EXPERT insight

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SPOTTING MARKET VOIDS

Emerging Markets: Look Before You Leap

By TARUN KHANNA & KRISHNA PALEPU

Since the concept was popularized in the 1980s, emerging markets have increasingly attracted attention. Multinational corporations regard emerging markets as a cheap source of manufacturing, an offshore location for technical support, a driver of growth amid stagnation and financial crisis at home, as well as the front line of new competitive pressures.

Yet emerging markets defy facile categorizations. An alternative definition conceives of a market as "emerging" when the specialized intermediaries necessary for the proper functioning of any market are absent or poorly functioning, requiring market participants to work to find new ways to bring buyers and sellers together for some productive exchange. Put this way, most markets, including those considered developed like the United States, are, to some degree, emerging.

This article discusses emerging markets based on this broad conception. We define the institutional voids that qualify a market as being emerging, and describe the factors that condition their development. With this richer understanding, managers will be in a much better position to leverage emerging opportunities in all their guises – whether in Asia, Latin

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America and Africa, the regions that attract the most attention, or in North America and Western Europe, less typical but no less full of business potential.

Beyond the BRICs

Over the past decade, business people have tended to define emerging markets along purely geographical lines; hence, the obsession with BRIC (Brazil, Russia, India and China) and all its countless variations: BRICS (plus South Africa), BRICET (plus Eastern Europe and Turkey), BRICM (plus Mexico) and BRICK (plus South Korea).

Then there are the CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) and the EAGLEs (the Emerging and Growth-Leading Economies of China, India, Brazil, Indonesia, South Korea, Russia, Mexico, Egypt, Taiwan and Turkey, featured in *IESE Insight* Issue 10). Financial institutions regularly produce rankings to highlight which of these markets are growing fastest and/or represent the best opportunities for investors.

The problem with this approach is that it is too simplistic and tends to treat emerging markets as one homogeneous whole, when the exact opposite is true. It also tempts multinational corporations to set their sights exclusively on what they see as the fastest growing markets abroad. They then attempt to fit those foreign markets around their own value proposition, only tinkering here and there at its edges. As a result, their business ventures often fail.

Instead, companies need to work the other way around: They need to adjust their value propositions to the markets they are most interested in. Above all, they need to shift their attention to the particular institutional voids that exist in these markets – for it is there the greatest challenges and opportunities exist, as shown by our research on the subject. In this article, we synthesize the lessons of dozens of scholarly and practitioner-oriented papers, 30 cases and our recent book, *Winning in Emerging Markets* (HBR Press), to clarify the confusion that abounds as to whether a market is or isn't emerging.

EXECUTIVE SUMMARY

Think "emerging markets," and most people think BRICs. The problem with this approach is that it is too simplistic and tends to treat emerging markets as one homogeneous whole, when the exact opposite is true. Instead of asking, "What's my emerging market strategy for Brazil, Russia, India or China?" companies should ask themselves, "In which ways is this particular market emerging?" Viewed this way, the answer may surprise them.

The authors synthesize a decade of their research to clear up the confusion that abounds as to whether a market is or isn't emerging. They first explain which institutional mechanisms need to be in place for the healthy functioning of any market, so managers will be able to recognize when these vital mechanisms are absent or deficient. Asking a series of key questions will help managers spot voids, making them better equipped not only to tackle the challenges but to leverage emerging opportunities in all their guises – whether in the countries that attract the most attention, or in the United States and Western Europe, which may still be "emerging" in some ways.

Institutional Voids: Key to Understanding Emerging Markets

In all markets, basic institutional mechanisms perform key functions or value-added activities. We have identified four types of market institutions that need to be present in order for a market to work. If there is an absence or failure of any of these institutional mechanisms, you end up with a malfunctioning market, as we witnessed with the subprime market in the United States.

CREDIBILITY ENHANCERS. These include accreditation agencies, rating agencies, rankings and auditors, which lend credibility by independently corroborating sellers' claims.

INFORMATIONAL ANALYZERS. The more information available to market participants, the better the decisions they make, and the smoother the market functions. In this regard, the role of

> Pure deregulation – simply lowering the barriers to entry and creating an open market space for business – doesn't, in and of itself, create a developed market. It takes more than that to have a functioning market.

financial analysts, consumer reports and media rankings is vital.

AGGREGATORS & DISTRIBUTORS. Big box retailers, financial institutions and talent placement agencies bring buyers and sellers together in an efficient way.

TRANSACTION FACILITATORS. Credit card providers, clearing institutions, brokers and employment exchanges further help to oil the wheels of commerce.

In addition to these four types of market institutions, public sector institutions perform two other essential roles: They *regulate markets* and they *adjudicate disputes* through government regulators, consumer protection agencies and judicial systems.

To illustrate the necessity of institutional mechanisms, consider this analogy: Suppose you take down the fence around a large, open field. What have you created? A golf course? Not exactly. For it to be one, you would need flags and holes, closely trimmed greens, meticulously planned fairways and a clubhouse that creates and enforces a world-class golfing culture. By the same token, pure deregulation – simply lowering the barriers to entry and creating an open market space for business – doesn't, in and of itself, create a developed market. What you have, certainly, is a large, open field. But it takes more than that to have a healthy functioning market.

An interesting case in point is Chile. Even after decades of aggressive efforts to create a functioning and effective free-market economy there, vital institutional voids persist in parts of the Chilean economy, once again underscoring the painstaking process of creating functioning market institutions, and the forces that constrain the rapid development of markets.

Four Constraints on Institutional Development

A host of factors condition institutional development, including:

HISTORY & POLITICS. Take the Shanghai Stock Exchange: Despite all its outward appearances of being a fully functioning stock market, the Shanghai bourse is anything but one – for the simple reason that corporate governance and transparent financial reporting are hard to develop in the absence of a vibrant democracy, an independent judiciary and a free press.

HUMAN CAPITAL. The quality of a country's human resources depends on various factors including its levels of labor mobility, education

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Product Markets

Ask yourself these key questions to spot the voids.

- Can companies easily obtain reliable data on consumer tastes and behavior? Are there cultural barriers to market research? Do market research firms operate in this environment?
- Can consumers easily obtain unbiased information on the quality of the goods and services they want to buy? Are there independent consumer groups?
- Can companies access raw materials and components of good quality? Is there an extensive network of suppliers? Can companies enforce contracts with suppliers?
- How strong are the logistics and transportation infrastructures? Have global logistics companies set up local operations?
- Do large retail chains exist? Do they reach all consumers or only the wealthiest ones?
- Do consumers use credit cards or does cash dominate transactions? Can consumers get credit to make purchases? Are data on consumer creditworthiness readily available?
- How do companies deliver after-sales service to consumers? Is it possible to set up a nationwide service network? Are third-party service providers available?
- What kind of product-related environmental and safety regulations are in place? How do the authorities enforce regulations?

and training, and contractual enforcement; the standard of its merit-based performance systems; and its recognition of workers' rights.

MUTUAL DEPENDENCY. Many of the market institutions depend on the development of other market institutions.

For example, credible financial reporting requires independent auditors; independent auditors can only be trained if world-class educational institutions exist; world-class educational institutions can only be created if there are world-class professors available; developing world-class faculty takes time, and so forth.

VESTED INTERESTS. As markets evolve, there will be losers as well as winners. The big question is: To what extent do vested interests represent a barrier to the proper functioning of a market? After all, those who stand to lose the most from institutional reform are hardly going to stand by as their privileges and power are eroded.

None of these factors is transient or trivial – quite the opposite, in fact. These factors take decades to evolve to a stage where a country's institutional structures actively support the proper functioning of a market. What's more, this evolution happens in an economic context that is extremely complex and dynamic. As such, emerging markets are hardly utopian places to do business.

Implications for Companies

These complexities should serve to enhance our understanding of emerging markets. Rather than viewing them as a monolithic collective of poor but fast-growing geographies, we should think of them as a conceptual framework.

In that sense, markets are "emerging" everywhere, even in pockets of the United States, Western Europe and other supposedly developed markets.

A recent example is the global financial crisis, which resulted directly from the institutional failings of the subprime market – a market that was, to all intents and purposes, "emerging." Due to myriad institutional failures on the part of both public and private institutions, investors were not fully aware of how to rate, trade and account for the securities being packaged and sold to them by Wall Street's biggest banks.

On a more positive note, PayPal is a good example of a business taking advantage of an emerging opportunity in a mature market setting, by carving out a new role for itself as an intermediary in the growing world of Internet transactions.

Many companies ask themselves, "What should our business strategy be in relation to the emerging markets of China or India?" This is the wrong question to ask. Think like PayPal did: Focus on how certain markets are emerging and how your company can address the challenges and opportunities posed by those markets' institutional voids. Then, work to eliminate those voids through entrepreneurial effort and activity.

Each emerging market must be treated on its own terms. China and India are worlds apart in terms of their institutional voids and cannot be treated the same. As with most aspects of business, there is no one, simple, straightforward formula for navigating the challenges before you.

Labor Markets

Ask yourself these key questions to spot the voids.

- How strong is the education infrastructure, especially for technical and management training? Is there good elementary and secondary education? Are data available to determine the quality of educational institutions?
- Do people study and do business in English or in another international language like Spanish, or do they mainly speak a local language?
- Can employees move easily from one company to another? Does the culture support that movement? Do recruitment agencies facilitate executive mobility?
- Is pay for performance a standard practice? How much weight do executives give to seniority, as opposed to merit, in making promotion decisions?
- Would a company be able to enforce employment contracts with senior executives? Could it stop employees from stealing trade secrets and intellectual property?
- How are the rights of workers protected? How strong are the trade unions?
- Do the laws and regulations limit a firm's ability to restructure, downsize or shut down?

Spotting Institutional Voids

The first step when surveying the business landscape in search of emerging opportunities is to spot the institutional voids. Especially when operating in BRIC countries, companies will inevitably run up against institutional voids. The important thing is not to let yourself become paralyzed by them.

Instead, treat institutional voids with common sense, employing the same array of tools that you would with any business to seize market opportunities: play to your strengths, build capabilities, reshape the environment, adapt accordingly or bide your time until the context changes.

To facilitate this task, we have developed a series of questions relating to four areas of emerging market success: product markets, labor markets, capital markets and the macro context (see boxes). Let's consider each of these areas by comparing the institutional voids as found in Brazil, Russia, India and China, as well as in Europe and the United States.

Product Markets

When studying a potential emerging market, you need to ask yourself two questions that are essential for businesses looking to reach customers: Do large retailers exist in the country? Do these retailers reach all consumers or just the ones who can afford them?

In the United States, there is a long-established network of large retailers serving all sections of society. In Brazil, the retail markets are developing quickly. In Russia, retail networks are still fairly undeveloped, though there are encouraging signs of improvement. In India, they are growing but still only represent 3.5 percent of sales, while China's retail sector is modernizing but remains quite fragmented.

Another key product-related question that multinationals need to ask themselves is: Do consumers use credit cards, or does cash dominate transactions? Also, are data on customer creditworthiness readily available?

In Brazil, there is, on average, one credit card for every 2.26 people. In Russia, there is only one credit card for every 100 people. India is marginally better, with one out of every 42 people possessing a credit card. In China, it's one out of every 56.

Microsoft's delicate handling of its entry into the Chinese market illustrates how a company can exploit institutional voids in product markets to carve out a profitable presence. When Microsoft realized that foreign-owned companies were not treated evenhandedly by Chinese regulators, it shifted its focus toward collaborating with a local firm, with which it codeveloped a localized version of Windows. The company also experimented with a subscription model, as well as with differentiated versions of products, in order to overcome the constraints on sales resulting from Chinese consumers' limited access to credit.

Labor Markets

In labor markets, companies need to explore how the rights of workers are protected. They also need to consider how strong the country's labor unions are, and whether they defend workers' interests or only advance a political agenda.

There is much less industrial action in the United States than in Europe, but the level of unionization varies greatly across each of the member states there. In Brazil, trade unions are strong and pragmatic; likewise in India, where the trade union movement is active and volatile. The influence of unions in Russia is declining rapidly, while the only recourse for Chinese workers is to join an official body that

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answers to the government.

Apart from the rights of workers, companies need to assess the state of local management talent: Does the local culture accept foreign managers? Can employees move easily from one company to another? Do recruitment agencies facilitate executive mobility?

In terms of English-language skills, Brazil boasts a large pool of talent but with varying degrees of proficiency in English. In Russia, employment agencies are booming, but there are varying degrees of English proficiency. In India, local hires are generally preferred over expatriates, but the advantage there is that local candidates speak English. China's market for managers is relatively small and static, and many of them are not fluent in English.

Recognizing the institutional voids in emerging markets is not for the sole purpose of knowing what you're letting yourself in for, so you can avoid them. Quite the contrary: These voids may themselves present the best opportunities for your company to gain a stronger foothold, as General Motors found when venturing into the Chinese market.

When GM entered China, it realized that the country's workforce had limited technical training. Instead of compensating for this void by shipping more staff from the United States, GM saw an opportunity to make up for this shortfall. It collaborated with Shanghai Jiao Tong University to establish an automobile technology R&D and talent training institute. This initiative has paid off in two ways: It has ensured future generations of well-educated, highly trained local workers, while at the same time nurturing closer ties with key stakeholders, i.e., scientists and engineers dedicated to research in automotive manufacturing, materials, propulsion systems and other energy-efficient technology. For GM, it wasn't China per se but rather the lack of technical training that was the defining feature that made it an emerging market.

Capital Markets

Ask yourself these key questions to spot the voids.

- Are financial institutions managed well? Is their decision making transparent? How effective are the banks, insurance companies and mutual funds in collecting savings and channeling them into investments?
- Can companies raise large amounts of equity capital in the stock market? Is there a market for corporate debt?
- Does a venture capital industry exist? If so, does it allow individuals with good ideas to raise funds?
- Do independent financial analysts, rating agencies and the media offer unbiased information on companies?
- How effective are corporate governance norms and standards? Are corporate boards independent and empowered, and do they have independent directors?
- Are regulators effective in monitoring the banking industry and stock markets?
- How well do the courts deal with fraud?
- Is there an orderly bankruptcy process that balances the interests of owners, creditors and other stakeholders?

Capital Markets

How effective are the country's banks in collecting savings and channeling them into investments? Can companies raise large amounts of equity capital in the stock market? Is there a market for corporate debt? These are just some of the questions related to capital markets that companies need to ask when entering a new market.

In Europe and the United States, companies can usually get bank loans easily and gain access to investors through the stock markets. In many other parts of the world, capital markets are not nearly as developed.

For example, Russia's banking system is dominated by state-owned entities, although it does have a booming IPO market. Brazil has a good banking system that works efficiently and a healthy market for IPOs. India has a well-developed local banking system, and also

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offers the possibility of equity to both local and foreign companies. In China, by contrast, foreign companies need to rely on home markets for financing.

Another issue is the reliability of performance data. In Europe and the United States, there is a high level of transparency, although the rise of off-balance-sheet items might point to growing voids. Brazil has a well-functioning system based on common law. Russia has been shifting toward following international standards, so it is moving in the right direction. India, whose judicial system is based on common law, works quite well. China offers little corporate transparency, and its accounting standards are weak.

The case of the Indian telecom company, Bharti Airtel, is instructive of how companies can navigate emerging capital market voids, and turn them to their advantage. The company found that local capital-providing intermediaries were highly underdeveloped in India, so it approached foreign partners, who not only provided the necessary capital, but also opened access to global resources and strategic advice. The void of underdeveloped information providers and certifiers prompted the firm to forge partnerships, which ultimately earned Bharti Airtel greater credibility among investors when it went public.

Macro Context

The fourth vital area where institutional voids exist relates to the macro context. The issues include the vibrancy and independence of the media, and the level of activity and influence of non-governmental organizations, civil rights groups and other social agents.

The United States has powerful NGOs and a dynamic media sector. Similarly, India's vigilant NGOs and lively media act as important safeguards against corporate and governance abuses. Brazil boasts influential media but marginal NGO influence. In Russia, the media are mostly controlled by the government and NGOs remain weak and underdeveloped. Chinese media are muzzled by the government, and independent NGOs are few and far between, so one cannot count on them too much to keep abuses in check.

Putting It All Into Practice

Most multinational corporations learn to crack emerging markets with immense difficulty. Strategies need to be constantly revised and redrawn as part of a constant process of experimentation. Only then do they stand a chance of finding the appropriate combination or sequence of approaches to align their businesses with emerging contexts.

Macro Context

Ask yourself these key questions to spot the voids.

- To whom are politicians accountable? Are the roles of the legislative, executive and judiciary clearly defined?
- Does the government go beyond regulating business to interfering with it or running companies? Do the laws articulate and protect private property rights?
- Is the judiciary independent? Do the courts adjudicate and enforce contracts in a timely and impartial manner?
- How vibrant and independent are the media? Are nongovernmental organizations, civil rights groups and environmental groups active?
- Do people tolerate corruption in business? Can strangers be trusted to honor a contract?
- What restrictions does the government place on foreign investment? Is the presence of foreign intermediaries allowed, including market research and advertising firms, media companies, banks, management consulting firms and educational institutions?
- How long does it take to start a new business? How cumbersome are the procedures for permitting the launch of a wholly foreign-owned business?
- Are there free trade agreements with other nations? If so, do those agreements favor investments by companies from some parts of the world over others?

> Pinpoint the critical institutional infrastructures that are missing in the emerging market. Determine to what extent these institutional voids might affect your ability to access desired market segments.

Companies must also overcome the competitive challenge posed by the fact that firms currently operating in emerging fields – whether BRIC countries or unstable, contested business environments in the developed West – are already one step ahead in their understanding of these markets' institutional strengths and weaknesses, enabling them to scale up or go global that much faster.

Before doing anything in emerging markets, you need to dedicate time to a process of introspection, reflection and assessment. What is your core business model? Which parts of it are changeable?

Next ask yourself: Which market institutions does your business model depend on in your home market? Of these, which are core and which are transferable?

The second phase involves a rigorous assessment of the emerging markets that you have set your sights on. This means defining the opportunity each market presents, and identifying the segments to target. Use the questions in the boxes to identify the institutional voids in this emerging market.

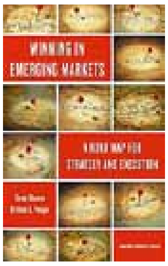
By going through this exercise, you will be able to pinpoint the critical institutional infrastructures that are missing in the emerging market. You need to determine to what extent these institutional voids might affect your ability to access desired market segments.

Once this has been done, you need to choose the strategies to mitigate or leverage those voids. This means opting to:

- **REPLICATE.** You could choose to rely on the comparative strengths and advantages of your existing brand, credibility and know-how, and attempt to repeat that in the new context.
- **ADAPT.** You could choose to adapt your business model, your products or your organizational framework to the institutional voids.
- **GO IT ALONE.** You could choose to enter the emerging space and seek to position yourself as the prime player in that environment.
- **ACQUIRE CAPABILITIES.** You could choose to navigate the space through local partnerships or joint ventures to make up for your own voids. Indeed, in some BRIC markets, partnerships between multinationals and emerging giants have proven to be vehicles for the transfer of breakthrough ideas between market contexts.
- **ACCEPT.** You could take the limiting factors of the new market context as a given and accept the implications for your business. In spite of the voids, you'll enter anyway.
- **GO ELSEWHERE.** You could decide it's not worth it and seek opportunities elsewhere.

Whatever you choose, one thing is certain: Emerging markets are breeding grounds for innovation and experimentation. New ideas and business models are born in such contexts, and will continue to shape industries around the world. As such, it behooves everyone to understand these markets better. ☐

TO KNOW MORE



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