replace products regularly, because their percentage of truly discretionary income is lower: in China and India, for example, about 40 percent of average household income is spent on food and transportation, compared with 25 percent in the United States.

The best way to make sense of this picture is to take a granular view using product categories. For individual categories, multinationals should first identify whether consumer needs in emerging markets are fundamentally global or local. A good proxy for this issue is the similarity of product offerings across geographies, as shown on the horizontal axis of Exhibit 2. Second, multinationals can assess the consumer's ability to afford a given product. Useful approximations include category penetration and product availability in key developing markets, as well as the willingness of consumers to "stretch" to buy less-affordable products. By developing a perspective on whether and to what extent consumer tastes are global or local and combining

[1] We define emerging middle-class consumers as those with yearly incomes of $13,500 to $113,000, in purchasing-power-parity terms.

Exhibit 2

Four category-specific strategies can help companies serve middle-class consumers in developing markets.



[1] Spicy, wafer-thin Indian bread.

For each category, two questions drive strategy: how accessible the category is for middle-income consumers, and how local those consumers' tastes are.

that with a clear view on the affordability and accessibility of a given product, multinationals can go a long way toward determining the strategies and business models that will allow them to gain scale quickly.

Identifying consumers with similar needs across markets

The first category, at the top right of the matrix, comprises products and services for which consumer needs are quite similar across geographies and affordability is not a constraint. There is little need to create marketing plans to roll out such products in different countries, one after another: we've found that it's most efficient to identify similar consumer segments across countries and to build scalable business models for each cluster. Examples of products in this category include personal banking, mobile communications, consumer electronics, and pharmaceuticals, which have similar industry structures, rates of consumer adoption, and socioreligious factors across geographies.

A leading multinational retail bank's marketing team, for example, used longitudinal consumer data to identify five clusters across multiple Asian countries. These segments included one of conservative users very loyal to their local banks (in India, Indonesia, the Philippines, and Taiwan) and another of remote-channel users who were highly price sensitive (in Hong Kong, Singapore, and South Korea). The bank successfully designed and implemented a specific product and channel strategy for each of these five segments across countries.

Targeting premium consumers in product niches

The category on the bottom right of the matrix comprises emerging-market consumers who have the means to buy products and services that are widely available or even mass market in the developed world. (For the vast majority of the emerging middle class, however, these products and services are neither affordable nor accessible—they are premium items.) While we forecast that less than 3 percent of total emerging-market households will be in this bottom-right category in 2025, their prosperity and the fact that their behavior resembles that of consumers in the developed world has historically made this category appealing to multinationals.

Capturing the loyalty of these consumers and, as they develop new needs, upgrading them is the key. Since emerging-market consumers want value—even in this category—companies should offer products at "mass premium" price points. Consumer electronics manufacturer LG has found that people in many developing markets are more willing to pay for better service than are their counterparts in the developed world. The company launched a premium offering that not only

gives consumers a full-time contact person who acts as a go-between with LG and monitors the health of products but also guarantees maintenance visits within 6 hours (compared with the normal 24-hour commitment).

Shaping the market by localizing

The third category, on the top left of the matrix, comprises affordable and accessible products, such as low-cost snacks and highly localized baby-care hygiene products. In this category, there's clear merit in evaluating how companies can scale up across markets, even if needs are local. One approach is to shape the market through minor product enhancements and sharper positioning that encourages consumers to shift toward more globally convergent offerings over time and allows companies to enjoy greater economies of scale and lower delivery costs. In India, for example, PepsiCo successfully shaped the snack market by creating a new platform, called Kurkure, for younger consumers. The product feels entirely local, though it is packaged and distributed by Frito-Lay.

Other strategies for penetrating this affordable, accessible, and local market are to use celebrity endorsements and to leverage local knowledge, either selectively, in areas such as distribution, or through more comprehensive alliances. The partnership between Norwegian telecommunications company Telenor and Bangladesh's Grameen Telecom, for example, resulted in the creation, in 1997, of Grameen Phone, now the country's largest mobile operator.

Reinventing the business model

The final category, on the bottom left of the matrix, represents products and services for which needs are (and will probably remain) very local and affordability is a challenge. In this segment, the potential available market share is high, though the market looks small, since consumers often substitute cheaper products, from adjacent categories, that satisfy similar needs rather than buy a higher-priced global product. The first step for multinationals is to define the market by measuring current total consumption, examining product alternatives that satisfy similar needs, and studying potential spending likely to be unlocked once incomes grow. Companies then need to make their products more affordable and accessible, looking at everything from capital expenditures to product features to distribution. There's real value in working with local players to drive product, distribution, and sales innovations in that "last mile" before reaching consumers.

Beer manufacturer SABMiller, for example, decided it could not achieve price points that would spur demand in Africa without changing its business model. It retooled its factories for cheaper,

locally sourced ingredients (such as cassava and sugar rather than barley and maize) and used local distributors to ensure the availability of its products. The result: lower prices, growing demand, and significant increases in market share across several African countries.

• • •

Traditional approaches in which companies enter markets one by one and focus on a handful of brand and market combinations will not meet the challenges of the developing world's large and growing body of middle-class consumers. Companies need to become adept at building and sharing customer information across markets and more willing to work with others to gain scale quickly. In some regions, such as Africa, multinationals may even need to work with the public and social sector to ensure that consumers have adequate income to generate demand.

Structural changes might also be required. Because multinationals may have to adopt different business models by market, category, and brand, they need flexible and responsive organizations. Cisco, for example, has created a second world headquarters, in India, to spearhead its push into the country, while other companies are establishing centers of excellence to identify, recruit, and develop staff that can be deployed locally. Using local vendors is critical to running a lean operation: many multinationals have found, for example, that capital outlays in emerging markets are often only 30 percent of those required for a factory in the West if they use local resources for plant and process engineering and to execute projects.

Finally, companies need to be aware of perhaps the biggest bottleneck to seizing the emerging middle-class opportunity: talent. Relying excessively on expatriates is likely to stifle an organization's ability to scale up adequately across markets—there simply won't be enough staff. We believe that building talent academies inside companies to accelerate leadership development is a good step. Yet the rapid growth in many emerging markets may make traditional "grow your own" or "hire from within" approaches manifestly inadequate to meet staffing needs. By addressing these structural and operational imperatives and identifying the best approaches to achieve the scale needed to serve the growing middle class, multinationals can meet their high expectations for international growth.

The authors would like to acknowledge the contributions of Georges Desvaux, Vishal Dixit, Martin Elling, John Forsyth, Prashant Gandhi, Trond Riiber Knudsen, Vikram Vaidyanathan, and Ireena Vittal to this article.

David Court (David_Court@McKinsey.com) is a director in McKinsey's Dallas office, and **Laxman Narasimhan** (Laxman_Narasimhan@McKinsey.com) is a director in the Delhi office.

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Building brands in emerging markets

Companies that harness word-of-mouth effects, emphasize in-store execution, and get their brands onto shoppers' short lists for initial consideration are more likely to capture the loyalty of emerging-market consumers.

Yuval Atsmon, Jean-Frederic Kuentz, and Jeongmin Seong

As the rapid growth of emerging markets gives millions of consumers new spending power, those consumers are encountering a marketing environment every bit as complex and swiftly evolving as its counterpart in developed countries. Product choices and communication channels are exploding, as is the potential of digital platforms; and, as everywhere, consumer empowerment is on the rise.

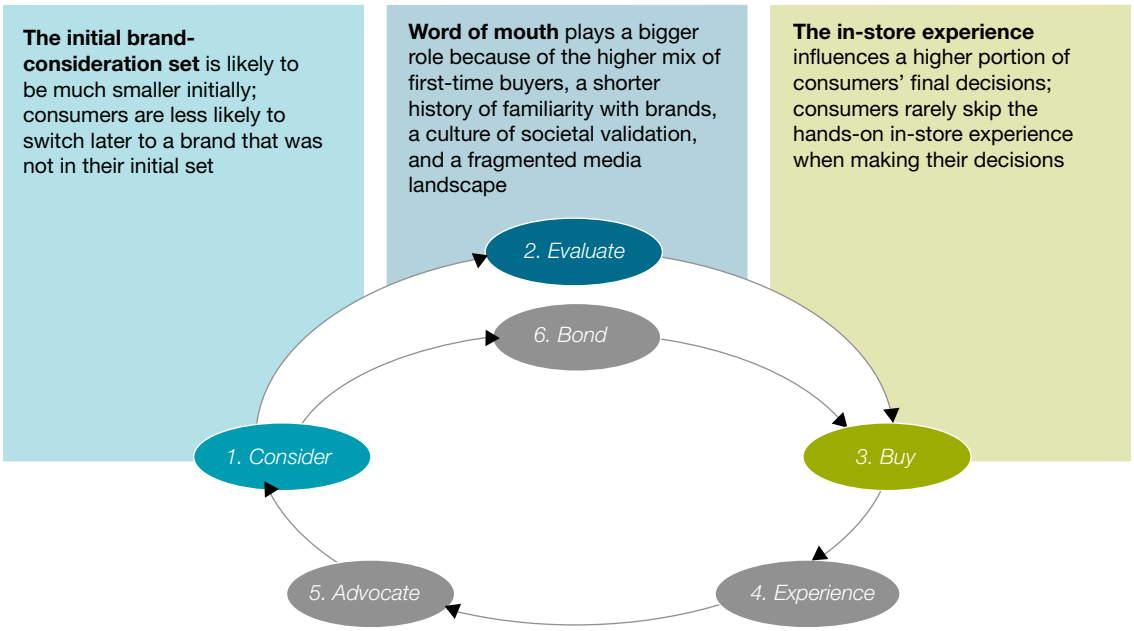
The impact of these changes has been so profound in developed markets that three years ago, our colleague David Court and his coauthors proposed a new approach for understanding consumer behavior.[1] On the basis of research involving 20,000 consumers across five industries and three continents, our colleagues suggested replacing the traditional metaphor of a "funnel," in which consumers start at the wide end with a number of potential brands in mind before narrowing their choices down to a final purchase. Envisioning consumer behavior as less of a linear march and more of a winding voyage with multiple feedback loops, our colleagues put forward an iterative framework, which they called the *consumer decision journey*, and identified four critical battlegrounds where marketers can win or lose.

These four battlegrounds are initial consideration, when a consumer first decides to buy a product or service and thinks of a few brands; active evaluation, when the consumer researches potential

[1] See David Court, Dave Elzinga, Susan Mulder, and Ole Jørgen Vetvik, "The consumer decision journey," mckinseyquarterly.com, June 2009.

Exhibit 1

Three factors in the consumer decision journey take on greater importance in emerging markets than in developed markets.



purchases; closure, when the consumer selects a brand at the moment of purchase; and post-purchase, when the consumer experiences the product or service selected. The battlegrounds are as relevant for emerging markets as they are elsewhere. As in developed markets, technology is unleashing the possibility of increasingly deep customer engagement at each phase of the journey, but with some important twists reflecting differences in the characteristics of emerging-market consumers, who generally don't have the same level of experience with brands and product categories as their developed-market counterparts do. Many are still looking to buy their first car, first television, or first package of diapers, for example.

In this article, we highlight the implications of three key differences between emerging- and developed-market consumers that we've uncovered in our research (Exhibit 1). First, harnessing the power of word of mouth is invaluable, as it seems to play a disproportionate role in the decision journeys of emerging-market consumers. Second, getting brands into a consumer's initial consideration set is even more important in emerging markets, because that phase of the journey appears to have an outsize impact on purchase decisions. Finally, companies need to place special emphasis on what happens when products reach the shelves of retailers, because the in-store phase of the consumer decision journey tends to be longer and more important in emerging markets than in developed ones.

Harnessing word of mouth through geographic focus

Word of mouth plays a more central role in the decision journeys of emerging-market consumers

than for those in developed markets. When we surveyed food and beverage consumers in a range of developed and emerging markets, roughly 30 to 40 percent of the respondents in the United Kingdom and the United States said they received recommendations from friends or family members before making purchases. Consumers in Africa and Asia reported higher, sometimes dramatically higher, figures: more than 70 percent in China and 90 percent in Egypt, for example (Exhibit 2). Similarly, 64 percent of the Chinese respondents said they would consider recommendations from friends and family for moisturizer, compared with less than 40 percent of respondents in the United States and the United Kingdom.

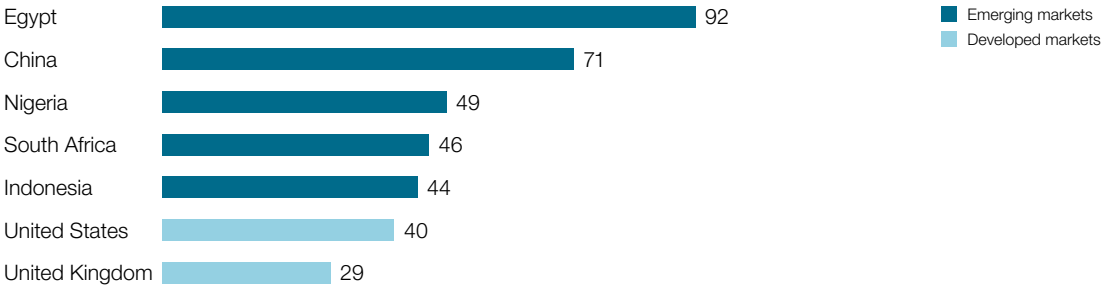
An important explanation for word of mouth's outsize role is that in a land of consumer "firsts"—more than 60 percent of Chinese auto purchasers are buying their first car and the comparable figure for laptops is 30 to 40 percent—few brands have been around long enough to ensure loyalty. Seeing a friend use a product is reassuring. Indeed, the less a consumer knows about a product and the more conspicuous the choice, the more the consumer is likely to care about the opinions of others. "The more people I know who are using a product," consumers reason, "the more confident I can be that it will not fall apart, malfunction, or otherwise embarrass me." The presence (or absence) of that confidence shapes the group of brands that consumers choose to evaluate. It is particularly influenced by the postpurchase experience of friends and family, along with their loyalty to a brand.

Often, word of mouth is a local phenomenon in emerging markets, partly because of the simple reality that emerging-market consumers generally live close to friends and family. In addition, word of mouth's digital forms, which transcend geography and are growing rapidly in emerging markets, still have more limited reach and credibility there than in developed ones. According to our annual survey of Chinese consumers, just 53 percent found online recommendations

Exhibit 2

Purchase decisions of emerging-market consumers are heavily influenced by recommendations from friends and family members.

% of respondents who have received recommendations on food and beverage products from family and/or friends before purchasing



Source: McKinsey 2011 surveys of 512 South African, 4,244 Chinese, and 1,198 Indonesian consumers; McKinsey 2011 online benchmark survey of 150 UK and 250 US consumers

credible—a far cry from the 93 percent who trusted recommendations from friends and family. That same survey showed that only 23 percent of Chinese consumers acquired information from the Internet about products they bought. For food, beverage, and consumer-electronics customers in the United States and the United Kingdom, that figure is around 60 percent.

Word of mouth's relatively local nature means that companies in emerging markets are more likely to reap higher returns if they pursue a strategy of geographic focus than if they spread marketing resources around thinly (targeting all big cities nationwide, for example). By attaining substantial market share in a cluster of cities in close proximity, a company can unleash a virtuous cycle: once a brand reaches a tipping point—usually at least a 10 to 15 percent market share—word of mouth from additional users quickly boosts its reputation, helping it to win yet more market share, without necessarily requiring higher marketing expenditures.

In China, the bottled-water brand C'estbon has a very small national share, but a 25 to 30 percent market share, on average, in the southern part of the country. Most of the brand's sales are to small stores and restaurants, where it has a dominant 45 to 50 percent share in that region. In India, this approach worked for P&G, with its Whisper brand of sanitary napkins, which the company introduced in targeted local communities by offering training and free samples to adolescent girls in schools. After successfully creating word of mouth in those communities, P&G gradually expanded the campaign to reach over two million girls at 150,000 schools. The result was a drastic reduction in the use of cloth-based protection—to 6 percent, from 66 percent, among the targeted group, according to the company's assessment.

Building brands that get considered

Emerging-market consumers tend to consider smaller sets of brands initially and, compared with consumers elsewhere, are less likely to switch later to a brand that was not in their initial set. For example, research we conducted in nine product categories (including food and beverages, consumer electronics, and home and personal-care products), indicated that Chinese consumers initially consider an average of three brands and purchase one of them about 60 percent of the time. The comparable figures in the United States and Europe are four brands, with a purchase rate of 30 to 40 percent.

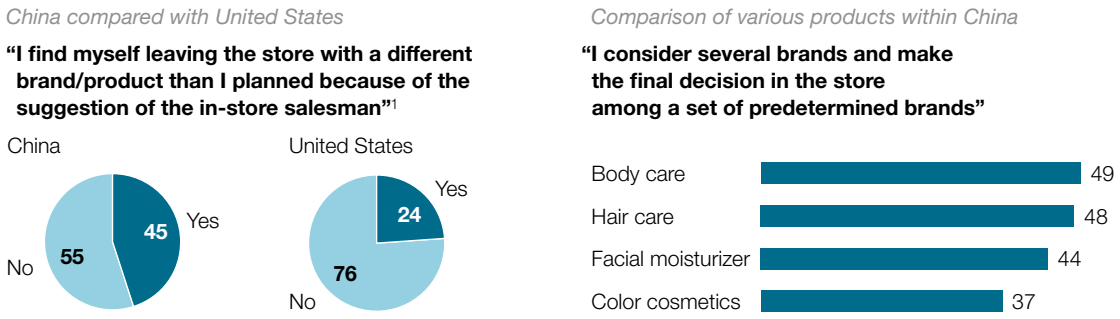
To include a brand in the initial consideration set, consumers must obviously be aware of it, so achieving visibility through advertising on TV and other media is an essential first step. Here again, geographic focus is critical. Emerging-market consumers not only generally live close to friends and family but also tend to view local TV channels and to read local newspapers rather than national ones. (China, for example, has about 3,000 mostly local TV stations.) Gaining a high share of voice through local outlets in targeted geographies can help create a sense that a company's priority brands are in the forefront—which is valuable, because status-conscious, relatively inexperienced emerging-market consumers tend to prefer brands they perceive as leaders.

But spending heavily on advertising alone is not sufficient to ensure consideration. Companies also need to reach these consumers with messages that have been tailored to suit local market preferences and concerns, and are thus more likely to be trusted. Testing messages—even those that have delivered powerful results in developed markets—is a key part of that equation. When

Exhibit 3

In-store execution heavily influences consumer decisions in China.

% of respondents



[1]Yes = respondents who strongly or somewhat agree; no = respondents who strongly or somewhat disagree.
Source: 2008 McKinsey survey of 5,372 Chinese consumers and ~300 US consumers

Acer China tested its slogan "Simplify my life" in China, as part of a campaign emphasizing the low cost of its PCs, the message didn't resonate. For typical Chinese consumers, a PC is a big-ticket purchase, so they care chiefly about durability. Chinese purchasers of PCs also tend to be entertainment rather than productivity oriented. In focus groups, it became clear that Acer's intended message of "great value for money" was arousing suspicion that the company's products might not perform reliably. A change in Acer's message to stress reliability rather than simplicity and productivity helped the company to build a more relevant and trusted brand, to get onto the short lists of more consumers, and to double its market share in less than two years.

Winning the in-store battle

The in-store phase of the consumer decision journey tends to be longer and more important in emerging markets than in developed ones. Emerging-market consumers have a penchant for visiting multiple stores multiple times and for collecting information methodically, especially when they purchase big-ticket items. The typical Chinese decision journey in one major consumer electronics category takes at least two months and involves more than four store visits. These consumers like to test products, interact with sales reps to collect product information, and negotiate with retailers to get the best deal.

As a result, in emerging markets there is significantly more room to influence and shape consumer decisions at the moment of purchase. We first quantified this distinction in 2008 (Exhibit 3). This finding has been reinforced by subsequent research revealing, for example, that the in-store experience is by far the biggest factor in finalizing emerging-market consumers' flat-screen-TV purchase decisions and that Chinese consumers are almost two times more likely to switch brand preferences while shopping for fast-moving consumer goods (45 percent) than US consumers (24 percent) are.

Important as it is to control the in-store experience, the challenge can hardly be overstated.

Products may be sold in tens of thousands of retail outlets after going through two or three layers of distributors. Companies often have limited visibility into what happens at the moment of purchase. Inconsistent merchandising, packaging, and in-store promotions can easily overshadow superior products and carefully crafted advertising strategies.

The first step in avoiding such waste is gaining a clear view of the retail landscape—how it is segmented and where the priority outlets are. Companies must then develop tailored control systems based on incentive schemes, collaboration with distributors, and retail-management programs. For priority outlets, companies must often deploy a heavy-control model using supervisors and mystery shoppers with supporting IT infrastructure to ensure that the performance of stores is visible enough to assess.

Unilever deploys massive resources in India to cover 1.5 million stores in tens of thousands of villages. Many of the salespeople carry a handheld device so that they can book replenishment orders anywhere, anytime, and synch their data with distributors. In Indonesia, Coca-Cola sells 40 percent of its volume directly to local retailers, with whom it collaborates closely. The lion's share of Coke's remaining Indonesian volume is sold to wholesalers with fewer than five employees and less than $100,000 in annual revenues. These wholesalers, in turn, distribute Coke products to small retailers. To improve in-store execution in the many outlets Coca-Cola doesn't serve directly, the company deploys additional support, including supplying them with free coolers and dispensers and providing sales-effectiveness training for merchants.

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Although these principles—harnessing word of mouth, getting brands into a consumer's initial consideration set, and emphasizing in-store execution—may sound obvious, acting on them is not easy. It requires bold investment decisions, efforts to build the skills of local teams, and the courage to operate in ways that are fundamentally different from what headquarters might regard as normal. Fortunately, the potential rewards are commensurate. When emerging-market consumers perceive a brand consistently and positively across the major touch points, including friends and family and the in-store experience, they are far more likely to choose that brand, profiting companies that spend smartly rather than heavily.

Yuval Atsmon (Yuval_Atsmon@McKinsey.com), who was based in McKinsey's Shanghai office from 2006 to 2012, is a principal in the London office, **Jean-Frederic Kuentz** (Jean-Frederic_Kuentz@McKinsey.com) is a principal in the Taipei office, and **Jeongmin Seong** (Jeongmin_Seong@McKinsey.com) is an associate principal in the Shanghai office.

Leda Catunda
Vestidos, 1988
Courtesy of the artist

Selling to mom-and-pop stores in emerging markets

Although this article on emerging-markets retail is from 2007, its lessons remain important. Since then, both in emerging markets and in developed-market channels that are fragmented (such as food service), leading consumer goods companies have successfully applied approaches like those described here for segmenting outlets and deepening engagement between salespeople and central marketers. Indeed, technological advancements are making these principles even more powerful: for example, GPS-equipped handhelds are enabling salespeople to tailor offerings more closely to individual stores.

Alejandro Díaz, Jorge A. Lacayo, and Luis Salcedo

One indelible image of Latin America is the independent mom-and-pop shop: ubiquitous retailers that range from street stands and kiosks peddling soft drinks and snacks to corner stores selling groceries—roughly a million such businesses in Brazil, more than 800,000 in Mexico, and 400,000 in Colombia, for example. Despite the inevitable consolidation as large modern retailers (such as Carrefour, 7-Eleven, and Wal-Mart Stores) grow, mom and pops will represent a significant share of retail sales in Latin America and many other emerging markets for quite some time.

Traditionally, large packaged-goods companies have earned healthy margins by selling directly to mom and pops. Small shopkeepers, who have only limited negotiating leverage, often provide favorable or even exclusive distribution deals in return for support such as coolers, shelves, and merchandising services. In this environment major Latin American (and some multinational) packaged-goods companies have enough scale and standardized service to fend off smaller competitors and earn favorable returns.

But it's becoming more difficult for consumer goods companies to earn easy profits from mom and pops. The appeal of serving them has attracted an increasing number of consumer goods companies and brands, thus increasing the competition for their limited shelf space and cash. Meanwhile, major retailers are moving in, driving down the sales and margins of the mom and pops. Falling volumes, in turn, raise the cost of selling to and servicing them.

Packaged-goods companies seeking to maintain profitable relationships with traditional stores and to outmaneuver competitors in this hard-to-serve channel must embrace a reality that most have long ignored: mom and pops are incredibly diverse, and the same consumers frequent different ones throughout the week on different occasions, even though these shops are close to one another and may stock the same items. A

beer shopper without a refrigerator might go to the corner grocery store to pick up a large bottle for home consumption, split a six-pack with friends after work at a shop that has a pool table, and share a case with teammates following soccer practice at a third store with outdoor seating. A packaged-goods company can therefore have a substantial market share in one shop while underperforming in a similar place right down the street.

A few leading packaged-goods companies have begun making sense of this diversity by segmenting outlets the same way sophisticated marketers segment consumers. These companies develop a rich understanding of the occasions when different people are likely to shop at specific shops, of what most appeals to these men and women when they do shop, and what offers make different shop owners loyal to suppliers. This understanding, in turn, allows companies to decide which shops merit investment and how to tailor cost-effective promotions, displays, discounts, incentives, and sales and distribution approaches in ways that will boost sales and reward shopkeepers financially.

The sales force plays a crucial role in this more discerning approach. Salespeople observe outlets and survey consumers and shopkeepers, besides negotiating packages of incentives with owners and tracking how well they keep their end of the bargain—how much they charge, what displays and promotions they use, and how much shelf space they give different products. Since the typical salesperson is responsible for as many as 300 outlets, he or she needs a lot of support. Well-structured training, performance-management, and incentive systems help ensure consistent execution, and handheld wireless devices can help salespeople to feed headquarters information about the outlets and to receive recommended tactics in return.

Applying state-of-the-art tools to the problems of serving traditional retail shops has yielded dramatic results for packaged-goods companies in Latin America, other emerging markets (including Africa, Asia, and Eastern Europe), and even those parts of Western Europe and North America where retailing is highly fragmented. Brewers, carbonated-beverage makers, confectioners, snack producers, tobacco companies, juice makers, and producers of personal-care goods have all enjoyed significant revenue, margin, and cost benefits by moving away from prevailing “one-size-fits-all” strategies for serving mom and pops.

Pressure from two sides

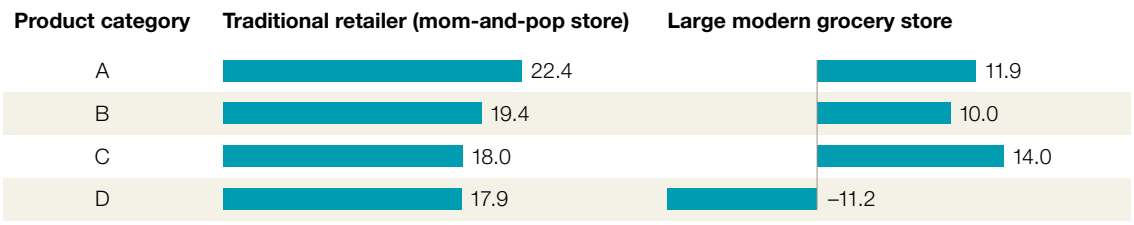
Traditional retailers in Latin America account for one-quarter to one-half of all grocery sales and hold dominant positions in some categories and markets: mom and pops, for example, sell about 95 percent of the beer consumed in Colombia and control more than 80 percent of carbonated-beverage sales in Mexico. The sheer number of these outlets often increases even as major retailers expand. The number of traditional shops in Mexico, for example, has risen by more than 25 percent over the past five years.

Several factors explain the resiliency of the mom and pops. For starters, most are located in the same neighborhoods or even blocks as their target consumers, who often don’t own cars. Furthermore, the smaller scale of mom and pops means that they can serve areas with low population densities or limited purchasing power, where modern retailers aren’t economically viable. In addition, some traditional retailers are

Exhibit 1

Large packaged-goods companies have profitable relationships with mom-and-pop stores.

Latin American packaged-goods companies, EBITDA[1] as % of sales, by type of outlet



[1] Earnings before interest, taxes, depreciation, and amortization.

informal: they avoid paying taxes, and in certain countries, particularly Brazil, that reduces their costs enough for them to charge prices similar to or even lower than those of modern stores. What's more, since traditional shop owners normally live in the same neighborhoods as their customers, who are often their close friends, they can extend credit with no collateral and little risk of default, further binding consumers to their shops. Finally, tradition also plays a role. In the words of a large Mexican retailer's CEO, "Mexicans have been going to the *mercado* and *tianguis*[1] since the Aztecs. It is in our way of life."

Over the years, many large packaged-goods companies have formed cozy, profitable relationships with the mom and pops (Exhibit 1). The prevailing formula involves dividing a country into broad geographic zones—examples in Ecuador, for instance, would be Quito, Guayaquil, the coast, and the Andes. In each region's mom and pops, a packaged-goods supplier generally employs the same promotions, communications tactics, and displays. To protect volumes and keep the largest traditional outlets happy, consumer goods companies often provide them with long-lived assets (such as coolers and tables), as well as product displays, posters, and promotional materials.

Now the game is changing. Major retailers are on the march in Latin America: they account for roughly three-quarters of all grocery sales in Brazil and Chile and about half in Mexico, where there are more than 7,600 modern convenience stores; Wal-Mart alone boasts annual sales of more than $15 billion in the region and has consistently increased its revenues at annual rates in the high single digits. Modern and traditional retailers have already collided in large urban markets. As these become saturated, large retailers are venturing into smaller cities, poorer neighborhoods, and rural areas, where mom and pops predominate. The result, everywhere, is similar: their revenues and profitability are down. Sales per traditional outlet have also been falling—by 3 percent a year in Mexico, for instance.

Just as traditional retailers are coming under pressure, more packaged-goods companies are

[1] Public and open-air markets, respectively.

An alternative to the prevailing one-size-fits-all strategies involves developing a better understanding of mom-and-pops, tailoring bundles of incentives that create value for shop owners, and rethinking sales and service.

trying to win their business, in part because modern retailers are tough customers. Traditional shopkeepers, with their limited shelf space, are therefore in a stronger position when they negotiate with suppliers. (It is easiest to cut favorable deals with regional manufacturers of discount brands.) To complicate matters further for large packaged-goods companies, distribution costs are rising as "drop sizes" (such as the number of soda cases delivered to a shop each week) fall. Even powerful global brands like Coca-Cola, whose bottlers have in recent years lost share to discount brands among traditional retailers in Ecuador and Peru, are feeling the effects.

Embracing the diversity of mom and pops

Fortunately for packaged-goods companies, there is an alternative to the prevailing one-size-fits-all strategies for dealing with mom and pops. It involves developing a better understanding of the characteristics of these shops and of the marketing techniques that move consumers to buy from different ones at different times, tailoring bundles of incentives that create value for shop owners who work toward mutually agreed-upon goals, and rethinking sales and service to make them more cost effective. This approach works equally well with formal and informal mom and pops.

Pulling off a more differentiated strategy requires careful coordination. First, the central marketing organization conducts core analyses of consumer needs and consumption occasions. The sales organization's trade-marketing group then uses the general consumer analysis to create a segmentation scheme for outlets. Once that is done, the trade-marketing group helps salespeople to categorize the shops in their territories. The salespeople, in turn, deliver a tailored bundle of brands, products, prices, margins, merchandising, and services to each segment of shops the company targets. Finally, the trade-marketing group creates detailed outlet-level performance reports for the salespeople (and, in some cases, for third parties such as distributors or merchandisers) and rewards them by how well they execute the segment strategy.

A wide range of consumer goods companies have begun following this approach:

- A brewer whose sales had been flat enjoyed a 10 percent jump in the volumes sold at traditional shops after it had segmented and targeted them more carefully.

- A carbonated-beverage company recently boosted its market share at mom-and-pop stores by nine percentage points, largely at the expense of

discount brands that had previously been raising their share. Another beverage company spent 20 percent less on distribution while improving its market share among traditional shops by relying more on telephone sales and batching deliveries for outlets that, according to a new segmentation scheme, require less high-touch service.

- A tobacco company categorized the universe of traditional outlets. For each segment, it designed strategies based on the demographic profile of consumers who frequented that kind of shop. This improved segmentation led the company to increase its brand-building investments in a small number of strategic shops while simultaneously reducing its sales, distribution, and merchandising (or "route-to-market") costs by 12 percent for the mom-and-pop channel as a whole.

Understanding and segmenting outlets

To categorize thousands of outlets, packaged-goods companies must borrow from the tool kit of sophisticated marketers around the world who analyze "need states" representing the intersection of what consumers want and how they want it.[2] Need-state segmentation is generally applied to consumers, not stores. Packaged-goods companies in Latin America, for example, sometimes conduct such analyses in major urban areas, where large retailers serving a great diversity of consumers make a store-specific approach unnecessary. It is sufficient to understand, say, that "people consume brand X when they wish to relax with friends over several inexpensive beers and don't want too many calories."

But a consumer-level understanding isn't enough when customers frequent a number of shops regularly, and shop-specific characteristics influence each purchase decision. In this environment, packaged-goods companies need to evaluate what consumers want when they go to a particular type of shop and how they want to have it presented to them (Exhibit 2).

[2]Stephen J. Carlotti Jr., Mary Ellen Coe, and Jesko Perrey, "Making brand portfolios work," mckinseyquarterly.com, November 2004.

Exhibit 2

An analysis of need states can help companies determine what consumers want from a particular type of traditional shop.

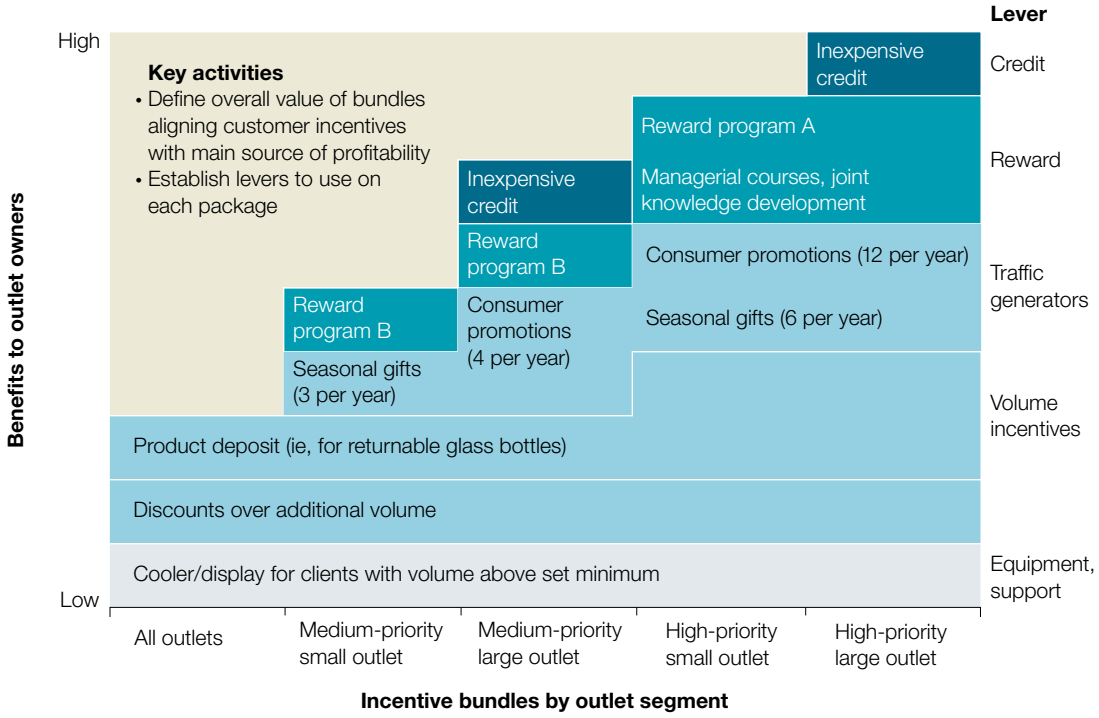
Share of volume sold in given outlet segment (sample illustration), %

■ Primary need state

Consumer need state	Outlet segment: Convenience	Activities, eg, game of pool	Place to take a break	Space to hear music
Socializing	20	**56**	5	20
Craving excitement	18	8	12	**48**
Gathering after sports	15	11	**28**	8
Everyday routine	22	13	**45**	11
Pick up and go	**25**	12	10	13

Exhibit 3

Design incentive bundles for shop owners by determining the size of the opportunity to increase sales in each store.



One soft-drink company built on its overall consumer segmentation approach by drilling down to an outlet-specific one: it had its trade-marketing group, working with a few salespeople and an outside research firm, administer one-on-one quantitative surveys in a representative sample of its retailers. Their analysis highlighted a number of distinct channel segments, including shops where people go for quick breaks during the workday, stores with pool tables where friends meet, outlets where men congregate after sports practice for refreshments, places where local residents gather to celebrate and listen to music, and shops where people pick up food and beverages they will consume as soon as they arrive home. Once the general outlet segmentation was established, the trade-marketing organization distilled five questions that salespeople could ask consumers and shopkeepers to categorize the thousands of shops the company served.

After a company completes an outlet segmentation based on consumption occasions and need states, it can tailor an approach for each type of shop. In those where consumers make quick purchases and convenience is important, for example, one brewer gave shopkeepers vertical coolers intended to entice people to buy beer on their way out. A nonalcoholic-beverage company supplied returnable glass bottles that are more affordable than disposables for stores where

low-income consumers make small daily purchases. The same company found that for outlets frequented by young consumers on weekends after they play soccer, it is critical to have outdoor tables (prominently depicting the company's brand) where players can cool down following games. The company and shopkeepers also cosponsored small neighborhood soccer tournaments to cement, in the minds of consumers, the link between these shops and time spent socializing with other players after games while drinking the company's brand of soft drink.

Creating value for store owners

Deciding what will appeal to consumers in each outlet is only part of the puzzle. Packaged-goods companies also need to develop bundles of benefits that will help shop owners prosper in today's competitive retail environment (Exhibit 3). This step is critical because even the best-conceived consumer strategies need the shopkeepers' support to succeed. In our experience, cooperation from Latin America's increasingly stretched mom-and-pop store owners can be ensured only by helping them make more money. Alternative approaches, such as extracting promises of exclusivity in return for a table and cooler, are becoming less effective.

A brewer's experience highlights the broad range of possible benefits. Some that are extremely valuable to shopkeepers are actually relatively inexpensive. The owners of shops with table seating were extremely interested in branded T-shirts, which save them the expense of buying uniforms for beer servers. The owners of shops where consumers gather to listen to music particularly liked the idea of anniversary parties for their shops, complete with banners and promotional materials. Stores emphasizing low prices on daily purchases valued inexpensive credit and free bottles.

Consider as well the experience of a nonalcoholic-beverage business that asked a segment of Mexico's mom and pops to use a new company-branded cooler that would require them to spend more on electricity. The company, emphasizing that additional soda sales would compensate them for the cost, offered a free case of soda every month in exchange for a commitment to keep the branded coolers connected and well stocked. In other Latin American countries, the same beverage company found that "management 101" courses and small life insurance policies for shop owners made them more loyal.

Determining what benefits to offer shops requires a company to understand its opportunities to increase sales in each one—something that can be quantified in terms of its outlet-level market share. Obtaining this detailed information falls on the shoulders of salespeople and, in some cases, on outside market research firms. In our experience, shopkeepers are surprisingly forthcoming with information on their volumes, service levels, and margins—perhaps because they hope that openness will boost the odds of obtaining favorable terms of supply.

Having identified the store-level revenue and profit opportunities, companies must tailor their incentive and service packages to ensure positive returns on investment and avoid spiraling costs. For one beverage company, this approach meant not offering rich incentives to all outlets. In fact, its outlet segmentation and competitive assessment suggested that it dealt with three tiers of shops: those meriting large packages worth up to $5,000 a year, others warranting smaller investments of $500 or

so, and places where opportunities for volume growth were so limited that any investment would be a mistake. In our experience, no more than 5 percent of all outlets typically fall into the high-potential group, and up to half warrant no investment whatsoever.

Ensuring cost-effective execution

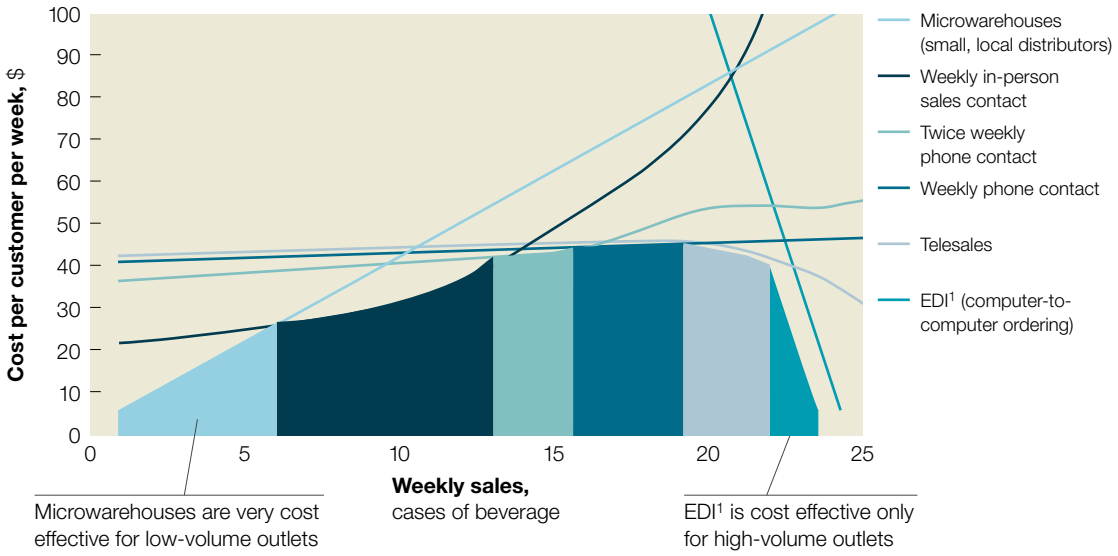
Once packaged-goods companies decide what they want to offer consumers and shop owners and where they want to offer it, the final question is how to execute flawlessly at the point of sale while keeping costs as low as possible. In our experience, packaged-goods companies in Latin America haven't thoroughly assessed the mix and efficiency of their route-to-market techniques. Most companies will probably need a broad range of sales coverage, distribution, and merchandising approaches for the different outlet segments in each geography they serve (Exhibit 4).

To understand what these approaches might look like in practice, consider the experience of another beverage company, which had salespeople visit high-potential shops several times a week to take orders and check in on promotional activities. It also employed merchandising specialists to place products and merchandising materials, as well as clean coolers in these shops. Midtier ones, by contrast, received just a single visit a week from the salespeople and none from the merchandisers. For another group of outlets, the company created an

Exhibit 4

Route-to-market models can be optimized to minimize cost to serve.

Sales and distribution methods by outlet segment, beverage company example



[1] Electronic data interchange.

outbound telesales group that called shopkeepers on predefined days and times to take orders. This telesales model reduced the cost to serve some outlets by more than 40 percent, without making sales calls less effective. The company also found that in certain areas independent truck operators could distribute its products and merchandising materials at far lower cost than in-house personnel could.

Efforts to improve the quality and cost-effectiveness of execution don't end when a company gets its mix of sales and service right. It's also important to root out volatility, which often comes in the form of lumpy order sizes and surging deliveries on certain days (such as Fridays), and waste, which is common during delivery runs, when drivers may take circuitous routes or load and unload trucks inefficiently. Companies in industries ranging from automotive assembly to airlines to retail banking have fought volatility and waste for years by using "lean" operational techniques that experience shows to be applicable to serving mom-and-pop shops as well. When a tobacco company conducted a time-and-motion analysis of its sales and delivery people and redesigned operating guidelines to cut down on low-value activities, for instance, the cost of each route fell by more than 12 percent, without any decline in the effectiveness of sales or deliveries.

• • •

Maintaining profitable relationships with mom-and-pop shops is more and more challenging. Packaged-goods companies can raise their volumes and margins alike by understanding why consumers shop at different types of stores, what incentives to offer shopkeepers, and how to deliver cost-effective sales and service.

The authors would like to thank Pablo Ize for his contributions to this article.

Alejandro Díaz (Alejandro_Díaz@McKinsey.com) is a director in McKinsey's Chicago office, **Jorge Lacayo** (Jorge_Lacayo@McKinsey.com) is a principal in the Mexico City office, and **Luis Salcedo** is an alumnus of the Lima office.

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Tinga Tinga art from Tanzania
Tingatingastudio.com

How we do it:

Three executives offer advice on competing in Africa

William Egbe,
president
of Coca-Cola
South Africa

Jacko Maree,
CEO of Standard
Bank Group

Maria Ramos,
CEO of Absa

Support socioeconomic development: William Egbe

For more from William Egbe, watch the executive panel discussion "Can Africa continue to grow?" on mckinseyquarterly.com.

We have operations in every single country on the continent, even some that do not have governments, like Somalia. People ask, "How does that work?" It works because you understand that you can create a business opportunity, and people can see beyond the politics to engage around the business opportunities. The other reason it works is because you engage local investors in those businesses, to participate in the spoils.

That's very fundamental to have a sustainable business. Multinationals cannot operate in Africa without ensuring that they're building the business system that enables the communities in which they do business to benefit, to thrive and prosper, but also that the locals have a significant stake in those businesses. You actually have a much more valuable business system when you have partners along the value chain who have a vested interest in the long-term survival of your business because they derive a living from your business system. That is the ultimate formula for sustainability on the continent. It doesn't make sense to try to keep all of the gains for yourself.

Companies also have to understand that to have a license to operate in Africa, they have to earn that license, not from the governments but from the consumers. And that license means that you're doing things that support socioeconomic development. You have a role in doing things to support the improvement of the standard of living of Africans. It means that you have to invest in the communities in which you do business—creating jobs, providing skills, providing business opportunities.

Entrepreneurship is critical. For businesses to be able to reduce poverty in Africa, it's not going to come from big companies creating jobs. There's no economy where the bulk of the job creation comes from big companies. It comes from small and medium enterprise.

And if you dig a little bit deeper in entrepreneurship, one aspect that large companies tend to overlook is around supporting female entrepreneurs. We found that, for example, when we wanted to set up small entrepreneurs to help us with our distribution, the failure rate for the businesses that were run by women was half of the rate of the businesses run by men. We also discovered that the female owners of these minor distribution centers were better able to retain their employees. They had lower turnover than the male owners. So when we start looking at what the sweet spots in which we're going to focus our investment to accelerate development in Africa are, we have to look at some of these areas.

"Companies have to understand that to have a license to operate in Africa, they have to earn that license, not from the governments but from the consumers."

William Egbe is the president of Coca-Cola South Africa. Before joining Coca-Cola in 1997, he worked for Eastman Kodak in the United States and Germany.

Understand the local environment: Jacko Maree

For more from Jacko Maree, see "The China–Africa business connection: An interview with the CEO of Standard Bank," on mckinseyquarterly.com.

There are risks to doing business in Africa, but no more so than in some of the Latin American economies or even Russia and Asia. The question is how to manage those risks once you've understood them. We spend a huge amount of time coming to grips with the particular risks that may occur in some of these countries and then try to mitigate them.

Understanding risk is more than just a financial concern. One has to be mindful of ensuring that you're seen as being helpful and relevant to the local economies rather than just extracting profits by providing a service. When you're dealing with developing countries, the issue of the social relevance of your company is completely different from when you're dealing with a developed economy. For banks, more so than other enterprises, the question that often comes up when you are visiting government officials or major corporate customers is, "What are you doing for our country?" A bank cannot typically turn around and say, "Well, we're just here to help you with your transactions or your financing requirements." You have to be involved and committed to the communities in which you operate.

"The most important question for multinationals is, 'Are you going it alone or are you going to work with partners?'"

Jacko Maree has served as CEO of Standard Bank Group, Africa's largest financial institution by assets, since 1999. A former chairman of the Banking Association South Africa, he is a director of Liberty Life.

The most important question for multinationals is, "Are you going it alone or are you going to work with partners?" Sometimes, having a local partner is really the most obvious way to go. Clearly, you always need advice from someone who understands the local environment. In a number of the countries in which we operate, we have chosen to work in formal partnerships. In some geographies, we have tried to position ourselves first as a local player and second as a multinational.

For major multinationals looking to expand on the African continent, a key question is whether you have sufficient resources to tackle the challenge. What we have found in a number of these countries is that, initially, you've got to use quite a lot of your own resources rather than rely on local skills. Over time, of course, that changes.

Expect no shortcuts: Maria Ramos

For more from Maria Ramos, see "Assessing Africa's business future: An interview with the CEO of Absa," on mckinseyquarterly.com.

The first piece of advice I give our teams—and remind myself of—is that we need to do very thorough due diligence. We need to understand that if we are going to invest in another country, we must understand that environment well, irrespective of whether you're investing in Africa or investing in any other geography.

You are going to find some challenges in Africa that you probably wouldn't be finding if you were investing in, for example, parts of Europe. There certainly will be challenges in some aspects of infrastructure and in telecommunications—the World Bank says that African countries lag behind their peers in other parts of the developing world by just about every measure of infrastructure coverage. If you do encounter challenges, what's required is a thorough engagement and commitment to the investment you're making.

Sometimes investments have longer return horizons than they do at other times, and that requires you to put some of your best people, technology, and systems on the job. There are no shortcuts. This is not one of those places where you're going to come in and make a quick buck and leave. That said, we believe that the countries offering the strongest growth potential in the coming years are Angola, Ghana, Nigeria, Uganda, and Zambia, which are likely to be the biggest gainers from development in the mining, energy, and other infrastructure sectors.

"We believe that the countries offering the strongest growth potential in the coming years are Angola, Ghana, Nigeria, Uganda, and Zambia."

Maria Ramos is the CEO of Absa, one of South Africa's largest financial-services companies. Before joining Absa, in 2009, Ramos was CEO of Transnet, South Africa's state-owned transport and logistics company.

RUNNING THE DISTANCE

To succeed in emerging markets, many global companies must retool themselves for the long term in ways that are very different from how they have operated for decades in developed economies. Consider, for example, a surprising research finding in "Understanding your 'globalization penalty'": on several critical organizational-health indicators (including direction setting, coordination and control, and innovation), top multinationals generally underperform successful companies that stick closer to home. A critical reason, as discussed in "Organizing for an emerging world," is that greater complexity is making global organizations more difficult to manage—particularly in emerging markets, where the opportunity costs from organizational friction are even higher than they would be elsewhere. Companies need to consider major changes, including grouping activities according to nongeographic criteria (such as growth goals), moving the corporate center nearer to high-growth markets, and revamping internal information sharing.

Finding the talent to manage these new structures will not be easy. In "How multinationals can attract the talent they need," the authors recommend grooming local highfliers, strengthening the company's brand as an employer, and actively encouraging more managers to leave home. Jesse Wu, worldwide chairman of Johnson & Johnson's consumer group, agrees in a wide-ranging interview that also

In this section

Illustration by Daniel Hertzberg

stresses the importance of integrating successful emerging-market companies slowly in order to protect their business models.

In general, companies need to rebalance their internal priorities so that they can execute effectively and give emerging markets the attention they need. “Building a second home in China” argues that companies hoping to succeed in that country can no longer treat it as an interesting side bet; instead, they must take China as seriously as they do their home market, raising their aspirations and their performance standards. Likewise, “How multinationals can win in India” sets out an explicit scorecard for evaluating how well an organization is adapting to local realities.

For all the opportunity that emerging-markets consumers will create, they are also likely to exacerbate challenges that companies are already confronting as global competition for resources becomes more acute. “Growth in a capital-constrained world” notes that global savings are unlikely to keep up with emerging economies’ surging demand for capital. Companies can prepare by boosting capital productivity, building strong relationships with capital suppliers in reserve-rich countries like China, securing more long-term funding, and rethinking business models that are overly dependent on low-cost funding.

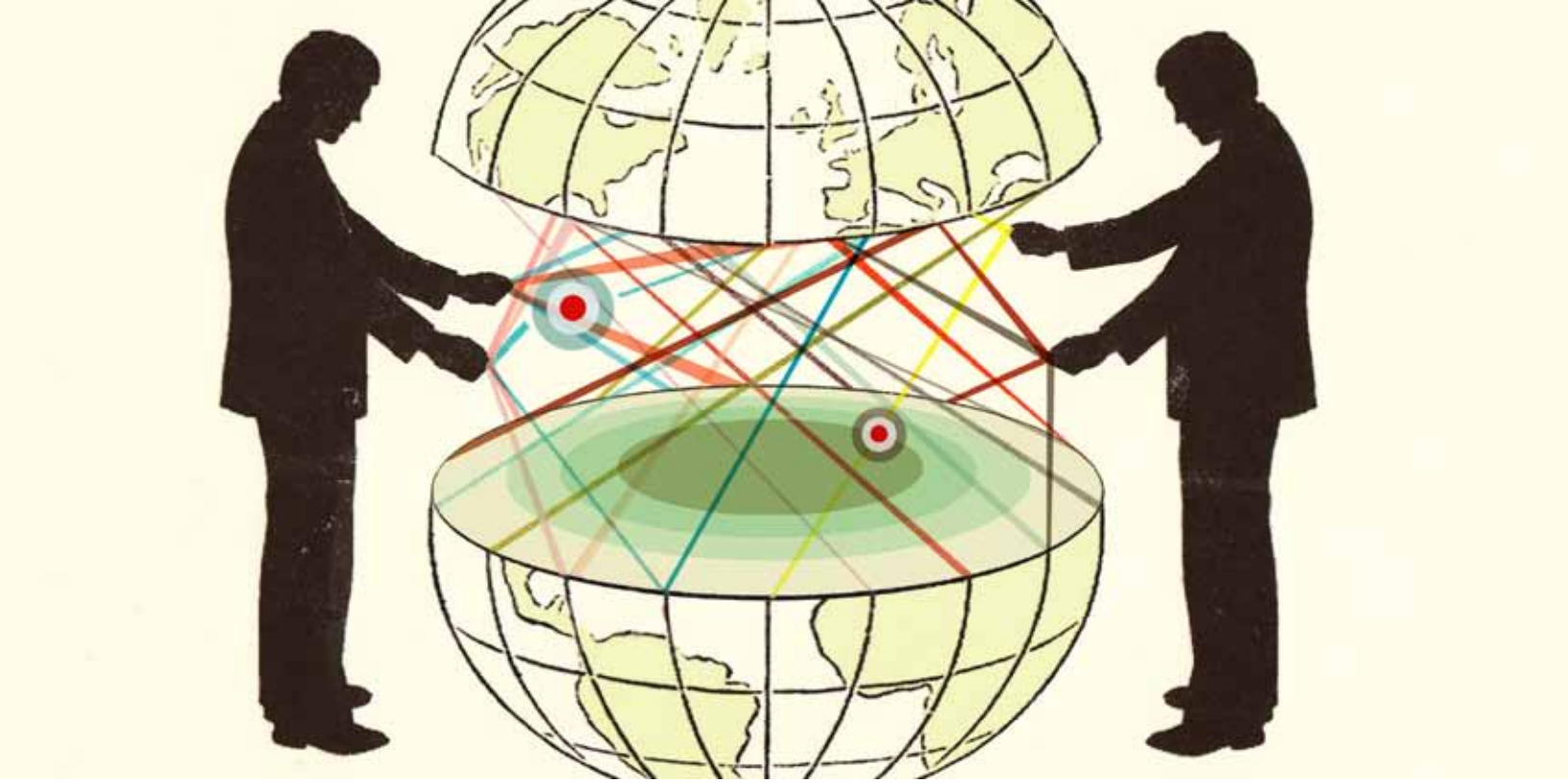


Illustration by Mark Allen Miller

Understanding your 'globalization penalty'

Strong multinationals seem less healthy than successful companies that stick closer to home. How can that be?

Martin Dewhurst, Jonathan Harris, and Suzanne Heywood

The rapid growth of emerging markets is providing fresh impetus for companies to become ever more global in scope. Deep experience in other international markets means that many companies know globalization's potential benefits—which include accessing new markets and talent pools and capturing economies of scale—as well as a number of risks: creeping complexity, culture clashes, and vigorous responses from local competitors, to name just a few.

Less obvious is a challenge identified by our latest research: global reach seems to threaten the underlying health of far-flung organizations, even highly successful ones. In particular, we have found that high-performing global companies consistently score lower than more locally focused ones on several critical dimensions of organizational health—direction setting, coordination and control, innovation, and external orientation—that we have been studying at hundreds of companies over the past decade. Understanding this threat, and its causes, is a first step toward diminishing its impact.

Weaknesses

The data to support this finding come from McKinsey's organizational-health index database, which contains the results of surveys of more than 600,000 employees who assessed the health

[1] We compared the degree of globalization using four metrics: the proportion of sales originating outside a company's home geography, the proportion of employees

working outside a company's home region, the geographic diversity of a company's top management team, and the proportion of shareholders residing outside a company's home region. Of these, we weighted the source of sales and the location of management most heavily.

[2] For more, see Scott Keller and Colin Price, "Organizational health: The ultimate competitive advantage," mckinseyquarterly.com, June 2011.

of nearly 500 different corporations. Within this database, we identified 20 "local champions," which had outperformed their industries over the previous ten years, and 18 "global champions," which had likewise outperformed their industries and met our composite criteria for full globalization.[1]

We then compared these companies across the elements of organizational health, which we define as the ability to align around a strategy or change program, to execute, and to renew a company faster than its competitors can (exhibit).[2] Highlights of this analysis included the following:

- High-performing global organizations are consistently less effective at setting a shared vision and engaging employees around it than are their local counterparts.
- These global leaders also find maintaining professional standards and encouraging innovation of all kinds more difficult.

Exhibit

Do companies pay a penalty for being global?

[1] Companies were defined as global based on proportion of sales outside of home geography, proportion of employees outside of home region, geographic diversity of top management team, and proportion of shareholders that are outside of home region.

Source: Organizational-health index database; McKinsey analysis

- Because they do business in multiple countries, they find it more challenging than local leaders do to build government and community relationships and business partnerships.

These findings are troubling. For starters, the weaknesses touch on all three major areas of organizational health—alignment, execution, and renewal. Since related research from our colleagues Scott Keller and Colin Price indicates that at least 50 percent of an organization's long-term success is a function of its health, this globalization penalty should be a red flag for high performers with a rapidly expanding international reach. What's more, the global leaders we studied represented the cream of the crop—they not only enjoyed strong financial performance but also had significant global scale and scope, which is why we included them in the sample. If organizations like these can't stay healthy as they grow globally, can any company?

Pain points

To understand what lies beneath these findings, we interviewed executives at 50 global companies. Those interviews, while hardly dispositive, suggested a relationship between organizational health and a familiar challenge: balancing local adaption against global scale, scope, and coordination.

Almost everyone we interviewed seemed to struggle with this tension, which often plays out in heated internal debates. Which organizational elements should be standardized? To what extent does managing high-potential emerging markets on a country-by-country basis make sense? When is it better, in those markets, to leverage scale and synergies across business units in managing governments, regulators, partners, and talent? One global company, hoping to realize the benefits of scale and, simultaneously, of focusing intently on India and China, recently started deploying business unit "CEOs," whose responsibilities cut across both of those high-growth markets.

Complicating matters further, our interviews suggested that, for most companies, about 30 to 40 percent of existing internal networks and linkages are ineffective for managing global–local trade-offs and instead just add costs and complexity. Many companies, for example, can't identify transferable lessons about low-income consumers in one high-growth emerging market and apply them in another. Some

It may be time to reimagine what the corporate center does—and whether a single center can effectively direct and control global operations.

struggle to coalesce rapidly around market-specific responses when local entrants undermine traditional business models and disrupt previously successful strategies.

Finally, many executives we interviewed are clearly wrestling with the corporate center's role in their increasingly globalized institutions. The feasibility of centralizing three functions in particular—human resources, finance, and marketing (broadly defined to include brand and reputation management)—was a question a number of leaders raised. In fact, our interviews suggest that it may be time for some companies to reimagine what the corporate center does, even to the extent of considering whether a single center is suited to the task of effectively directing and coordinating global operations.

It's easy to see how organizations working through such fundamental structural and operating questions might also struggle with activities—like setting a clear direction, building alignment, and maintaining innovative energy—that contribute to organizational health. Since even leading multinationals appear to suffer this globalization penalty, the importance of addressing it will only grow larger in the years ahead. For more and more companies, the globalization imperative is intensifying, and that could present additional organizational and leadership challenges that are not yet fully understood.

Martin Dewhurst (Martin_Dewhurst@McKinsey.com) is a director in McKinsey's London office, where **Suzanne Heywood** (Suzanne_Heywood@McKinsey.com) is a principal; **Jonathan Harris** (Jonathan_Harris@McKinsey.com) is a director in the New York office.

Illustrations by Francesco Bongiorni

Organizing for an emerging world

The structures, processes, and communications approaches of many far-flung businesses have been stretched to the breaking point. Here are some ideas for relieving the strains.

Toby Gibbs, Suzanne Heywood, and Leigh Weiss

As global organizations expand, they get more complicated and difficult to manage. For evidence, look no further than the interviews and surveys we recently conducted with 300 executives at 17 major global companies. Fewer than half of the respondents believed that their organizations' structure created clear accountabilities, and many suggested that globalization brings, as one put it, "cumulative degrees of complexity."

However, our research and experience in the field suggest that even complex organizations can be improved to give employees around the world the mix of control, support, and autonomy they need to do their jobs well. What's more, redesigning an organization to suit its changing scale and scope can do much to address the challenges of managing strategy, costs, people, and risk on a global basis.

Our goal in this article isn't to provide a definitive blueprint for the global organization of the future (there's no such thing), but rather to offer multinationals fresh ideas on the critical organizational-design questions facing them today: how to adjust structure to support growth in emerging markets, how to find a productive balance between standardized global and diverse local processes, where to locate the corporate center and what to do there, and how to deploy knowledge and skills effectively around the world by getting the right people

communicating with each other—and no one else.

Rethinking boundaries

Global organizations have long sought to realize scale benefits by centralizing activities that are similar across locations and tailoring to local markets any tasks that need to differ from country to country. Today, as more and more companies shift their weight to emerging markets, boundaries between those activities are changing for many organizations.

At some point, they will need to adapt their structures and processes to acknowledge this boundary shift, whose nature will vary across and within companies, depending on their industry, focus, and history. In one recent case, an international publishing company created global "verticals" comprising people who work on content and delivery technology for similar publications around the world. But it was careful to leave all sales and marketing operations in the hands of local country managers, because in publishing these activities can succeed only if they are tailored to local markets. In the case of IBM in Asia, the company has globalized its business services but left the businesses local.

IBM's experience in Asia

IBM's vice president of global strategy for growth markets, Michael Cannon-Brookes, described to us the structural redesign of the company. Shortly after the start of the new millennium, its leaders realized that having each country operation in Asia run a complete suite of business services to support different product brands no longer made sense; there was simply too much duplication of effort. In each country market, these leaders identified 11 services with common features in functional areas: supply chain, legal, communications, marketing, sales management, HR, and finance. Each function was assigned a global "owner" with the task of consolidating and refining operations to support businesses in the region's different countries. The company then assessed which essential elements of each function to keep and which redundant (or potentially redundant) elements to eliminate.

From these assessments grew the "globally integrated enterprise model," which evolved into an entirely new structure for IBM's global operations. "Instead of taking people to where the work is, you take work to where the people are," says Cannon-Brookes. IBM sought out pools of competitive talent with the skills required to perform each service at different cost points. Then it built teams of specialists geographically close to the relevant pool to meet the region's needs in each service. So now, for instance, IBM's growth market operations are served by HR specialists in Manila, accounts receivable are processed in Shanghai, accounting is done in Kuala Lumpur, procurement in Shenzhen, and the customer service help desk is based in Brisbane. Globalizing functions that were previously country based has been a huge corporate-wide undertaking for IBM.

"This is a cultural transformation," says Cannon-Brookes. "Changing organization charts can take a few mouse clicks. Changing business processes can take months. Changing a culture and the way employees adapt to new ways of working takes years."

A complex calculus

To repeat, though, no company's restructuring should be viewed as a blueprint for that of another. On the one hand, the importance of

Some companies have reduced regional layers to teams of ten or fewer members, who may focus on people strategy or business intelligence.

regional layers seems to be growing for companies in sectors such as pharmaceuticals and consumer goods. Regional centers of excellence in these sectors often are cost effective. Brand and product portfolios often differ significantly between regional outposts and the traditional core, and greater regional muscle can make it easier to pull local perspectives into global product-innovation efforts.

On the other hand, we've seen companies conclude that the traditional role of their regional layers—as "span breakers" helping distant corporate leaders to gather data and distill strategically important information—is becoming obsolescent as information technology makes analyzing, synthesizing, and exchanging information so much easier. Today's faster data exchanges, along with faster travel and video conferencing, make it feasible for some organizations to group their units by criteria other than physical proximity—for example, similar growth rates or strategies. (For more on the role of technology in managing global organizations, see sidebar, "Technology as friend or foe?")

That's led some companies to reduce regional layers to teams of ten or fewer members. Those teams might focus on managing people strategy in a region or on gathering high-level business intelligence that feeds into regional-strategy setting—for example, spotting regional, country, and competitive risks and opportunities. Wafer-thin regional layers have the added benefit of curbing "shadow" functional structures (in HR, marketing, and so forth), which tend to sprout unplanned in larger regional organizations. Although these structures are not clearly visible to the corporate center, they add considerable cost and complexity.

Process pointers

As IBM's experience illustrates, executives evaluating the structure of their companies will often be drawn into considering which processes should be global or local. That's sensible: in our survey of more than 300 executives at global companies, processes emerged as one of the 3 weakest aspects of organization, out of 12 we explored. Some companies have far too many processes—nearly a third of the surveyed executives said that their companies would be more effective globally with fewer standard ones. Some companies, especially if they grew by M&A, don't know how many processes they have or what those processes are. And, most important, few can distinguish standard processes that create value from those that don't or can identify the value drivers of worthwhile standard processes.

For managers grappling with these issues, here are some ideas that have proved valuable in practice:

- *Don't standardize more than is necessary.* For example, businesses and regions should be allowed to choose their own locally relevant key performance indicators (KPIs) to track, on top of the four or five KPIs used in the global process for setting annual targets.

- *Fit technology to the process, not vice versa.* Standard screen-based processes may ensure global compliance in an instant but can lock in globalized costs too. Before making huge investments in technology to standardize a process, businesses must be sure they can realize the expected return.

- *Prefer standard principles to detailed rules for local processes.* For instance, to hire an assistant in a new location, managers need only a set of global fair-hiring principles, not chapter and verse on how to hire.

- *Listen to voices from all the functions that are—or should be—involved in making a process better and make sure those people can continue communicating with each other.* Standard processes, by themselves, are not enough to capture all of the potential value from a company's global footprint: ongoing communication between people who influence and execute processes helps to capture more of it.

- *Implement new processes from the top.* Consultation on design is important, but business leaders may eventually need to cut the talk and mandate a new process. Unfashionable command-and-control methods can be appropriate in this sphere because, as one executive explained, "Locations aren't nearly as different as they think they are."

Lightening the corporate heart

Over the past decade, corporate centers have been slimming down. Many have shed their traditional roles of providing the business units with shared backbone services. Similarly, some companies have found locations other than the corporate headquarters for centers of excellence on, among other things, innovation or customer insights and sometimes host them within one business for the benefit of all. This leaves slim corporate centers free to focus on their perennial headquarters roles: upholding the organization's values, developing corporate strategy, and managing the portfolio of businesses

and their individual performance in line with those values and strategies.[1]

However, even a newly focused corporate center can struggle to grasp just how diverse a company's markets have become and how fast they are changing: one group based in the United States accepted 2 percent growth targets from its local managers in India because the US market was growing by only 1 percent a year. But the Indian economy was growing much faster, so precious market share was lost.

Corporate centers are likely to make better strategic calls if they move closer to the action. Locating headquarters in a growth market also sends a clear signal about company priorities to current and future employees, as well as to investors, customers, and other external stakeholders. However, a lot of corporate centers can't or won't move in their entirety, for reasons of history, convenience, or legal constraints. So we see a growing number of companies creating a global "virtual headquarters," in which vision-setting and coordinating activities and centers of

[1] For more on the role of the corporate center in establishing strategic direction, see Stephen Hall, Bill Huyett, and Tim Koller, "The power of an independent corporate center," mckinseyquarterly.com, March 2012.

Technology as friend or foe?

Inexpensive electronic and voice communications, video-conferencing, technology-enabled workflows, and, most recently, social-networking technologies have transformed connectivity and knowledge sharing within complex global organizations. Aditya Birla's HR director, Santrupt Misra, says, "Our use of ICT (information and communications technology) has really helped us become global. For example, we acquired Colombian Chemicals six months ago, and the first thing we established is . . . connectivity between them and our locations elsewhere so they have access to our portal, our knowledge, our e-learning, and every other support." The company puts out regular live Web-casts aimed at all employees and their families. It also makes all internal vacancies visible to all employees, to foster the sense of belonging to a community that is local and global at the same time. Similarly, IBM's internal Beehive Web site helps employees to connect with peers they meet on interdepartmental projects or meetings, to brainstorm for current and new projects, and to approach higher-ranking people they wouldn't normally have contact with to share ideas and ask for advice.[1]

Yet fewer than one-third of the more than 300 global executives we surveyed and interviewed believed that their companies were getting the most out of information and communications technology. For all its benefits, it sometimes creates challenges such as the following.

Exacerbating pressure. A senior executive at one company's central site in China says he regularly works a "second shift" on conference calls when he should be asleep—not good for him or the company in the long term. Jesse Wu, worldwide chairman of Johnson & Johnson's consumer group, observes, "Many people in New York like to

[1] For more, see Joan M. DiMicco, et al., *Research on the Use of Social Software in the Workplace*, Conference on Computer Supported Cooperative Work (CSCW), San Diego, California, November 2008; and Karl Moore and Peter Neely, "From social networks to collaboration networks: The next evolution of social media for business," Forbes.com, September 15, 2011.

excellence are placed in different areas around the world: global procurement may be located in a geography quite different from that of, say, global talent. Thus companies can move headquarters activities closer to high-priority markets without having to shut up the home headquarters.

For instance, ABB has shifted the global base of its robotics business from Detroit to Shanghai, where it has built a robotics R&D center and production line in response to expected demand for robots in Asia. Other firms are going for a split center, with a site in a mature market and another in an emerging one. US technology company Dell, for instance, has set up a functional headquarters in Singapore in pursuit of greater financial, operational, and tax efficiency. The US oil and gas company Halliburton created a second headquarters, in Dubai, to speed up decision making by putting it closer to major customers.

Who should staff the lighter corporate center? To cross-pollinate ideas and knowledge, have global calls on a Friday morning, so they can get everything clear before the weekend. However, that's Friday evening in Asia, thus unnecessarily affecting a colleague's family life on the other side of the world." Company leaders have to model the time zone sensitivity on which a healthy global organization depends.

Locking in complexity. Computerized forms can instantly standardize a process around the world, but once that process is locked in, technology can make changing it complicated and expensive. One global retailer, for example, generated significant value by standardizing supply chain processes in its home market and then adapted and extended the system to its operations overseas. Whenever overseas operations wanted to tweak their local procedures, a change to the global IT system was involved, making such small but necessary changes very costly.

Elevating issues indiscriminately. One leader of a global company based in an emerging market notes: "With the growth of ICT, we have become more headquarters-centric. This hasn't been a deliberate policy; it's just that people in the distant territories have found ICT an easy way to kick the ball upstairs."

While these are avoidable problems, they underscore the fact that technology is not a panacea for companies facing organizational challenges. Rather, its creative deployment should reinforce—and be supported by—a company's organizational design.

a headquarters ideally needs to attract but not retain talent. Picture it as the beating heart of the organization, pumping high-potential staff to and from the business units and replenishing each person with the oxygen of learning. Given the right HR mechanisms, a headquarters could do without any permanent staff except the CEO and his or her direct reports; other executives could have fixed-term appointments and then return to a business unit or function. The diversity of the corporate center's constant flow of staff would then naturally reflect a company's international reach and strengths.

Coordinating communication

Having the right structures and processes to enable growth and reduce complexity is a triumph in itself. But even the best-structured organization with the most carefully designed processes may falter without the right linkages between them. By the same token, two-thirds of the executives at global companies we recently surveyed said that their ability to create internal links was a source of strength.

To get the best from modern communications and a global network of contacts, managers should focus their communications, both regular and intermittent, on contacts that really matter to their jobs. Leaders can help by making it easier for their people to forge the kind of Web-based connections and communities of interest that spread knowledge quickly. But they also must protect managers from the need to spend a lot of time in conversations and meetings where agendas and decision rights are so hazy that they can't get their jobs done.

Taking stock

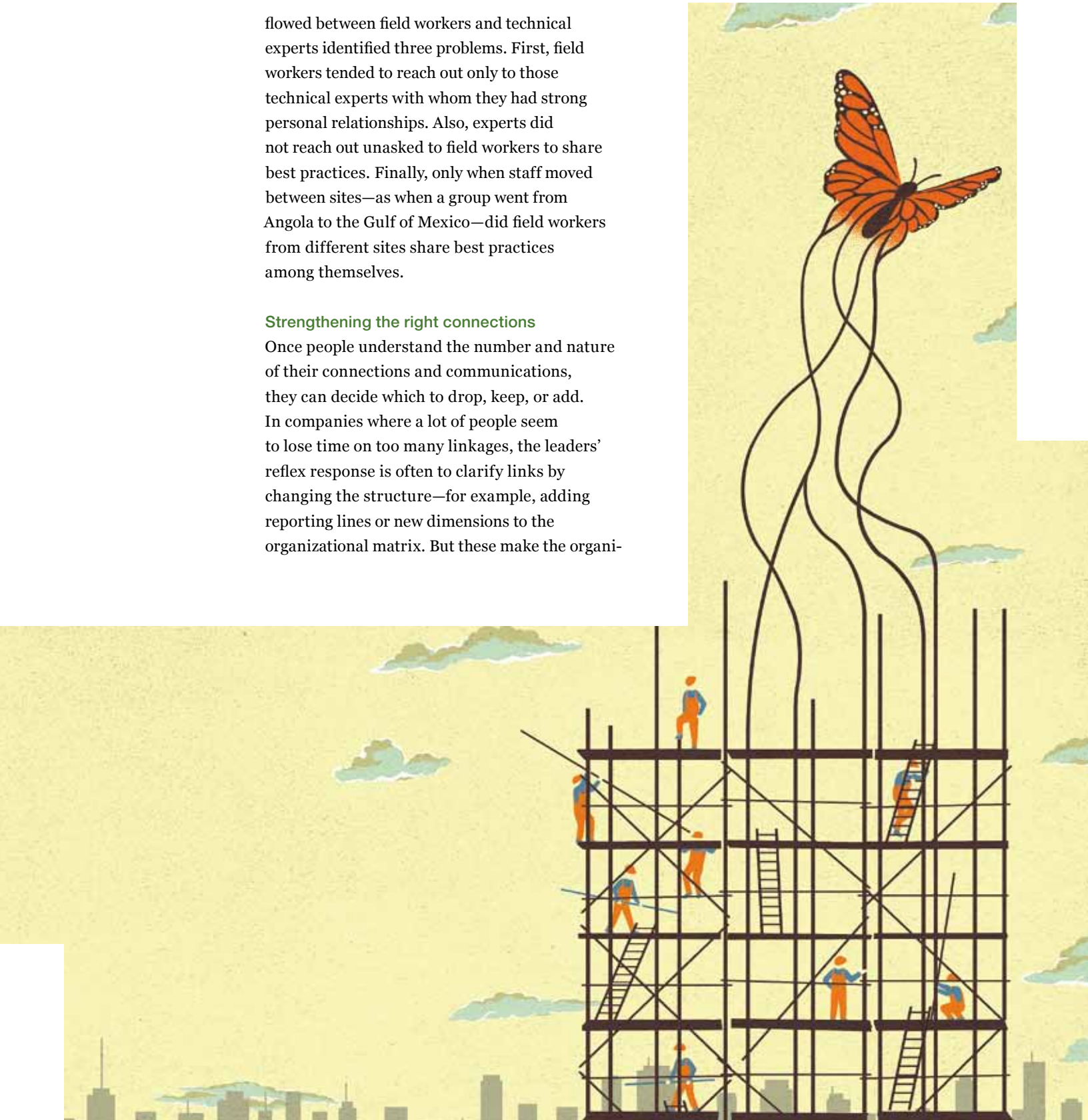
Understanding the number and value of the communications that managers participate in is a first step in finding the sweet spot. A variety of tools are available to help. They include interviews with employees; social-network analyses, which map the frequency and effectiveness of communications; and employee surveys that review connections among a company's major business, functional, and geographic units to find out why they're sharing information, the importance of the information they get to meeting their performance or strategic goals, and how effectively they share it.

Leaders of a global oil and gas company, for example, understood that operations personnel weren't sharing best practices well, because a quick review showed that the company had dozens of ways to operate a given rig. Managers also knew that workers facing problems in the field (such as equipment breakages or uncertainty about the local terrain) didn't know how to get expert help quickly and effectively. A social-network analysis of how information

flowed between field workers and technical experts identified three problems. First, field workers tended to reach out only to those technical experts with whom they had strong personal relationships. Also, experts did not reach out unasked to field workers to share best practices. Finally, only when staff moved between sites—as when a group went from Angola to the Gulf of Mexico—did field workers from different sites share best practices among themselves.

Strengthening the right connections

Once people understand the number and nature of their connections and communications, they can decide which to drop, keep, or add. In companies where a lot of people seem to lose time on too many linkages, the leaders' reflex response is often to clarify links by changing the structure—for example, adding reporting lines or new dimensions to the organizational matrix. But these make the organi-



zation more complex and costly to manage; dual reporting lines will almost certainly double an executive's administrative burden, to take only the most obvious example.

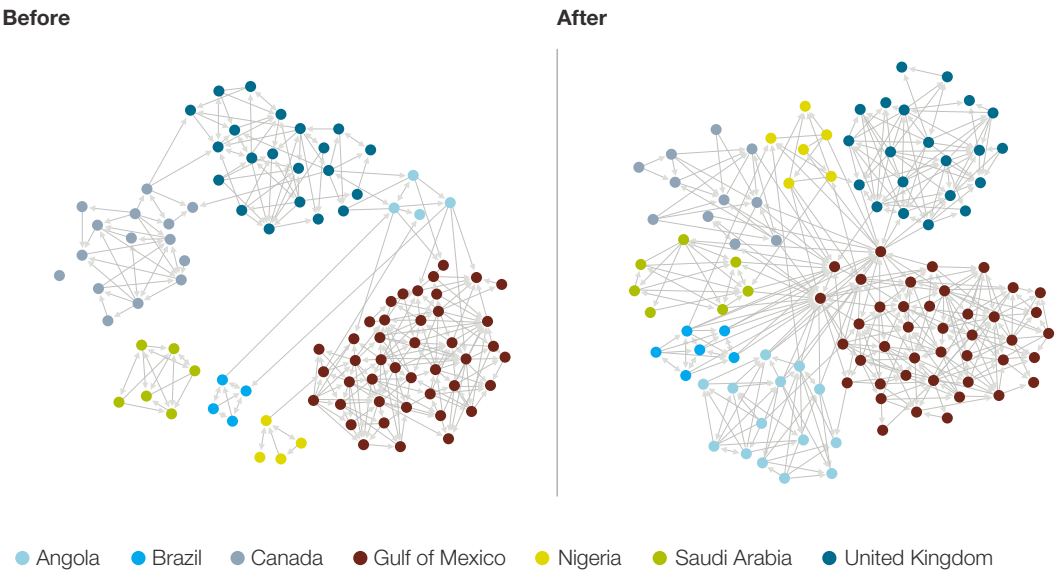
Better solutions can come from considering a wider range of linkage mechanisms, their different strategic purposes, and what must be in place to make them work. For example, coaching or mentoring links transfer knowledge across an organization and build future leaders. They require strong, personal, and frequent interactions based on trust. Other knowledge transfer connections, such as those for sharing documents, can be weaker, impersonal, and less frequent. Although these kinds of relationships deliver important gains, they do not have to be formally enshrined in a structure or process.

If people have too few contacts (as at the oil company) or contacts in the wrong places, managers with a particular area of responsibility will have to identify who needs knowledge in that area, who has it, and how best to connect them. One way companies can foster strong personal ties is to designate someone to nurture them until they flourish unaided. When researchers analyzed social networks and e-mails among teams developing aerodynamic components for Formula 1 racing cars, they found that teams that designated someone to keep in touch with peers working on related products across geographies were 20 percent more

Exhibit

One oil company used a social-network analysis to target improved communication between field workers and technical experts.

Social-network analysis at a major oil and gas company



productive than teams whose managers interacted less often.[2]

The oil company above transferred some field workers to peer teams elsewhere. That move forged global connections and expanded the collective expertise on which each field worker could draw. New networks blossomed (exhibit) and quickly showed results: within a year, productivity rose by 10 percent, while costs related to poor quality fell by two-thirds.

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Structure, processes, and linkages are interrelated: it's easier to avoid duplication in organizational structures when a company gets the balance right among global, regional, and local processes—and vice versa. Clear structures and processes also clarify roles, helping to focus communications, while structure and process problems can undermine the effectiveness of managers' global networks and communications. Focusing on some of the points where structure, processes, and communications intersect, and engaging all the stakeholders involved to work on those critical junctions, can release benefits that ripple across organizations.

[2] Jacomo Corbo and Gary Pisano, *The Impact of Information Networks on Productivity*, Circuits of Profit conference, Budapest, June 20, 2011.

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Toby Gibbs (Toby_Gibbs@McKinsey.com) and **Suzanne Heywood** (Suzanne_Heywood@McKinsey.com) are principals in McKinsey's London office; **Leigh Weiss** (Leigh_Weiss@McKinsey.com) is a consultant in the Boston office.

Illustrations by Francesco Bongiorni

How multinationals can attract the talent they need

Competition for talent in emerging markets is heating up. Global companies should groom local highfliers—and actively encourage more managers to leave home.

Martin Dewhurst, Matthew Pettigrew, and Ramesh Srinivasan

Global organizations appear to be well armed in the war for talent. They can tap sources of suitably qualified people around the world and attract them with stimulating jobs in different countries, the promise of powerful positions early on, and a share of the rewards earned by deploying world-class people to build global businesses. However, these traditional sources of strength are coming under pressure from intensifying competition for talent in emerging markets.

- Talent in emerging economies is scarce, expensive, and hard to retain. In China, for example, barely two million local managers have the managerial and English-language skills multinationals need.[1] One leading bank reports paying top people in Brazil, China, and India almost double what it pays their peers in the United Kingdom. And a recent McKinsey survey in China found that senior managers in global organizations switch companies at a rate of 30 to 40 percent a year—five times the global average.

- Fast-moving, ambitious local companies are competing more strongly: in 2006, the top-ten ideal employers in China included only two locals—China Mobile and Bank of China—among the well-known global names. By 2010, seven of the top ten were Chinese companies. As one executive told us, "local competitors' brands are now stronger, and they can offer more senior roles."

[1] China and German Statistical Yearbook 2005; McKinsey Global Institute; University of Frankfurt survey.

- Executives from developed markets, by no means eagerly seizing plum jobs abroad, appear disinclined to move: a recent Manpower report suggests that in Canada, France, Germany, the United Kingdom, and the United States, the proportion of staff ready to relocate for a job has declined substantially,[2] perhaps partly because people prefer to stay close to home in uncertain times.

How can global organizations best renew and redeploy their strengths to address these challenges? Our experience suggests they should start by getting their business and talent strategies better aligned as they rebalance toward emerging markets. This is a perennial challenge, made more acute by extending farther afield. But the core principles for estimating the skills a company will need in each location to achieve its business goals, and for planning ahead to meet those needs, are similar enough across geographies not to be our focus here. Rather, we focus on two additional questions. How can global organizations attract, retain, and excite the kinds of people required to execute a winning business strategy in emerging markets? And what can these companies do to persuade more executives trained in home markets to develop businesses in emerging ones, thereby broadening the senior-leadership team's experience base?

Becoming more attractive to locals

A big historic advantage global companies have over local competitors is the ability to offer recruits opportunities to work elsewhere in the world. A small number of executives, in fact, have moved from leading positions in emerging markets to a global-leadership role, including Ajay Banga, president and CEO of MasterCard Worldwide; Indra Nooyi, chairman and CEO of PepsiCo; and Harish Manwani, COO of Unilever.

But big global companies need a lot more role models like these if they are to persuade highly talented local people to join and stay. A recent McKinsey survey of senior multinational executives from India found that few companies were providing opportunities overseas in line with the aspirations and capabilities of ambitious managers.[3] We've also heard this concern voiced in many interviews. A senior executive at a global company in Asia told us, "In our top-100-executive meetings, we spend more than half of our time speaking about Asia. But if I look around the room I hardly see anybody with an Asian background." Another put the problem more bluntly: "Leaders tend to promote and hire in their own image."

The makeup of most multinational boards provides further evidence: in the United States, less than 10 percent of directors of the largest 200 companies are non-US nationals, up from 6 percent in 2005 but still low considering the global interests of such companies. Western ones can start working on these numbers by refining their approach to developing top talent in emerging markets. Many also need to rethink their brands to win in a fast-changing talent marketplace.

Prepare your highfliers for top roles

There's no silver bullet for developing or retaining emerging-market talent. Examples such as the ones below present different paths, but each company will need to find its own.

Global-development experiences at Bertelsmann. The German media giant tries to develop—and retain—top managers through specialized training programs. In India, for example, its high-potential employees can apply for a Global Executive MBA from Institut Européen d'Administration

[2] *Migration for Work Survey*, ManpowerGroup, 2011.
[3] A February 2012 McKinsey survey, with 118 respondents, of 17 multinational companies' operations in India.

des Affaires; over the three years this benefit has been available, motivation and retention rates among alumni of the program have sharply increased for less than it would have cost to give them salary hikes. In addition, Bertelsmann's CEO program brings local-market employees to the corporate center, where they gain exposure to the range of functional and geographical issues they can expect to encounter as leaders. Having spent a couple of years at the center, recruits then compete for senior roles in local or regional markets. They return with a solid understanding of the organization and its strategy, as well as an extended network based on trust gained from working intensively with leaders across the company.

Breaking cultural barriers at Goldman Sachs. The global bank is one of many firms that have designed special programs to tackle cultural and linguistic barriers impeding local executives from taking jobs at the global level. In 2009, for example, Goldman Sachs launched a program in Japan to help local employees interact more comfortably and effectively with their counterparts around the world, with a focus on improving cross-cultural communication skills. The firm has extended this "culture dojo," named after Japan's martial-arts training halls, to China and South Korea and plans to launch programs in Bangalore and Singapore.[4]

Local-leadership development at Diageo. Nick Blazquez, the drinks company Diageo's president for Africa, questions whether leadership training today must include experience in a developed economy. "I used to think that to optimize the impact, a general manager should work in a developed market for a period of time, because that's where you see well-developed competencies. But I'm just not seeing that now. If I think about marketing competencies, for example, some of Diageo's most innovative marketing solutions are in Africa." In fact, he notes, "we in Africa have developed some of Diageo's leading digital-marketing programs. So I don't think that there's a need anymore for somebody to have worked in a developed market for them to be a really good manager. That said, I do feel that a good leader of a global organization would be better equipped having experienced both developed and developing markets." For global companies in a similar position, acknowledging that local highfliers can drive global innovation without first serving a long apprenticeship in a developed economy could unlock massive reserves of creative energy.

Enhance your brand as an employer

While there's no substitute for development programs that will help emerging-market recruits rise, global organizations need to strengthen other aspects of their employer brands to succeed in the talent marketplace in these countries. Historically, globally recognized companies have enjoyed significant advantages: they knew they were more attractive to potential local employees than any local competitor. "We still have the attitude that someone is lucky to be hired by us," one executive told us. But today, many local fast-growing and ambitious companies have more pulling power. And multinationals based in emerging markets are conscious of the work they must do to sustain their levels of recruitment. As Santrupt Misra, Aditya Birla's HR director, says: "We are growing as a company more rapidly than people grow, so we need to develop more peer leaders. Simultaneously, we need to [maintain] a very strong employer brand so that if we do not manage to develop enough people, we can hire."

[4] Michiyo Nakamoto, "Cross-cultural conversations," *Financial Times*, January 11, 2012.

Established global companies should consider the same strategy. In any market, the basic ingredients of a strong employer brand will be competitive compensation; attractive working conditions; managers who develop, engage, and support their staff; and good communication. One challenge for global companies is to manage the tension between being globally consistent and, at the same time, responsive to very diverse local needs. Some degree of local tailoring is often necessary—for example, to accommodate the preference for near- over long-term rewards in Russia. However, any tailoring must sit within a broadly applied set of employment principles. Tata sets out to "make it a point to understand employees' wants, not just in India, but wherever Tata operates," according to its group vice president of HR. It has a tailored employee value proposition for each of its major markets; for example, it stresses its managers' quality to employees in India, development opportunities in China, and interesting jobs in the United States.

In some markets, particularly in Asia, global organizations are extending awareness of their brands as employers by building a relationship between themselves and their employees' families. For example, Motorola and Nestlé have tried to strengthen these links in China through their family visits and family day initiatives. Aditya Birla Webcasts its annual employee award ceremony to all employees and their families around their world. And in all markets, companies are likely to find that many young, aspiring managers view being part of a broader cause and contributing to their countries' overall economic development as increasingly important. Articulating a company's contribution to that development is likewise an increasingly important component of any employer brand.

Encouraging homebodies to venture abroad

Even if a global company can find, keep, and develop all the local leaders it wants, it still may need more executives from its home market to work at length in diverse emerging ones so they learn how these markets function and forge networks to support the company's future growth. To that end, some leading firms are replacing fixed short-term expatriate jobs with open-ended international roles. This not only deepens the expertise of the executives who hold them but also eliminates a problem cited by a European car executive we interviewed in South America: expat leaders become lame ducks toward the end of their overseas terms, progressively ignored by local managers.[5]

[5] For more on the challenges facing expat managers, see Jeffrey A. Joerres, "Beyond expats: Better managers for emerging markets," mckinseyquarterly.com, May 2011.

Developed-country operations have much to gain from executives versed in emerging-market management. “Leaders’ mind-sets are very different,” says Johnson & Johnson’s worldwide consumer group chairman Jesse Wu. “When you’re running an emerging market, you always operate under an austerity model. When you’ve been operating in emerging markets and come to the United States, you become aware of the little things, like how much people use color printers for internal documents. All these little things add up. Everybody’s happy with emerging-market growth,” but he adds that it “necessitates a lot of changes worldwide, not only in emerging markets.”

Global organizations’ growing need for managers willing to work for long stretches overseas is coinciding with a decrease in their willingness to go. “US talent over time seems to have become less mobile than executives from Europe, Asia, or Latin America,” says Wu. “We need this to change.”

Reversing the trend will take time. In firms where long-term success depends on moving across businesses, functions, and regions, that expectation should be crystal clear to all managers. Schlumberger requires managers to rotate jobs every two to three years across business units and corporate functions: the company expects that executives will spend 70 percent of their total careers working outside their home countries. Similarly, a leading mining company expects its people to have experience in at least two different geographic regions, two different businesses or functions, and even two different economic environments (high and low growth, say) before they can move into senior-leadership roles. Of course, it’s crucial to help managers abroad maintain their connections and influence back home and to provide close senior-executive mentorship—as HSBC does for participants in its International Management program, who are sent to an initial location, far from home, and can expect to rotate again after 18 to 24 months.

Making sure that new executives can contribute strongly and avoid mistakes when they arrive in new markets also is important. In 2010, IBM began sending executives to emerging markets as consultants, with the goal of investing time helping long-standing customers and other stakeholders. This way, the executives not only developed business in new geographies but also got to know the new markets and developed their personal skills. Dow Corning and FedEx

Global organizations’ growing need for managers willing to work for long stretches overseas is coinciding with a decrease in their willingness to go.

have realized similar benefits by providing free services in emerging markets.

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We have presented some snapshots here of how companies are getting better at attracting talent and developing leaders in emerging markets and of what it takes to cross-fertilize talent between different geographies. As the world's economic center of gravity continues to shift from developed to emerging markets, more companies will wrestle with these issues, and some definitive best practices may well appear. For now, though, the global talent market is in flux, just like the global economy.

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Martin Dewhurst (Martin_Dewhurst@McKinsey.com) is a director in McKinsey's London office, where **Matthew Pettigrew** (Matthew_Pettigrew@McKinsey.com) is an associate principal; **Ramesh Srinivasan** (Ramesh_Srinivasan@McKinsey.com) is a director in the New York office.

‘Emerging-market growth necessitates worldwide changes,’

The worldwide chairman of Johnson & Johnson’s consumer group, Jesse Wu, was born in Taiwan and spent most of his career in Asia. In this interview with McKinsey’s Martin Dewhurst and Tracey Griffin, Mr. Wu talks about how J&J integrates its acquisitions, how companies can ensure that more executives from emerging markets have opportunities to join global leadership teams, and where global companies may have an edge over their local competitors.

Martin Dewhurst and Tracey Griffin

McKinsey: *How does Johnson & Johnson think about which products sell in emerging markets?*

Jesse Wu: Right now, I believe our products are more suitable to the middle-income consumer than the bottom of the pyramid, and we have learned over time that reaching out to middle-income consumers is actually very efficient. You can use an attractive premium brand to expand reach and grow revenue, for example, by offering the product in a smaller size to help consumers reduce out-of-pocket cash. You have to be careful, though, because once these premium brands go mass market, it can start to erode brand equity with higher-income consumers. It’s also important to have a brand aimed squarely at the mass market, which is why we acquired Dabao in China; the brand has grown and become important to our business there. In the longer term, a midmarket brand will return more without the risks of expanding an existing prestige brand.

Another pitfall to watch out for is complexity—if you're not careful with complexity, you can create a less profitable business. Emerging markets add volume, but as you expand variants, you're also adding complexity to the supply chain, marketing, and other facets of the business, which can lower margins. Complexity plus lower margins can have unintended consequences if you're not very disciplined in your approach.

One important point to always keep in mind in emerging markets is that, just like consumers everywhere, emerging-market consumers are looking for good value, but they don't want "cheap." As we've expanded our lines to reach more consumers in the middle of the pyramid, we've been careful to keep product quality as high as in our higher-end brands. I always tell our new-product development teams, "Don't touch the juice." It's one thing to offer the same quality product in a smaller size, but what you don't want to do is offer a lower-quality product. That can kill brand equity quickly across the product line.

McKinsey: *How does Johnson & Johnson manage integration?*

Jesse Wu: When we do an acquisition in an emerging market, of a brand or a small to midsize company, we generally keep that operating company separate and decentralized. We try to protect its business model—large volume, fast turn, little advertising, whatever. I always remind people that the reason we bought the brand was because it was successful. The danger for an acquirer is that it's easy to come in and say, "We want better distribution. We want more advertising. We want better margins." But then you end up forcing the operating model in a different direction, which wouldn't be wise. The key is to understand fully the model you've bought into first. Only then, maybe after two or three years, can you start to think about making changes to the model. If you change the operating model too quickly, you also lose out on an important learning experience that may hold lessons for other brands and markets in your portfolio.

As for integration, we first empower the local team to manage the acquired business and follow the established business model. We normally see good results, and then we start thinking about integration. Some people argue it's more expensive upfront, but I think that knowing the intricacies of the company you acquired generates more growth down the road.

We go as far as to ask specifically for approval for visitors to the newly acquired company, particularly people from our internal functions. We do this to protect the acquired business from being overwhelmed by well-intentioned people who want to come in to see how they might add value but who may not be adding to the immediate business priorities. I continue to believe that one of Johnson & Johnson's strengths is that we always operate better, more nimbly—and we're better informed—than our competitors on the ground because of our decentralized empowerment culture. It's important to empower the local team or region so that we don't have to give all of the instructions from the center.

However, we have also learned as a highly decentralized company that if you're not careful, you can end up with a fragmented approach—for example, different IT systems in different countries. So we've said, "OK, certain things are not going to be decentralized anymore," like strategy for the brands. We're also trying to build consensus on growth drivers for the future

and determine which geographies to focus on, so that the role of the brand and role of the market become clear. You'd be surprised by how something so basic is not always as easy as it sounds.

McKinsey: *As a leader of a global company who spent most of his career in emerging markets, how do you think companies should meet the challenge of having enough leaders with local knowledge?*

Jesse Wu: The United States is a very important market, but the United States is not the market. If all the global positions are based there, over time you will be overly influenced by the United States. Given that growth is going to come from Latin America and Asia, I advocate putting global positions in the growth markets or growth regions to make it easier for us to hear the voice of our future customers. For example, we've moved key global franchise and R&D heads to emerging markets. This is probably a "test and learn" model, but I think it will generate a higher level of growth and help the rest of the world understand what the challenges are.

Leaders' mind-sets are very different. When you're running an emerging market, for example, you always operate under an austerity model. When you've been operating in emerging markets and come to the United States, you become aware of the little things, like how much people use color printers for internal documents. All these little things add up. Everybody's happy with emerging-market growth, but there are implications for technology, investment, talent, and so on. Emerging-market growth necessitates a lot of changes worldwide, not only in emerging markets. Our job is to prepare for that, so that

Jesse Wu

Vital statistics
Married, two grown children

Education
Graduated with a major in economics from National Chengchi University, Taiwan

Received his MBA from Duke University

Career highlights
Johnson & Johnson Group of Consumer Companies (1989–present)

Worldwide chairman, Consumer (2011–present)

Company Group chairman, Global Markets Organization

International vice president, Asia-Pacific (2003)

President, Greater China (2000)

Finance director, China

Finance director, Taiwan

Fast facts
A recipient of the Magnolia Award from the Shanghai municipal government, given in recognition of his contributions to Shanghai's development

Sits on the board of directors of the Consumer Goods Forum, a global industry network of more than 650 retailers and manufacturers

a couple of years from now we will have made the mind-set changes to accommodate where our growth is.

Talent is an issue that anyone with a global business needs to be concerned about. On the one hand, US talent over time seems to have become less mobile than executives from Europe, Asia, or Latin America. We need this to change. On the other hand, if you look at talent in other global markets, particularly in Latin America and Asia, many leaders are very good at a local level but struggle a bit when they start to have regional responsibilities. Among the reasons for this are having to use English as a business language and having to adjust to extensive travel to conduct business. It takes dedicated training and patience to be able to put local talent into regional and global roles. But in the end it's worth it, because once you can pick someone from Russia or South Africa, you have an expanded talent pool that's much more attuned to thinking globally and that's in touch with the needs of various kinds of consumers. We've been moving talent recently between the United States and other markets, in both directions, and we'll be doing more of it in the future. Only when you're proactively moving talent around the world will people realize that there isn't just one operating model that works.

If you aren't very, very careful with talent development it's unlikely that your growth is going to be sustainable. When I have multiple opportunities to invest in, I would choose to invest where we have a strong local team; in practice, this has directly affected our business decisions.

McKinsey: *If talent is still a huge challenge, is there any area in which you see global companies having an edge over local competitors?*

Jesse Wu: In our industry, brands are important—people in India, China, and Russia have heard of multinationals' brands and have a strong desire for them. Beyond that, I believe that multinationals allocate capital more efficiently, so in the long term we compete better. Capital efficiency is critical to sustaining a company, which is why Johnson & Johnson has lasted over a hundred years while others come and go. A local company that starts small and establishes some level of success, and then all of a sudden can go public at a price-to-earnings ratio of 30 to 50, would tend to think that capital is relatively easy to get. More established companies, over the years, always look at the return on investment—whether it's an acquisition, machinery, or new technology—so we tend to allocate our capital more efficiently. I think that will continue to be a relative competitive strength for multinationals.

Martin Dewhurst (Martin_Dewhurst@McKinsey.com) is a director in McKinsey's London office and **Tracey Griffin** (Tracey_Griffin@McKinsey.com) is a director in the Washington, DC, office.

Building a second home in China

Multinational companies hoping to succeed in China can't treat it as an interesting side bet any longer; they need to take China as seriously as they do their home market.

Jeff Galvin, Jimmy Hexter, and Martin Hirt

The past two years have underscored China's resilience and dynamism. Its economy has been booming against a backdrop of global stagnation. China's business environment, in particular, has been changing fast, with new regulatory policies and a rising cost of doing business affecting the playing field for multinationals (see sidebar "Cautious sentiments").

But the real story, in our view, isn't China's continued, rapid evolution. It's the fact that, in far too many cases, executives still aren't making China as central as it should be to their global strategy. In sectors ranging from auto parts to consumer electronics, semiconductors, aviation, and electricity transmission equipment, China is fast becoming the competitive battlefield on which global winners are determined. Even when companies are not competing in China, their Chinese and foreign rivals may soon be exploiting advantages earned there to compete in global markets.

With the stakes this high, the implication is clear: it is no longer possible for most companies to succeed in China while treating it merely as an interesting side bet. Instead, they need to start building a second home in China. At the core, this means committing a company as seriously to success in China as in its home market. The starting point is to set targets for performance in China that are on par with those at home: companies need to raise their aspirations for, and rigorously measure, a variety of targets. Some of them, such as senior-executive time spent on China and knowledge of Chinese customers, are challenging to quantify but no less important than more straight-

forward metrics regarding market share in China or sourcing volumes. Then companies need to deliver against those targets by bringing to China their global best practices across the value chain, adapting them as needed to local conditions, and executing against them. This sounds easy but happens so rarely that it's a powerful competitive differentiator.

Why you may need a second home in China

For a simple illustration of China's long-term importance, let's consider a relatively modest industry: piano manufacturing. By some estimates, China has at least 50 million piano students among its 650 million urban residents. As China adds 20 million urban residents every year and average incomes in cities rise, the number of piano students will surely grow in unison. It is not hard to imagine a time in the near future when China has 100 million piano students.

While the parents of these piano students will want to purchase pianos for their children, it is unlikely that the large and expensive pianos in many North American or European homes will be well suited to smaller, multigenerational Chinese homes. Some company will develop and bring to market a value-priced, more appropriately sized piano that sells well in China. It may be Pearl River Piano; it may be Great Wall Instruments; it may be Steinway & Sons or Yamaha. Someone will do it. Once that company's piano wins in China and gains the advantages of scale, it will have a good chance of being successful, first, in other emerging markets (such as Brazil, India, and Turkey) and, soon thereafter, in Germany and the United States. While this may sound far-fetched, two-thirds of the world's violins are already made in China.

Pianos exemplify the impact China will have on the structure of many industries as its role in the global economy expands far beyond low-cost manufacturing. Now, in industries ranging from musical instruments to semiconductors to auto parts to electricity transmission equipment, competition in China is leading to the creation of new products that have the potential to win in global markets—and, importantly, the winners can be either Chinese or foreign companies. One US company found that to be competitive in China, it had to redesign a semiconductor product to bring its cost down dramatically. Once the company was able to deliver such compelling value, its factory in China, which had been built to supply the domestic market, ended up exporting nearly 80 percent of its production.

In 2009, China became the world's largest market for cars. Here again, the initial game is local. But once the "value for money" cars now on sale in China reach a certain quality level, the global auto industry will likely be changed profoundly. It's only a matter of time: consider, for example, the relentless pursuit by Chinese companies of Western automotive assets—typified by Geely Automobile's recent acquisition of Volvo—and of capability-enhancing joint ventures, such as the two, involving Chinese companies and GM, that together sold more than 2.5 million vehicles in 2011. Meanwhile, BYD Auto, a Chinese battery maker that has been focusing on making an electric car, announced that it will have one for the US market. Warren Buffett is a believer: he bought a 10 percent stake for $230 million.

Of course, it would be naïve to suggest that China must be a second home for every company or product line or that it will be possible in all cases to capture significant market share and scale

advantages there and to exploit them globally. In some industries with dominant incumbent players or significant regulation (such as power generation or electricity transmission and distribution), it may not be feasible in the foreseeable future to gain significant Chinese market share.

Even where local market opportunities are limited, though, it's still possible to gain global advantages by leveraging China effectively. A company might, for example, develop a Chinese sourcing program that gives it a leg up on competitors in other markets by providing access to the lowest-price, high-quality components. Or it might establish a leading R&D center, become an extremely desirable employer, and leverage China's abundant pool of low-cost but high-quality engineering talent for global product development.

Determining the role and importance of China is an industry- and company-specific exercise that requires a combination of competitive analysis, market research, war-gaming, and creative scenario planning. In our experience, too few

Cautious sentiments

An AmCham-China[1] survey published in March 2010 found that 38 percent of US businesses now feel foreign companies are "unwelcome" in China, up from 26 percent just two months earlier and the highest percentage recorded since AmCham began conducting the survey four years ago. The European Chamber of Commerce is reporting similar concerns among its members. The explanation for these cautious sentiments goes beyond recent tensions between China and Google or concerns about the value of the renminbi and China's role at the 2009 Climate Change Conference in Copenhagen.

For starters, there's a perception that efforts are underway to limit foreign companies' access to the Chinese market. In 2009, China announced a National Indigenous Innovation Product accreditation policy that would give advantage in government procurement to products certified as containing "indigenous innovation." Fifty-seven percent of foreign technology companies surveyed recently said the policy would hurt their future business, and 37 percent said they were already feeling the impact, even though the policy was not yet officially in place. Similarly, in 2009, a new antimonopoly law was created to prevent any company from gaining a dominant position that would affect the competitive landscape in China. The first use of this law was to block Coca-Cola's acquisition of China Huiyuan Juice.

What's more, the cost of doing business is rising. Wage growth has averaged 15 percent annually since 2000. The renminbi has risen, and most multinationals expect this trend to continue. Tax law changes in 2008 reduced certain investment incentives and imposed a 10 percent withholding tax on repatriated dividends. All these factors reduce China's cost advantage versus other

[1] The American Chamber of Commerce in the People's Republic of China.

executives focus on China's long-term impact in a serious way—and when they do, most conclude that China is more important than they previously imagined.

Measuring your second home

We've written in the past about how Danfoss, a European industrial-controls manufacturer, overhauled its operations in China after deciding that a focus on market share, as opposed to revenue, was the only way to avoid being eclipsed by competitors.[1] Danfoss illustrates the importance of translating bold aspirations into metrics, which can be either quantitative or qualitative.

Quantitative metrics

Danfoss focused on market share, but that's just part of the equation. The key is to review the entire business model, understand where China's impact will be greatest, raise the relevant aspirations accordingly, and then measure them rigorously. For example, what percentage of a company's sourcing should come from China, and what should be the cost of the items sourced there? In our experience, when companies—

low-cost countries, while high stock market valuations of Chinese companies make it more expensive to grow through acquisitions.

Although we don't know how these trends will evolve, our experience—and the private reflections of executives who logged many miles in China—suggest that multinationals should take a long-term and comparative perspective on recent events. For example, some of the new tax rules represent, to a certain extent, a leveling of the playing field, which previously favored multinationals. Similarly, some new regulations, such as the anti-monopoly law, have long-established analogues in the European Union and the United States and in fact represent China's own attempt to move toward developed-market norms. A top executive at one large multinational recently mused that many of China's policies today remind her of France's industrial policies 30 years ago—and German and US companies did not abandon the French market.

To repeat: there is a broad consensus that the introduction or application of new regulations appears to be disadvantaging some non-Chinese companies. But what seems equally clear is that China is going through an evolution in its business environment, and the end game is far from certain. Given the importance of the market, rather than turning away, prudence suggests looking hard for ways to navigate this dynamically evolving business landscape.

Too few executives focus on China's long-term impact in a serious way—and when they do, most conclude that China is more important than they previously imagined.

whether they are retailers or electronic-component manufacturers—assess the economics of their Chinese suppliers as rigorously as they assess suppliers at home, they often find that despite how low procurement costs in China seem, they still are overpaying significantly by local standards. Manufacturing productivity is another area worth measuring seriously. In many industries, Chinese factories today can achieve the same levels of productivity as those elsewhere in the world. Or consider this: how many PhDs in Xi'an might be worth hiring to support global product-development efforts?

All that said, market share is not a bad starting point for many companies. Conducting "how big could we really become?" exercises can be eye opening. For example:

Medical equipment. One medical-equipment company found that the potential market in China for its products was 35 percent larger than it had thought, simply because it had not previously considered a large group of customers whose budgets, it wrongly perceived, were too small to be worth targeting.

Infrastructure. An infrastructure company found that the market for its existing products was 140 percent larger than it previously estimated, largely because it had been considering only the same industrial-customer segments it served outside of China.

Industrial automation. An industrial-automation company found that the premium segments it had initially targeted constituted just 25 to 35 percent of the potential market opportunity for its products. And while the gross margins in the segments it served were indeed higher (around 40 to 50 percent), those in the value segment it was neglecting were still 25 to 35 percent, on average.

Qualitative metrics

Alongside such quantitative metrics, companies seeking to build a second home in China need to pay at least as much attention to softer measures of their commitment to the country. Surprisingly, many European and US executives who ask themselves questions like the ones below identify a significant gap between the stated importance of China and its actual place on their priority lists:

Time spent in China. How much time each year do your global CEO, CFO, and other C-suite executives actually spend in China? When was the last time the company held a board meeting in China? How does this compare with the number of trips or board meetings in Europe, Latin America, or North America? Is this the right balance?

[1] See Jimmy Hexter and Jonathan R. Woetzel, "Bringing best practice to China," mckinseyquarterly.com, November 2007; and William E. Hoover Jr., "Making China your second home market: An interview with the CEO of Danfoss," mckinseyquarterly.com, February 2006.

Visibility into China operations. Do any of your China business leaders, within either corporate functions or business units, report directly to the CEO? Is the person reporting to the CEO about China based there? Are your China operations important enough to your company's future that the CEO should hear about them firsthand?

Chinese representation in the senior team. How many of the company's board members are from China? How many top executives are from China?

Knowledge of Chinese customers and suppliers. In the home market, most CEOs and business unit leaders know the CEOs of current (and potential) customers and suppliers quite well. Does your CEO have similar personal relationships in China?

Relationships with government leaders and regulators. In home markets, top business leaders know government leaders and regulators well and often join government advisory boards. Does your CEO have the same level of familiarity with government leaders and regulators overseeing your business in China? Do you play any advisory roles in China that are similar to those you play in your home market?

One multinational was so disturbed by its answers to questions like these that it immediately promoted the leaders of its major business units in China to the same executive status as the leaders of businesses in Western Europe. Another company, after investigating why it had identified many promising acquisition targets in China yet never followed through on them, found that nearly all of the acquisition ideas were being vetoed within its business units before reaching the CEO. In response, the CEO created a monthly China M&A review.

These examples highlight an organizational issue. Many multinationals have a "China CEO" who is the public face of the company there and tries to develop or influence overall China strategy. But line operations in China often roll up into global business units or functions headquartered in Europe, Japan, or the United States, where most of the P&L responsibility typically remains. The home market also continues to "own" and make decisions for global R&D, product development, IT, and other functions. In this way, business unit leaders in China effectively become sales managers—several steps removed from real decision making about what they are selling and sometimes even how they are selling it.

It's not impossible for a US-based executive to develop the mind-set, gain the exposure, and stay sufficiently current on the Chinese market to make good, timely strategic and operational decisions. But it's hard—which is why we believe more companies will need to place significant global leaders in China, as Wal-Mart Stores did several years ago when it moved to Shenzhen the company's head of sourcing, who has made major contributions to Wal-Mart's Chinese sourcing efforts. IBM, too, recently moved its global sourcing leader to China. (See sidebar "How one company is making China its first home" for another example.)

Making your second home as strong as your first

While it may sound obvious that companies should bring their best practices to China, too often that's the exception rather than the rule. Few multinationals conduct anywhere close to the same level of primary customer research in China as they

How one company is making China its first home

Julian Birkinshaw

Irdeto Access, a Dutch software company, recently moved its CEO and global headquarters to China. In 2007, the producer of content security solutions for media operators in digital pay-TV, Internet, and mobile communications was a 700-employee company headquartered in Amsterdam. Most of its sales had historically been in Europe, but the growth opportunities were primarily in Asia. As CEO Graham Kill recalled, "A mother ship in Holland, with satellite regions elsewhere, was not going to provide us with the growth we wanted." Nor did Kill feel "well placed to respond" to Chinese competitors, such as China Digital TV, that "had emerged from nowhere and were eroding our positions."

After considering a number of options, the company decided to replace its Amsterdam headquarters with a "dual-core" headquarters split between Amsterdam and Beijing. This meant that decision making and traditional headquarters functions would be shared across the two locations. To show commitment to the change, Kill moved himself and his family to Beijing in August 2007, with two other members of the executive team following in 2008. Over the next two years, Irdeto's business in Asia grew dramatically, and many customers pointed to the CEO's Beijing location as a factor in their decision to work with the company.

The new arrangements also led to measurable changes in internal attitudes and behavior. Irdeto allowed me to survey managers prior to the December 2007 headquarters shift, and then twice afterward, in 2008 and 2009. Among other things, I looked, using network analysis,[1] for changes in the degree to which middle managers based in Asia found themselves centrally involved in and able to influence decision-making processes. The change was dramatic: the centrality of Asian (not just Chinese) managers rose more than 20 percent, and their level of influence increased nearly 30 percent. By the time of the 2009 survey, in fact, the influence scores for Asian managers actually exceeded those for Europeans (exhibit). The quality and quantity of communication between the Asian and European parts of the company also improved significantly.

Of course, Irdeto faces some practical challenges in making its dual-core headquarters work. Not every senior executive is prepared to sign up for a spell in Beijing, and executive-committee meetings are harder to schedule than they used to be. But for Graham Kill, these are problems the company simply needs to work through. And as more Asian executives move into senior-management positions, the model becomes easier to sustain.

Julian Birkinshaw is a professor at the London Business School.

[1] For more on network analysis, see Robert L. Cross, Roger D. Martin, and Leigh M. Weiss, "Mapping the value of employee collaboration," mckinseyquarterly.com, August 2006; and Robert L. Cross, Salvatore Parise, and Leigh M. Weiss, "The role of networks in organizational change," mckinseyquarterly.com, April 2007.

Exhibit

After Irdeto shifted to a dual-core headquarters with locations in Amsterdam and Beijing, the centrality and influence of its managers in Asia rose dramatically.

Network analysis of centrality and influence (based on surveys of ~50 senior and middle managers at Irdeto with response rate of ~80%)

	Degree of centrality[1] (higher score = greater average centrality of managers)		**Index of overall influence**[2] (higher score = more influence)	
	Asian managers	**European managers**	**Asian managers**	**European managers**
2007	29.2	36.5	0.87	1.15
Shift to dual-core headquarters in Dec 2007				
2008	35.0	43.8	0.94	1.09
2009	35.4	45.8	1.12	1.10

[1]Degree to which managers reported being centrally involved in decision-making processes; highest possible score cannot exceed number of managers in network.
[2]Degree to which managers reported being able to influence decision-making processes; the measure indicates the influence of the regional office over global strategy, with an average score of 1.

Source: Julian Birkinshaw

would in Europe or the United States. Many distribution systems have insufficient reach or are outsourced to third parties purely on the basis of cost or ease of setup. After-sales service is rarely as good in China as it would be in a multinational's home market. The same often goes for manufacturing and product development.

One common rationale is that China is insufficiently developed to require the same sophisticated approaches employed elsewhere. Another is that despite China's potential, the current market size makes investments in, say, cutting-edge market research or after-sales service uneconomic. Both views are shortsighted at best. Yes, the functional capabilities of most multinationals outshine those of many Chinese competitors. But the Chinese are catching up fast, and other multinationals are also in the mix. Those who wait for others to develop the market may well find that the game is over by the time they decide to give it their best shot.

Below are examples of simple steps that multinationals are taking to bring their natural strengths to bear in four key areas—technology and product strategy, marketing, distribution and service, and supply chain management. These areas, along with human resources and government relations, are all ripe with opportunity for multinationals to differentiate themselves (see sidebar "Is your second home as strong as your first?" for a set of diagnostic questions for multinationals about each area).

Technology and product strategy

In many, though certainly not all, product categories, Western and Japanese firms still have technology advantages over local Chinese

We believe more companies will need to place significant global leaders in China, as Wal-Mart Stores did several years ago when it moved to Shenzhen the company's head of sourcing, who has made major contributions to Wal-Mart's Chinese sourcing efforts.

rivals. What's more, our research and experience with Chinese consumers, as well as corporate and government customers, reveal a willingness among some segments—even value-oriented ones—to pay a premium for higher-quality products. Making the right trade-offs between product benefits and pricing levels often requires breaking with a company's single Europe- or US-centered product strategy.

For example, a leading global infrastructure company was frustrated by its inability to win large tenders in China, despite having the best technology and a lower operating cost over time than domestic or international rivals. Interviews with the infrastructure company's customers revealed, however, that their procurement processes promoted lower capital expenditures; total cost of ownership was a minor consideration. In response, the company decided to go to market with two products: the existing, top-of-the-line imported one, which would remain appealing to a subset of customers, and a new value-oriented product featuring technology that was better than any rival could offer but manufactured in China and priced similarly to products from the company's Chinese rivals. This simple, segmented approach to product design, based on straightforward customer research, is something the multinational probably would have adopted long ago if conditions in the EU countries or the United States had demanded it. But with managers in the United States still making product decisions, the opportunity had been missed in China—until the company began paying that market more attention.

Marketing

Marketing, as practiced by leading Western companies, is a nascent concept in China. Most Chinese companies develop products for the local market primarily on the basis of an intuitive, experience-based understanding of customer needs. Market research, when undertaken, rarely probes for the sort of nuanced understanding that fuels product innovation in developed markets. Coca-Cola, Colgate-Palmolive, P&G, and other global packaged-goods players are competing effectively in many categories by exploiting their sophistication in market research, product development, and brand management. In contrast, few Chinese companies have significant experience to date developing sophisticated brand messages or images.

Nonetheless, in our experience, many multinationals—even leading ones—make mistakes, such as segmenting the Chinese market as they would developed markets, and are astounded at how far off base their underlying assumptions prove to be when they actually conduct deep customer research. For example, when one large

It's not impossible for a US-based executive to develop the mind-set, gain the exposure, and stay sufficiently current on the Chinese market to make good, timely strategic and operational decisions.

Is your second home as strong as your first?

Technology and product strategy	Do you offer as large a range of products in China as you do in your home market? Have these products been designed based on Chinese customers' needs, or are they simply imported or "de-featured" Western designs? Are your price points at the same level as similar offerings from local or even foreign competitors?
Marketing	Has your company invested to know your customers in China as well as you do those in your home market? Is your market intelligence team in China just as big as the one your home market? Do you conduct as many primary market research studies as you do in your home market? Is your customer segmentation just as rigorous—or have you just applied one you use elsewhere?
Operations	Do you expect the same operational-performance levels in China as you do in your home market? Have you invested as many resources or as much expertise in building and refining your Chinese manufacturing, distribution, supply chain, and service models as you have in the European Union and the United States? Are your customer service centers just as close to Chinese customers as your centers in your home market are to customers there? Or have you taken shortcuts because "China is different"—such as working through third-party distributors, though you go direct everywhere else in the world?
Human resources	Is your HR team in China on the same scale as the one in the European Union or the United States? Do you follow a similarly rigorous process for finding potential hires—or do you rely more on references? Do you invest just as much in professional training and development programs, taught by equally qualified staff, as you do in your home market? Do you offer the same type of global rotational programs to rising Chinese executives as you do to those in other markets? Is your CEO just as aware of a rising star in the Shenzhen office as he is of someone in St. Louis or Munich?
Government relations	Do you have just as many and as capable government relations staff in China as you do in your home market? Do you have a similarly well-thought-through process for communicating with your regulators at the central, provincial, and city levels in China as you would in other markets? Are you helping to shape regulations there in the same way as you would elsewhere?

consumer goods company applied sophisticated customer research techniques to its distribution strategy for a new product, it completely revamped its rollout plan. Instead of prioritizing high-end customers in widely dispersed large and wealthy cities, it switched to a more targeted approach that focused on customers who exhibited similar preferences but lived in smaller city "clusters" within close proximity. The benefits were twofold: first, these customers were more receptive, on average, to the brand; and, second, the regional approach made it much easier for the company to ensure consistent, high-quality distribution from a single partner in each locality.

Distribution and service

In a country with as many dispersed and hard-to-reach markets as China, third-party distributors are sometimes necessary. But multinationals relying on them need to make sure these distributors don't underinvest in service levels and quality—which is a common practice for Chinese companies. In an attempt to grow rapidly and at low investment levels, one multinational chose to distribute its products through poorly trained third-party distributors that sold them, alongside rivals' offerings, on a price-per-kilogram basis. The company, frustrated with its performance—running a distant second to the leading multinational player in the market, with Chinese peers rapidly catching up—began creating a large direct-sales force trained to help solve customers' problems. For other companies, distributors may still be the right answer, provided that it's possible to craft a partnership that can tailor sales and service to customer needs.

Supply chain management

In recent years, as sales volumes in China and volatility have increased for multinationals, many have found that their traditional practice—retaining core planning functions at a global headquarters while relying on simple production and shipping requests to guide Chinese supply operations—no longer works. One leading electronics multinational watched inventories explode as planners found it impossible to coordinate production flows. The company first moved three experienced executives to China to stabilize the situation and then began reorganizing its global-planning roles, boosting the number and skill level of local planners and investing in more advanced IT support systems. These efforts to bring the Chinese supply chain up to global standards have been so successful that the company is revamping its entire supply chain across 14 of its Chinese factories and 30-odd external vendors.

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China is becoming the world's most important competitive battlefield, with companies that succeed there creating a foundation for global leadership. Multinationals hoping to win this game must recognize that China needs to be much more than a significant growth market; it needs to become their second home.

Jeff Galvin is an alum of McKinsey's Shanghai office; **Jimmy Hexter** (Jimmy_Hexter@McKinsey.com), who was based in McKinsey's Beijing office from 2003 to 2012, is a director in the Washington, DC, office; and **Martin Hirt** (Martin_Hirt@McKinsey.com) is a director in the Taipei office.

Illustration by Darren Diss

How multinationals can win in India

Companies should avoid simply imposing global business models and practices on the local market.

Vimal Choudhary, Alok Kshirsagar, and Ananth Narayanan

Over the past 20 years, multinational companies have made considerable inroads into the Indian market. But many have failed to realize their potential: some have succeeded only in niches and not achieved large-scale market leadership, while others haven't maximized economies of scale or tapped into the country's breadth of talent. The experience of a leading multinational consumer goods company illustrates the challenge: its revenue in India has grown by 7 percent compounded annually in the past seven years—almost twice the rate of the parent company in the same period. Nevertheless, the company's growth rate in India is only about half that of the sector.

For multinationals, the key to reaching the next level will be learning to do business the Indian way, rather than simply imposing global business models and practices on the local market. It's a lesson many companies have already learned in China, which more multinationals are treating as a second home market.[1] In India, this trend has been slower to pick up steam, although best-practice examples are emerging:

- A leading beverage company entered India with a typical global business model—sole ownership of distribution, an approach that raised costs and dampened market penetration. The company's managers quickly identified two other big

[1] See "Building a second home in China," page 138.

challenges: India's fragmented market demanded multiple-channel handoffs, and labor laws made organized distribution operations very expensive. In response, the company contracted out distribution to entrepreneurs, cutting costs and raising market penetration.

- A big global automobile company has become the one of the largest manufacturers in India, growing at a rate of more than 40 percent a year over the last decade, by building a local plant, setting up an R&D facility to help itself better understand what appeals to Indian customers, and hiring a well-known Indian figure as its brand ambassador.

To realize India's potential, multinationals must show a strong and visible commitment to the country, empower their local operations, and invest in local talent. They must pay closer attention to the needs of Indian consumers by offering the customization the local market requires. And multinational executives must think hard about the best way to enter the market. More and more, that will mean moving beyond the joint-venture approach that so many have adopted and learning to go it alone. (For a localization-assessment tool, see sidebar "Winning in India: An illustrative scorecard.")

It's essential that multinationals raise their game in India: the country's economy is expected to grow by upward of 6 percent annually in the next few years, among the highest rates of any big emerging economy. In several product and market categories—mobile handsets, for example—India could account for more than 20 percent of global revenue growth in the next decade. In other words, the future of many multinationals depends on their ability to succeed in India.

Empowering the Indian organization

Many multinationals in India are stuck in a profitability trap characterized by a lack of commitment to build country-specific operations and management systems. When expatriate company heads are brought in, their efforts often fall victim to short rotation cycles that inhibit the execution of long-term strategy.

One important differentiator is the ability to demonstrate a commitment to India through the economy's inevitable cycles and volatility. Policy makers and local entrepreneurs have long memories, and "state visits" by global CEOs and chairmen are not sufficient if a company doesn't follow through on its commitments.

One global electronics manufacturer offers a successful example of the benefits of a leadership commitment in India. After the company's efforts to set up a joint venture ran aground, it decided to do business on a stand-alone basis. The company launched an aggressive marketing campaign, but rather than raise product prices in India to pay for the effort, global headquarters financed it. Headquarters also helped the Indian subsidiary to source inexpensive components until it could take command of its own operations. The support and commitment of the global office in those early years made this company one of India's leading electronics manufacturers.

But a multinational power and automation technology company learned the hard way what happens when senior executives lack commitment to India. In the late 1990s, the parent company paid marginal attention to local operations there and was unwilling to adapt to changing market conditions. The perfor-

mance of the Indian unit declined—it lacked autonomy and faced hierarchical and bureaucratic roadblocks in its dealings with global headquarters. Finally, in early 2000, headquarters gave the Indian operations a high level of autonomy, and in response revenues rose by 30 percent (compounded annually) between 2001 and 2005.

Empowering local management is also critical for attracting and retaining talented staff. Many

Winning in India: An illustrative scorecard

1. Ensure top-leadership support and commitment through cycles	☐ Set bold and explicit aspirations over next 5 years (eg, 3x–5x growth in India) ☐ Send global CEO and relevant senior executives to India 3–4 times a year; engage in regular dialogue with top Indian clients ☐ Maintain appropriate local investments even through business cycles
2. Customize offerings to suit Indian market and customer needs	☐ Gain deep understanding of 4–5 target client segments and the initiatives that will deliver against a 3x–5x growth goal (ie, beyond just niche markets) ☐ Set high market share goals (eg, 15% or more) for the targeted client segments ☐ Tailor product/service packages to client segments' needs and local market differences
3. Create innovative and localized business model	☐ Commit to products that have 30% less functionality and that cost 50–70% less without compromising quality ☐ Build distribution network that mirrors customer targets; plan to expand it by 20–30% ☐ Employ robust supply chain in India (eg, reliable vendors conforming to quality specifications)
4. Scale up via deals and partnerships	☐ Assign a business-development/M&A team to scout for opportunities in India periodically ☐ Develop strong local partners and joint ventures; manage results proactively every quarter (ie, no arm's-length relationships)
5. Leverage India for global products, services, and talent	☐ Make India team a key R&D hub with sufficient resources to deliver results ☐ Deploy business-model and technical innovations from India in other relevant markets ☐ Global operations benefit from India's cost advantage, scale, and talent pool
6. Manage perceptions and regulation	☐ Maintain strong relationships with top 10 external stakeholders (government and regulators); don't rely on external agencies for this ☐ Achieve premium positioning for brand in India over local competitors; ensure that brand has sufficient Indian attributes (ie, not just a foreign label)
7. Empower local organization; offer a compelling people proposition	☐ Make India head a senior officer and part of global executive committees ☐ Provide India-based CEO with own investment budget and autonomy for most day-to-day decisions ☐ Include top 5 India executives in the global top 200 executives; monitor their career development at a global level ☐ Recruit 10% of global top 500 leaders from operations in India ☐ Achieve reputation as preferred employer (eg, place among top 100 employers in India)

multinationals are moving toward the creation of a strong Indian business unit and, in the process, moving away from functions or global products as the primary axis of governance. These companies are investing in top talent: the head of the Indian unit is experienced and knowledgeable about the market and has a direct line of communication with the global company's CEO. This direct connection to global management—combined with the ability to make decisions on capital spending, products, and pricing—holds a local leader more accountable and facilitates the sharper development and execution of strategy.

Likewise, a global conglomerate faced with declining sales in India recently consolidated all its business units there under one country head, who has direct profit-and-loss responsibilities. This top executive makes all major decisions, including headcounts, pricing, and product customization. All local business unit heads in India now report to him rather than to their global business unit leaders, as they had in the past. This change has helped concentrate resources and enabled faster decision making, allowing the company to better serve local customers and, ultimately, to grow more quickly.

Local empowerment should extend beyond the country head to lower levels of management, which can help drive innovation and entrepreneurialism on the ground and decrease times to market for new products. But structure is not enough. Multinationals need the right people—especially in middle management, a group critical to the successful execution of a growth strategy. Given the vast array of opportunities available in India and its relative shortage of management talent, multinationals have had to revise their models significantly. With the continuing professionalization of Indian companies, the country's stronger managers have less incentive to work for a branch of the multinationals, which must look beyond short-term tactical measures to attract high-quality people.

The most progressive global companies are moving in three directions. First, they create more globally visible local roles, which may include representation on executive committees. Such positions emphasize entrepreneurialism and greater authority and offer higher compensation. Second, these companies promote a meritocratic culture: accelerated career tracks, fair and transparent advancement processes, the absence of a "glass ceiling" for locals, a performance-based system that motivates self-starters, and differentiated incentives for high performers. Third, progressive global companies offer mobility and tailored leadership programs. Structured global rotations for strong performers and leadership-development courses (especially with some form of certification) are proving to be effective recruiting and retention tools.

Innovating for India

Multinationals are learning that many different Indias exist within the subcontinent. The big differences—the haves and have-nots, languages, literacy, and geography (including the urban–rural divide)—make it difficult for a global brand to satisfy all of the country's consumers. Multinationals also face the challenge of low-cost local competitors.

Indian consumers demand sophisticated products and services found in the West, but at lower prices. A one-minute call from a mobile phone, for instance, costs one to two cents in India, much less than it does in the United States. This aspect

Multinationals that enter India on a stand-alone basis generally fare better than those that create joint ventures with Indian partners.

of competition in India means that innovation is occurring not only through localized products and services but also in business models and processes.

To strike a balance between global brands and local positioning, multinationals can introduce sub-brands or models with features suited to Indian needs. They could also work with local suppliers to reduce costs, which would allow them to offer cheaper prices to the end consumer. Although many of these ideas are not new, multinationals have been slow to implement them in India. The key is that customization has to be a game-changing strategy rather than an incremental one: multinationals must aim to cut costs by 60 to 80 percent, with just a 30 percent reduction in features.

One of the classic examples of customization is the success of a Western farm equipment maker that builds and sells relatively low-cost, no-frills tractors in India. These are far less elaborate than most of the machines the company sells in the United States. As a side benefit, it started marketing a version of a lightweight tractor in the US market to farmers and others who wanted a less expensive yet sophisticated product.

Televisions offer another example. Marketing a consumer durable as straightforward as a TV poses a lot of challenges in India's rural market. Some consumers who don't speak or read English can afford to buy a TV but use it primarily to listen to music, so they want high-quality sound. A leading global electronics manufacturer has met this demand by offering television sets with menus in Hindi and five other important regional languages. It has also adapted some models by enhancing their sound systems to provide a better listening experience.

Similarly, a leading car manufacturer has set up a team of people to understand customer requirements and redesign the features of its products. Its design-to-value approach is becoming increasingly common: in India, multinationals devote more than 10 percent of their product-development resources to such efforts. We also find that best-practice international companies take talented employees from India and rotate them through the product-development organization globally. In this way, "frugal engineering" becomes an embedded capability—and frugal can mean both inexpensive and innovative.

Choosing the right entry strategy

One of the first and most important issues for a multinational considering doing business in India is ownership structure. Multinationals that enter the country on a stand-alone basis, our experience shows, generally fare better than those that use Indian partners to create joint ventures. Most global companies that opted for them have exited the Indian market, while

some have purchased the stakes of their partners or established majority shareholdings. One global consumer goods company, for example, bought out its Indian partner because of differences over product marketing and brand positioning. The multinational is now doing well in all the segments where it competes.

Multinationals that choose joint ventures as their entry vehicle into India think that a local partner can better navigate the market's complexities and manage regulatory issues. There is some truth to that idea, but in practice, joint ventures often tend to emphasize short-term performance over long-term goals, long-term commitment, and an alignment between the interests of the global and local partner. Without management control and a clear path to ownership, global companies may have no alternative but to exit the market. Joint ventures can be beneficial in some cases, but they are not essential if a multinational regards India as a priority market and regulations allow the company to have majority or complete. When joint ventures are necessary, multinationals should ensure that they have real management control and a clear path to ownership should that become necessary.

Partnerships with Indian companies need not be limited to joint ventures—multinationals should also consider strategic alliances with local players. An international technology manufacturer and an Indian company, for example, set up a local manufacturing plant that went on to double its production volumes every 18 months. This achievement set it on the path to becoming the largest of the multinationals' plants in India, with the world's lowest costs and high profit margins. From the multinational's point of view, the success of this strategic alliance moved India from the "nice to have" category into an essential part of its international operations.

A global pharmaceutical company established itself as a stand-alone entity but developed strategic alliances with a local manufacturer in licensing and supplies for the generic and off-patent segments. These agreements helped the multinational to enter India's fast-growing market for low-cost, easily accessible branded generics and off-patent medicines.

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Winning in India requires an intense and concerted effort. The multinationals need top leaders willing to make a commitment to the Indian operation and to localize and empower it. They must adapt to the Indian consumer's demand for innovative, low-cost delivery systems and high value for money products, as well as identify and implement an appropriate ownership model. Finally, senior executives of these companies should not neglect the management of local stakeholders, such as regulators and activists. The best efforts to localize an Indian business model will come to naught if these influential groups are overlooked.

Vimal Choudhary (Vimal_Choudhary@McKinsey.com) is a consultant in McKinsey's New Delhi office, **Alok Kshirsagar** (Alok_Kshirsagar@McKinsey.com) is a director in the Mumbai office, and **Ananth Narayanan** (Ananth_Narayanan@McKinsey.com) is a principal in the Chennai office; all the authors are coleaders of McKinsey's Asia Center.

Artwork by Francesco Bongiorni

Growth in a capital-constrained world

Structural shifts in the global economy will make capital scarce, but savvy companies that plan now can secure access to funding—and a competitive advantage.

Richard Dobbs, Alex Kim, and Susan Lund

For the past 30 years, the increasing availability of capital boosted global growth. Falling interest rates drove up asset prices, including real estate and equities, resulting in an unprecedented increase in perceived wealth. Consumers borrowed against the security that these assets provided, fueling a consumption boom that financial institutions, awash with liquidity, were happy to support. Companies and governments also found it relatively easy to finance investments and spending by issuing bonds. While this favorable capital environment penalized savers and resulted in asset bubbles, including the most recent one, it has provided a strong tailwind for global growth.

That wind is about to change direction. The 30-year era of progressively cheaper capital is nearing an end, primarily as a result, ironically, of rapid growth in emerging markets. Their expansion has kicked off a major investment boom: new roads, ports, water and power systems, other kinds of public infrastructure, housing, corporate plants, and machinery purchases will require enormous sums of capital. The government deficits and aging populations of developed economies will exacerbate the global demand for funding.

The bottom line: McKinsey Global Institute (MGI) analysis finds that by 2030, the world's supply of capital—that is, its willingness to save—will fall short of demand, or the desired level of investment. This gap will put upward pressure on real interest rates to balance the supply of and

demand for investment. (Inflationary pressures could boost nominal rates higher still.) And rising interest rates, in turn, could crowd out some investment and slow down consumption growth.

In short, for the first time in 30 years, business leaders will face the headwind of rising, long-term capital costs. As a result, executives should start rethinking their sources of capital, the efficiency with which they deploy it, and in some cases even their business models.

Surging demand for capital

A drop in global investment, more than the "savings glut" that is often cited, contributed to falling interest rates during the 1990s and early 2000s.[1] Investment fell from a peak of 26.1 percent of global GDP in the 1970s to a recent low of 20.8 percent in 2002 (Exhibit 1). This decline's impact on global liquidity was about five times larger than that of the growth in the money supply in excess of GDP or of the cumulative Asian current-account surpluses.

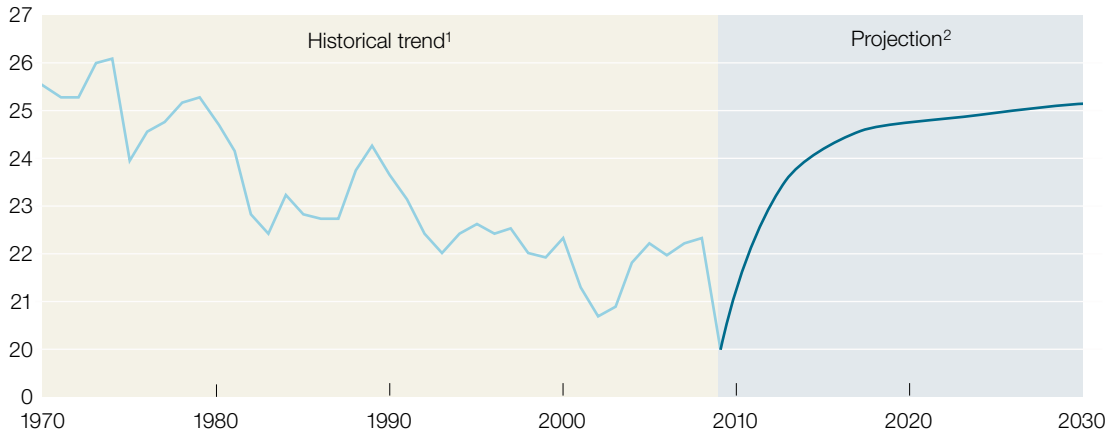
We are now at the beginning of a global investment boom, similar to earlier periods in economic history (such as the Industrial Revolution and the post–World War II reconstruction of Europe and Japan), and it will require massive investment in physical assets. The global investment rate began increasing after 2002, rising nearly three percentage points, to 23.7 percent in 2008, before dipping again during the global recession of 2008–09. While the increase from 2002 through 2008 resulted primarily from very high investment rates in China and India, it also

[1] Throughout this article, "investment" refers to spending on physical assets but not to investment in stocks, bonds, or other financial assets. "Savings" refers to after-tax income minus consumption, so any type of borrowing that increases consumption also reduces savings.

Exhibit 1

Global investment, which fell from a peak in the 1970s, is forecast to rebound within the next 20 years.

Global investment rate, 1970–2030, % of global GDP



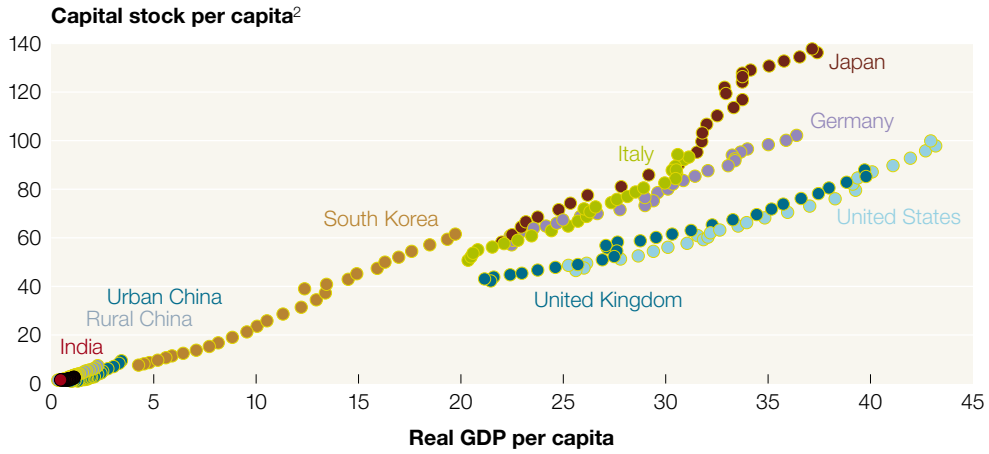
[1] Historical trend shown in nominal terms (based on actual prices and exchange rates) for 1970–2005; and in real terms (using 2005 prices and exchange rates) for 2006–09.
[2] Projection shown in real terms (using 2005 prices and exchange rates); assumes the price of capital goods increases at the same rate as other goods and no other changes in inventory occur.

Source: McKinsey Global Institute analysis

Exhibit 2

Low levels of capital stock in emerging economies such as China and India suggest that high investment rates could continue for decades.

Capital stock vs GDP per capita for selected countries,[1] 1980–2008, $ thousand



[1]At constant 2005 prices and exchange rates.
[2]Net fixed assets at end of year, assuming 5% depreciation rate for all assets.
Source: McKinsey Global Institute analysis

reflected higher rates in other Asian emerging markets, as well as those in Africa and Latin America, where demand for new homes, transportation and water systems, factories, offices, hospitals, schools, and shopping centers is surging. Given the very low levels of physical-capital stock in these economies, our analysis suggests that high investment rates could continue for decades (Exhibit 2).

By 2030, the global investment needed to support consensus estimates for economic growth could exceed 25 percent of GDP, or around $24 trillion, up from about $11 trillion in 2008.[2] Our analysis indicates that the increase will be smaller if global GDP growth is slower. However, investment could increase beyond the levels we analyzed if building costs rise faster than general inflation because of rising commodity prices. It could also increase more if additional investment is required to reduce greenhouse gas emissions to sustainable levels or to counteract the effects of global warming—for example, through the construction of coastal defenses against rising sea levels.

[2]At constant 2005 prices and exchange rates. The consensus GDP forecast is an average of forecasts by the Economist Intelligence Unit, Global Insight, and Oxford Economics.

A declining appetite to save

The capital to finance this growing need for investment comes from the world's savings. Over the three decades or so ending in 2002, the global saving rate (savings as a share of GDP) fell, driven mainly by a sharp decline in household savings (or at least additional borrowing) of mature countries. The global rate has increased

since then, from 20.5 percent of GDP in 2002 to 24 percent in 2008, as many of the developing countries with the highest saving rates—particularly China—have come to account for a growing share of world GDP. Our analysis suggests, however, that the global saving rate is not likely to rise in the decades ahead, because of several structural shifts in the world economy.

First, China's extraordinarily high saving rate will probably decline as it rebalances its economy to promote domestic consumption. China, with a national saving rate that topped 50 percent of its GDP in 2008, surpassed the United States as the world's largest saver. But if China follows the historical experience of other countries such as Japan, South Korea, and Taiwan, its saving rate will decline over time as the country grows richer (Exhibit 3). The country's leaders have already started to adopt policies that will increase consumption and reduce very high rates of corporate and government saving.[3] If China's strategy succeeds, it will save nearly $2 trillion less in 2030 than it would have at current rates. The impact on the global saving rate would be significant: a drop of around two percentage points compared with 2007 levels.

Expenditures related to aging populations will further depress global savings. By 2030, the proportion of the population over the age of 60 will reach record levels around the world. Recent research by the International Monetary Fund and Standard & Poor's suggests that government spending on health care, pensions, and other services for retirees could increase by three to five percentage points of global GDP by 2030.[4] This additional consumption will lower global savings, either through larger government deficits or lower household and corporate saving.

Skeptics may point out that since the 2008 financial crisis, US and UK households have been saving at higher rates, especially through paying down debt. In the United States, household savings rose to more than 6 percent of GDP in 2010, from a low of 2.8 percent in the third quarter of 2005. In the United Kingdom, savings increased from 1.8 percent of GDP in 2008 to around 4.5 percent in the second quarter of 2010. But

[3] Officials of China's government have said publicly that increasing consumption, and hence reducing the current-account surplus, will be a goal in the country's 12th five-year plan. See also the MGI report *If you've got it, spend it: Unleashing the Chinese consumer*, available free of charge on mckinsey.com/mgi.

[4] See *Fiscal Monitor: Navigating the fiscal challenges ahead*, International Monetary Fund, Fiscal Affairs Department, 2010; and *Global aging 2010: An irreversible truth*, Standard & Poor's, 2010.

History shows that real interest rates rise when investors—who always demand a premium to compensate for the risk of faster-than-expected inflation—become concerned about the potential for inflation spikes.

even if these rates persist for two decades, they would raise the global saving rate just one percentage point in 2030—not enough to offset the impact of increased consumption in China and of an aging global population.

Slower growth, higher capital costs?

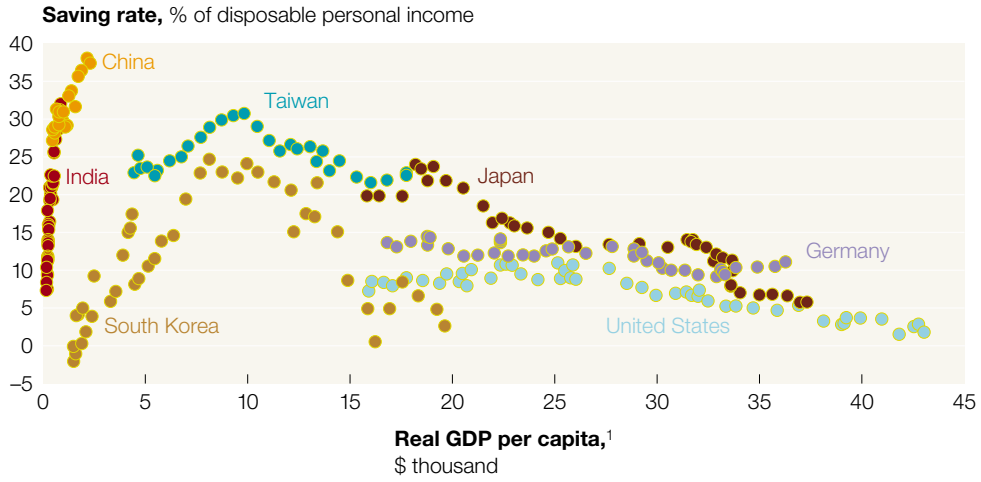
Together, these trends mean that if the consensus forecasts of GDP growth are accurate, the global supply of savings will be around 23 percent of GDP by 2030, falling short of global investment demand by $2.4 trillion. This gap could slow global GDP growth by around one percentage point a year. What's more, our analysis of several scenarios suggests that a similar gap occurs even if the GDP growth of China and India slows, the world economy recovers more slowly than expected from the global financial crisis, or other plausible possibilities transpire, such as the appreciation of exchange rates in emerging markets or significant global investment to combat and adapt to climate change.

The gap means real interest rates, which are currently at 30-year lows, are likely to rise in coming years. If real long-term interest rates returned to their 40-year average, they would rise by about 170 basis points from the levels seen in early 2011. The growing imbalance between the supply of savings and the demand for investment capital will be significant by 2020. However, real long-term rates—such as the real yield on a ten-year US Treasury bond—could start rising within the next five years as investors anticipate

Exhibit 3

Historically, as countries grow wealthier their household-saving rates decline.

Household-saving rate and GDP per capita for selected countries, 1960–2008



[1] At constant 2005 prices and exchange rates.

Source: Bank of Japan; Bank of Korea; Directorate-General Budget Accounting and Statistics, Republic of China; Global Insight; Reserve Bank of India; US Bureau of Economic Analysis; World Development Indicators, World Bank; McKinsey Global Institute analysis

The full McKinsey Global Institute (MGI) report—*Farewell to cheap capital? The implications of long-term shifts in global investment and saving*—is available free of charge on mckinsey.com/mgi, where you can also download the report as an e-book.

this structural shift. Furthermore, the move upward isn't likely to be a onetime adjustment, since the gap between the demand for capital and its supply is projected to widen continually from 2020 through 2030.

Capital costs could go even higher because of inflation. History shows that real interest rates rise when investors—who always demand a premium to compensate for the risk of faster-than-expected inflation—become concerned about the potential for inflation spikes. The emergence of an additional one billion middle-class consumers in emerging markets and massive investment programs in those countries are boosting demand for commodities, from food and water to energy and materials, resulting in inflationary pressures. Also raising investor worries are the expansive monetary policies that major governments have pursued—and the fear that heavily indebted governments will be tempted to reduce the real value of their debt by managing inflation less aggressively than in the past. If these fears are borne out, nominal rates, which reflect real rates plus inflation and determine the interest that companies must pay on their debt, could jump further.

Growing in the new environment

A company's growth prospects and competitiveness within industries and across countries could change significantly in a world of higher capital costs. Just as in the 1980s, when Japanese companies with access to cheap capital held an edge over their Western peers, companies today that can secure inexpensive capital—say, those based in high-saving countries, such as China—will have a new source of competitive advantage.

How executives respond to more expensive capital will depend on their industry and strategy. In the accompanying sidebar, our colleagues describe several steps that companies in a capital-intensive industry might take. For any company unable to finance its growth internally through retained earnings, however, there are some clear no-regrets moves:

Manage capital productivity. Companies that achieve higher capital productivity—output per dollar invested—will need less capital for growth and consequently will enjoy greater strategic flexibility. Capital productivity must therefore become an increasingly important priority for top management. In particular, senior-management teams need to focus with renewed intensity on the returns their investments generate, which too often were overlooked during the recent boom, and use returns on invested capital as a key performance metric for business unit and company-wide investments. They must also apply to capital expenditures the same discipline they apply to managing other costs.

Build relationships with the future suppliers of capital. Companies with direct and privileged sources of financing will have a clear competitive advantage. For example, in countries with high saving rates and limits on capital outflows, domestic companies may gain access to funding more easily than will their competitors elsewhere. We can see this dynamic today in China, where low-cost capital from the country's banks helps finance business expansion domestically and abroad. For companies in capital-intensive industries, it will be even more critical to develop links to large sources of capital. Traditionally, this effort involved nurturing relationships with major banks in financial hubs such as London, New York, and Tokyo. But going forward, it might also mean building ties with sovereign-wealth funds, pension funds,

How industrial companies should prepare for the end of cheap capital

Matthieu Pelissie du Rausas and Guillaume de Roquemaurel

Imagine you are running an aircraft manufacturer, a utility, or any other capital-intensive industrial company. Currently, you receive financial benefits from the interest-rate float on your customers' down payments, relatively low interest rates on your borrowing, and your ability to finance operations with short-term obligations in the capital market. In a more capital-constrained environment, however, our analysis suggests that you and many other industrial companies could see returns on equity decline up to two percentage points through the combined effects of increasing market debt rates, pressure from customers to limit advances, and lengthening debt maturities.[1]

How can you prepare? Some likely moves are similar to those suggested by our colleagues at the McKinsey Global Institute. For example, you might want to seek strategic partnerships with institutions that have easy access to capital and liquidity, such as sovereign-wealth funds. Certainly, you'll want to boost your capital productivity, perhaps by redesigning your supply chain to require less working capital and by becoming ruthless about the efficiency of major capital expenditures. And you're likely to be the kind of company that seriously examines the viability of your business model, based on its need for cash and the resulting risks. Here are some specific steps you should consider that executives in less capital-intensive industries won't.

Be prepared to finance demand. Customers might not have the cash or access to financing to buy your equipment. One response: develop and offer sophisticated credit solutions for your customers, as GE does in aircraft leasing. In extreme cases, you might even consider taking a stake in a proprietary bank, which would give you better access to and other financial institutions from high-saving countries with large pools of capital.

Rethink business models. For companies whose business models are based on cheap capital, the increase in real long-term interest rates may significantly reduce profits and undermine the ability to grow. The financing and leasing arms of consumer-durables companies, for example, may find it increasingly difficult to achieve the high returns of the recent past as their cost of funding increases. Growth will be harder for companies whose sales were dependent on consumer credit. For executives who think the new capital environment could compromise the viability of their business model, now is the time to start exploring alternative operational approaches or even revisiting their portfolio of businesses.

Ensure funding is long term. In a capital-constrained world, short-term capital may not be readily available. Companies should seek

[1] To understand how returns on equity could decline by 2 percentage points, imagine a company with €10 billion of revenue and €7 billion on each side of its balance sheet, including €3 billion of equity and €2 billion of debt. Around 1.5 percentage points of the 2-percentage-point decline in returns on equity could result from down payments dropping from 30 percent to 15 percent of revenue. The other 0.5 percentage points could result from increasing debt costs: say, 85 basis points because of longer maturities and a 150-basis-point increase in long-term interest rates.

market liquidity (including that provided by central banks) and enable you to build a more robust sales finance arm.

Identify suppliers who can also provide funding. Don't forget the potential of your suppliers—some of whom have access to domestic savings pools in certain countries—to be a source of capital. A Chinese steel manufacturer, for example, could provide access to China's export bank. To prepare for a capital-constrained world, corporations should immediately start identifying suppliers with funding capacity.

Monitor liquidity risks at critical suppliers. Since many suppliers will suffer in the new capital environment, you should think hard now about the "industrial ecosystem" whose survival is necessary to serve your customers. For the most critical suppliers, build a joint plan to help them cope with liquidity crises that might otherwise endanger their operations.

Prepare for a liquidity crunch. In a capital-constrained world, the odds of a severe liquidity shortage rise. Now is the time for corporations to think through which assets they will divest to raise cash in a time of need, to create innovative financial vehicles, to diversify the geographies of the banks with which they work, and to renegotiate contracts with suppliers and customers.

Matthieu Pelissie du Rausas
(Matthieu_Pelissie_du_Rausas@McKinsey.com)
is a director in McKinsey's Paris office,
where **Guillaume de Roquemaurel**
(Guillaume_de_Roquemaurel@McKinsey.com)
is a consultant.

more stable (though also more expensive) sources of funding, reversing the trend toward the increased use of short-term debt seen over the past two decades. The portion of all debt issued for maturities of less than one year rose from 23 percent in the first half of the 1990s to 47 percent in the second half of the 2000s. In the coming years, financing long-term corporate investments through short-term funding, instead of equity and longer-term funding, will be riskier. To align incentives more closely, boards should revisit some of their inadvertent debt-oriented biases, such as using earnings per share as a performance metric.

Encourage governments to get their budgets in order and prevent 'financial protectionism.'
The fiscal deficits made possible by recent low interest rates will not be as easily financed in the future and could crowd out private investment or even result in a government bond crisis. Governments should anticipate higher costs

of debt and act now to improve their public finances. Yet even with governments that exercise fiscal restraint, there is still a very real danger that they will resort to regulatory forms of financial protectionism to insulate their economies, or themselves as borrowers, from rising capital costs.[5] Business leaders should get off the sidelines and call for fiscal prudence and for keeping global capital flows open.

For three decades, the world has grown on the back of cheaper capital. The next few decades will be different, so companies need to prepare for an era in which scarce capital places new brakes on growth.

[5] Examples of financial protectionism include rules to stop state-insured banks or domestic pension funds from lending and investing abroad, to direct national pension funds and sovereign-wealth funds to make only domestic investments, or to require certain financial institutions to hold a proportion of their debt in their domestic government bonds.

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Richard Dobbs (Richard_Dobbs@McKinsey.com) is a director of the McKinsey Global Institute (MGI) and a director in McKinsey's Seoul office, where **Alex Kim** (Alex_Kim@McKinsey.com) is a consultant; **Susan Lund** (Susan_Lund@McKinsey.com), director of research at MGI, is based in the Washington, DC, office.

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Dominic Barton
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Bill Russo
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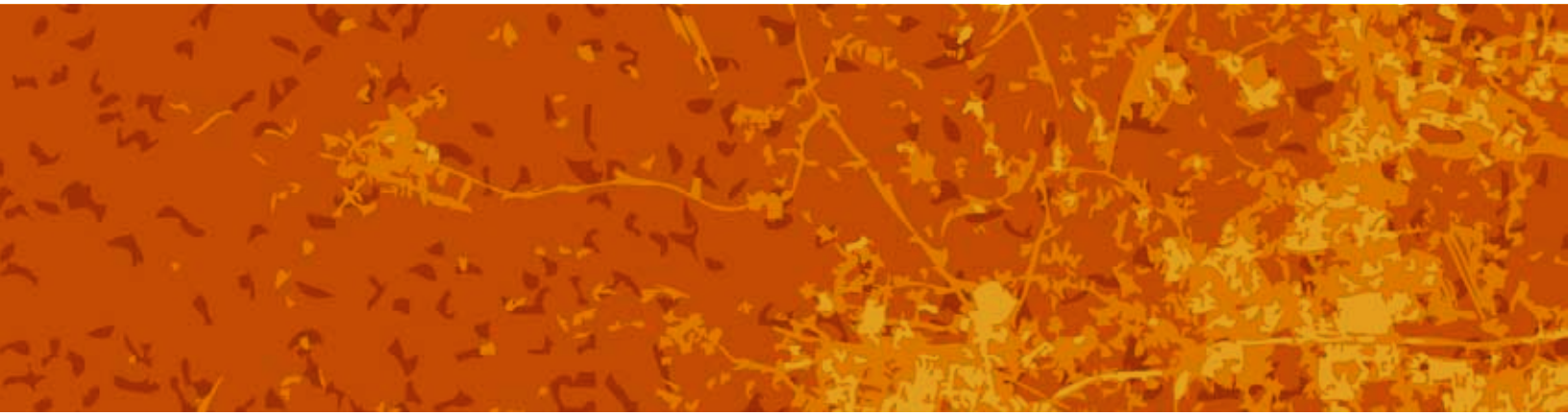
Ian St-Maurice
Fábio Stul
Alex Sukharevsky

Ten disciplines, one goal

By 2025, more than half the world's population will have joined the consuming classes, driving annual consumption in emerging markets to $30 trillion. CEOs recognize that winning in emerging markets, which represent 36 percent of global GDP, is the key to long-term growth. Yet the largest companies headquartered in developed economies derive only 17 percent of revenues from emerging markets. Despite their advantages with regard to scale, technology, and access to capital, multinationals often lose out to upstart competitors.

No single formula or capability guarantees success in emerging markets. We believe that global companies need to master ten disciplines in order to compete effectively. As with a decathlon, winning depends on all-around excellence. Sitting out an event is not an option. This collection explores the ten disciplines in detail, including examples of companies we see as being out in front in each.



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