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Laboratories of Innovation:

*Leveraging Emerging Markets
for Commercial Success*



Global manufacturers are focused intently on the opportunities to develop and sell their products in emerging markets. But long-term success will take far more than simply making minor adjustments to existing products, lowering prices, and developing new sales channels.

Companies will need to acquire a new set of competencies and organizational structures to generate a continuing stream of innovative products tailored to the needs of consumers and industrial buyers in emerging markets. They will need to take advantage of their parent company's governance, business processes, and management expertise to offer these products at dramatically lower prices that match the lower purchasing power of most buyers in emerging markets.

By creating markets for their products among more than three billion people and numerous companies in emerging markets, many of whom are not currently being effectively served in many categories, manufacturers have the ability to drive sustainable, profitable growth.¹ And they have the potential to develop products and skills that can be used to change the competitive landscape of developed markets as well.

These are some of the preliminary findings emerging from research by Member Firms of Deloitte Touche Tohmatsu ("Deloitte") on what is required for global manufacturers to realize the enormous market potential of the emerging economies of Asia, Eastern Europe, and Latin America. The research includes a survey that has been completed so far by more than 200 executives, in-depth case studies, and the extensive experience of Deloitte Member Firms in advising major manufacturers operating in emerging markets.

The business opportunity can not be overstated. The aggregate gross domestic product (GDP) of the 10 largest emerging economies is almost \$6 trillion, and many are growing rapidly.² China grew by 9.6% annually from 1990 to 2003, and India by almost 6%.³ China and

India are already the fastest growing cell phone markets in the world and China's auto market is now number three.⁴

Given these trends, it is not surprising that manufacturers see their future growth coming from emerging markets. When Deloitte asked manufacturing executives about the outlook over the next three years, 58% expected their company's revenues in emerging markets to grow substantially, compared to just 23% who were as optimistic about their prospects in developed markets.

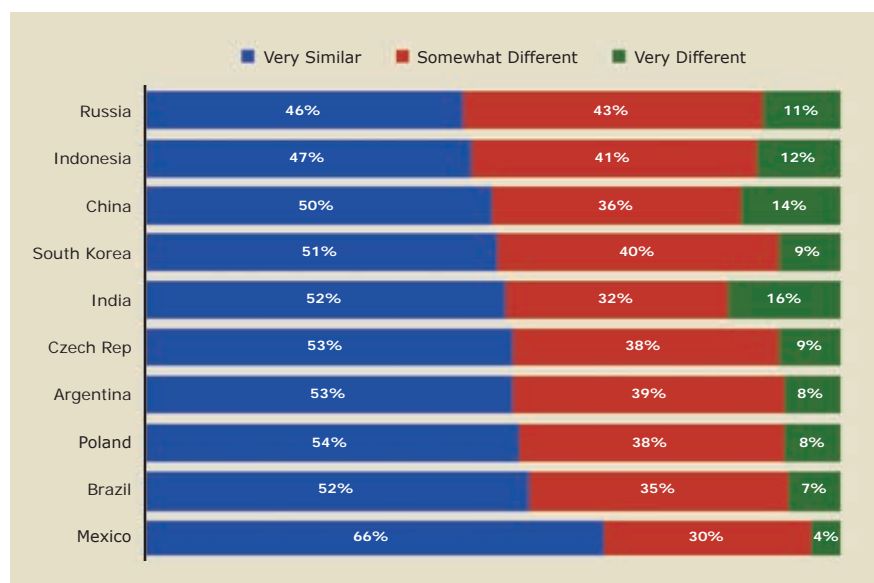
But too many manufacturers have attempted to serve these markets by simply offering their existing products with minor modifications, or often older products at somewhat lower prices. In most emerging markets, half or more of the executives surveyed said their products were

very similar to those sold in their home market. (Exhibit 1). When the companies surveyed did vary their product offerings, they were more likely to adjust the pricing or the discount/rebate policy, rather than to offer fundamentally different product features or types to appeal to the unique profile of emerging market customers. (Exhibit 2).

Global manufacturers have the opportunity to achieve substantial market share and profitable growth by developing innovative, low-cost products that meet the needs of emerging market customers, potentially "disruptive" innovations that create new markets by addressing the needs of customers not being served effectively.⁵ By going beyond their traditional innovation strategies targeted to the needs of developed markets – and taking advantage of their global

Exhibit 1

Products Sold in Emerging Markets Often the Same as at Home
How Products Sold by Company in Emerging Markets Compare to Products Sold in Home Market



Source: One or More Member Firms of Deloitte Touche Tohmatsu

capabilities – manufacturers can use emerging markets as real-world laboratories for innovation.

Given the size of the opportunity, why don't more major manufacturers develop new products for the emerging markets in which they compete? Simply put, it's a daunting challenge to design an array of profitable products that meet the needs of new customer segments and do so at prices that match the average per capita GDP in emerging markets. To add to the challenge, global manufacturers have built their capabilities and products on understanding the preferences, technical requirements, and acceptable pricing for consumers and businesses in developed markets. Now, they need to "unlearn" much of what has made them successful in order to develop and profitably commercialize far less expensive products that meet the very different needs of consumers and businesses in emerging markets.

Global manufacturers in emerging markets often pursue a high-volume strategy, selling products similar to those they sell in developed markets but dropping their prices and accepting lower margins. Among the executives surveyed from companies headquartered in developed markets, 42% said their company had lower gross margins in emerging markets than in its home market, while one-third said their margins were similar. Only 24% enjoyed higher margins.

But companies surveyed that did capture higher margins were more likely to have adapted to local requirements by varying their product offerings such as models, features, or pricing. For example, 73% of the companies with higher margins in emerging markets offered product models that were either very or somewhat different than what they offered in their home market. (Exhibit 3).

While smaller companies are often considered more agile in seizing new opportunities, Deloitte's findings suggest that the largest, most complex global manufacturers have an edge. Among the companies surveyed with more than \$1 billion in annual revenues, 38% had higher margins in emerging markets compared to 14% of smaller firms.

Fully 93% of these larger companies offered product types that were very or somewhat different in emerging markets, compared to half of smaller companies.

Clearly, each emerging market has a unique profile, and the right strategy for a company will depend on the nature of its industry and its capabilities, among other factors. However, too many manufacturers remain captive to the products and strategies that have served them well in the past, missing the opportunity to win new customers and grow profitable market share through innovations in emerging markets.

Organizing to innovate in emerging markets has fundamental implications across a company. Here are six critical issues that global manufacturers need to address to succeed.

Delivering Different Products at Dramatically Lower Price Points

Serving the majority of emerging market customers will require manufacturers to design products priced far below their offerings in developed markets. This is not simply a matter of shaving 10% to 15% off costs. Instead, new products need to be designed at prices that are orders of magnitude lower than in developed markets.

Nokia and Motorola now offer cell phone handsets for less than \$50, and Royal Philips Electronics NV

has a project to drive production costs below \$15 by 2008.⁶ Made in Romania, Renault's Logan is a \$6,000 car that was designed for the Eastern Europe market, but has proven to be popular around the world, including in Western Europe.⁷

Lower cost does not necessarily mean less sophisticated. Passive RFID chips developed by Philips enables an efficient transport payment system used in Shanghai and other major Chinese cities.

Global manufacturers can be certain of one thing: if they don't develop low-cost products, local firms will surely do so. Haier Group, the Chinese appliance manufacturer, has designed a tiny washing machine for the rural market that sells for just \$38.⁸

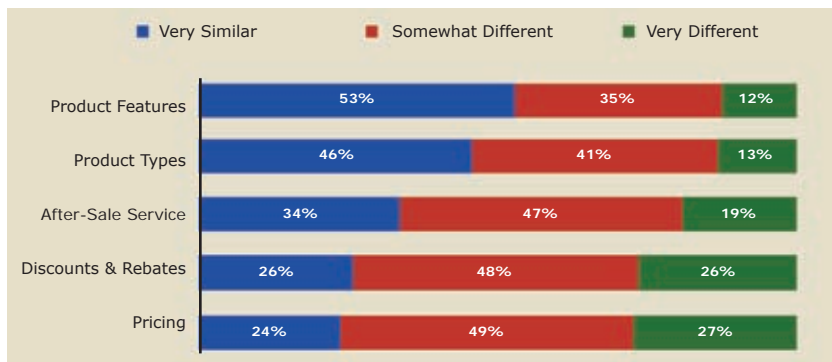
Acquiring Deeper Customer Knowledge

Companies need to invest the resources required to gain a deep understanding of the requirements of customers in emerging markets. Each country is different, and the needs within a single country can vary widely.

Procter & Gamble now spends 30% of its \$1.9 billion R&D budget on developing products for low-income consumers, with laboratories that recreate the temperature and humidity in Mexico and China.⁹ Not content with traditional methods, the company's researchers spend time in people's homes to understand how

Exhibit 2

Companies Less Likely to Adapt Product Features and Types
How Specific Attributes of Company's Products Compare in Emerging Markets and Home Market



Source: One or More Member Firms of Deloitte Touche Tohmatsu

they live and actually use products. The result has been a series of innovations including new versions of Tide and diapers designed to meet the special needs of low-income households.

Globalizing R&D

Many major manufacturers have now located R&D facilities in emerging markets not only to reduce expenses, often benefiting from tax credits and other government incentives, but just as important to better incorporate local needs and expertise into product design. Rather than confined to a few industry leaders, 40% of the executives surveyed at companies selling new products in emerging markets said these were designed locally. Due to their proximity to customers and key suppliers, Emerson turned to its engineering teams in the Philippines and other Asian countries when designing lower-cost power supplies.¹⁰

While the benefits can be substantial, a key challenge is to effectively integrate research and development teams around the world with each other and with commercial managers. In addition, an explicit strategy to protect a company's intellectual property assets is essential given the weaker patent and intellectual property protections in many countries.

Mastering the Complexity of Global Value Chains

For companies to deliver commercially viable products at dramatically lower prices requires an efficient global value chain encompassing governance, business processes, and management know-how. Deloitte Member Firm's research into the operations of the largest and most complex companies in its database of more than 800 global manufacturers have found that only 15% have successfully mastered the growing complexity of their value chains, but these companies are up to 50% more profitable.¹¹

Most importantly, as they expand sales in emerging markets, companies will need to strike a balance between efficient global value chains and the responsiveness that more autonomy for local subsidiaries

can provide. One promising approach is to create "micro" operations that can flexibly customize products to meet the needs of local markets or customer segments, while basing them on the efficiency and expertise provided by a global platform.

Adapting Marketing and Sales

Manufacturers need to consider carefully their approach to marketing and sales. Companies with fairly standardized products often rely on brokers, agents, and alliances to quickly create distribution channels. Some companies with more complex offerings instead develop their own sales forces or seek partnerships to reduce risk and lower the costs of after-sales service.

In India, Cisco invested in a large sales operation due to fewer technology distributors and integrators that serve as important sales channels elsewhere.¹² Cell phone makers in China predominantly sell their products through retail stores and local distributors, rather than service providers as is common in the United States.¹³

But global manufacturers can also find opportunities that local players have overlooked. Dell recognized

that more than 90 million people in China had Internet access either in their homes or at work. Defying conventional wisdom, Dell's online PC sales have been growing rapidly.¹⁴

Tailoring Talent Management

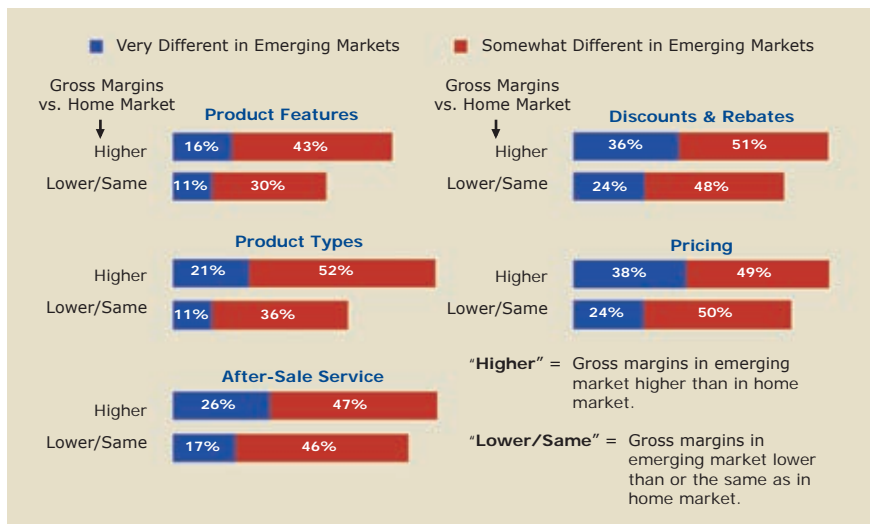
Manufacturing executives will need to rethink how they recruit, develop, deploy, and connect the skilled employees on which they rely. Once seen as an inexhaustible supply of low-cost labor, many emerging markets are now facing the same shortages of skilled labor that are all too familiar in developed countries. In addition to offering bonuses or other perks, strategies have included expanding recruiting outside the largest cities and providing additional training to less skilled hires.

Providing opportunities for professional growth and advancement is critical. Philips encourages its researchers to publish papers and apply for patents, and offers global prizes and recognition for innovative work.¹⁵ The Indian automotive manufacturer Mahindra & Mahindra Ltd., has created a separate engineering services division, Mahindra Engineering Services, that allows its key engineers to expand their skills by working on a wide range of projects.¹⁶

Exhibit 3

Companies with Higher Gross Margins in Emerging Markets are More Likely to Customize Product Offerings.

Percent Saying Attribute is Very Or Somewhat Different Compared to Home Market



Source: One or More Member Firms of Deloitte Touche Tohmatsu

Conclusion

Emerging markets are becoming the catalyst for new product and service innovation. But tapping the talent and growth potential of these rising economies will require manufacturers to shed many of their assumptions about customer needs, product design, and innovation strategies that they have relied upon in the developed economies.

Companies will need to look beyond traditional strategies in order to meet the needs of markets with significantly lower per capita GDP, while still leveraging the efficiency and expertise provided by their global networks. Those that do so successfully will thrive as the rules of global competition are rewritten in the years ahead.

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Global Manufacturing Industry Practice

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Key Questions to Answer

Global manufacturing executives should ask themselves the following key questions about their strategy in emerging markets:

1. Is your company developing fundamentally new products, with appropriate cost structures, that meet the unique requirements of consumers and industrial buyers in emerging markets?
2. Is your company developing innovations in emerging markets that can be brought back to change the competitive landscape in developed economies?
3. Has your company evaluated the benefits and challenges of locating R&D capabilities in emerging markets? Are your R&D operations integrated into a global infrastructure that takes advantage of common governance, business processes, and expertise?
4. How effectively does your company manage regulatory risks in emerging markets in such areas as intellectual property protection, labor laws, and taxes?
5. Is your company able to attract, develop, and retain the key employees it needs in emerging markets and integrate them globally?

Survey Participants

The preliminary responses to Deloitte's online survey on innovation in emerging markets comprised 209 executives in manufacturing companies with a variety of sizes, industries, and locations:

- Annual Revenues: Less than \$250 million (34%), \$250 million to \$1 billion (30%), \$1 billion or more (37%).
- Industry: consumer goods (25%), auto (23%), chemical/paper/metals (23%), industrial equipment (22%), aerospace & defense (7%), pharmaceuticals (7%), computer hardware (4%).
- Headquarters Location: United States/Canada (50%), Western Europe (28%), Japan/Australia (9%), emerging markets (14%).

Deloitte will release a report in April 2006 incorporating additional survey respondents and case studies.

Note: Percentages for annual revenues and headquarters location do not total 100 due to rounding. Percentages for industry do not total 100 since some companies operated in more than one industry.

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Notes:

1. United Nations Population Division, 2005 estimates.
2. World Development Indicators, 2005, World Bank.
3. World Development Indicators, 2005, World Bank.
4. "Branding Gains Respect in Emerging Markets," *The Wall Street Journal Asia*; January 3, 2006. "Here Be Dragons," *The Economist*, September 2, 2004.
5. *The Innovator's Solution*, Harvard Business School Press, 2003.
6. "Cell Phones for the People," *BusinessWeek*, November 14, 2005; "Philips Opens Low Cost Mobile R&D Center In Shanghai," *Dow Jones International News*, November 11, 2005.
7. "Renault's Manual Overdrive," *BusinessWeek Online*, July 19, 2005.
8. "China Design," *BusinessWeek*, November 21, 2005.
9. "The Switch to the Lower-Income Consumer," *Financial Times*, November 16, 2005; "Check the Depth of the New Customer's Pocket," *Financial Times*, November 16, 2005.
10. Interview with Mr. Randall D. Ledford, Senior Vice President and Chief Technology Officer, Emerson. December 2005.
11. Global Benchmark Survey by Member Firms of Deloitte Touche Tohmatsu, *Unlocking the Value of Globalization: Profiting from Continuous Optimization*. 2005.
12. "Cisco: Sold on India," *BusinessWeek*, November 28, 2005.
13. "Handset Makers Win Back China," *The Wall Street Journal Asia*, September 27, 2004.
14. "Computer Savvy," *The Wall Street Journal Europe*, July 6, 2005.
15. Interview with Dr. H. A. (Rick) Harwig, CEO Philips Research. January 2006.
16. Interview with Mr. Pravin N. Shah, Executive Vice President, and Mr. V. Jagannathan, Senior General Manager, Mahindra and Mahindra Ltd. December 2005.

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