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A special report on innovation in emerging markets

Here be dragons

The emerging world is teeming with new business models

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IN DECEMBER 1872 *HMS Challenger* sailed from Portsmouth to conduct the most ambitious survey of the oceans ever. During the ship's four-year journey the crew discovered over 4,000 unknown species and provided invaluable material for the raging debate about evolution.

Brett Ryder

Business travellers in today's emerging markets often feel a bit like the *Challenger*'s crew. They constantly come across what to Western eyes look like exotic corporate species and new, unfamiliar kinds of business which raise profound questions about the evolution of companies and business models.

Most emerging countries have a penchant for highly **diversified conglomerates**. India's Tata Group, which accounts for almost 6% of the country's GDP, has subsidiaries in carmaking, agricultural chemicals, hotels, telecommunications and consulting. Reliance Industries' range sprawls from petrol products and clothes to fresh food. But such diversification is not confined to giant organisations. China is full of small and medium-sized companies that have fingers in many pies, taking advantage of opportunities as they arise.

Many emerging countries also rely heavily on **state-owned enterprises**. These organisations are peculiar hybrids that have never been seen before; the closest relatives are the European trading companies of the 16th-19th centuries, such as Britain's East India Company. They are not old-fashioned nationalised companies run by the government and designed to control chunks of the national economy, but nor are they classic private-sector companies that sink or swim. Instead they are amphibious creatures that flit between sea and land, borrowing money from governments at subsidised rates one moment, plunging into the global market the next.

China and Russia are the main exponents. Thousands of Chinese companies have convoluted ties to central or local government. Russia has created a large class of state companies that enjoy various legal privileges. But countries in Latin America and the Middle East are jumping onto the hybrid bandwagon.

Hybrid organisations are particularly prominent in the energy sector. The world's 13 largest oil companies, as measured by reserves, are all controlled by governments, and three-quarters of the world's crude-oil reserves are in the hands of state-backed companies. Many of China's best high-tech companies, such as China Telecom and Lenovo, are also state-backed. But such organisations are active in lots of other areas too. Like the developing world's private giants, they are often diversified.

Adapt and survive

In their different ways both of these corporate forms are creative responses to their circumstances, much like the exotic ocean creatures that the *Challenger's* crew dredged up from the depths. Diversified conglomerates can adapt to environments rife with political and financial risks. Tarun Khanna, of the Harvard Business School, argues that they are also good at dealing with shortages of vital resources such as capital and talent. The Tata Group can use capital from established businesses to support growth in new ones, and has the resources to attract and train the best people. It can also use its brand name to sell all sorts of products. Indians who have grown up enjoying Tata tea might be more inclined to buy the latest Tata electric car.

State-owned companies also draw on long traditions. Authoritarian governments can use them to direct economic activity (and also to preserve their economic power). Local entrepreneurs can use them to seize business opportunities. And even Western multinationals can use them to gain access to difficult markets. Looked at one way, a huge organisation such as China Mobile is a throwback to an earlier era; looked at another way, it is an attempt by those in charge to embrace a more dynamic economy—an evolutionary change.

How are these companies likely to fare as they compete in a global marketplace? Most Westerners have little time for diversified conglomerates; they expect a "conglomerate discount" when they buy such shares on the stockmarket, and regard them as a primitive corporate form that will tend to disappear as local stockmarkets improve and investors rather than companies get to do the diversifying. But the inefficiency of capital markets is only one of the reasons for diversification. Two of the others—talent shortages and brand-building—are likely to be around for a long time yet. Conglomerates may have an enduring advantage in attracting and training talent in rapidly growing markets, and in building brands in regions where brand recognition is low and potential consumers are numbered in their billions rather than millions. The Tata Group reckons that its brand is worth about 100 billion rupees ($2.2 billion).

The case for state-owned companies is less robust. Hybrid companies are inherently confused organisations: unclear whether they are responsible to the state or the marketplace, and buffeted by contradictory pressures. They are subject to political meddling, often called upon to save "strategic" jobs and regularly used to oil the state patronage machine. Outsiders often find it hard to know whether to treat them as a business or an arm of government. And the OECD says that state-owned enterprises have significantly lower levels of productivity than private firms. But the road to real privatisation will be a long one, and the recent financial meltdown has hardly made emerging-market governments more favourably disposed towards the Anglo-Saxon model.

It would be foolish for Western companies to dismiss these new corporate life forms as evolutionary dead ends, but there is little scope for emulating them. The same is not true of many of the business models that the emerging world has come up with. They are not only important innovations in their own right but have serious implications for the way that Western companies run their affairs.

Learning from the masters

Three of them are particularly powerful. The first concerns rethinking economies of scale, which usually involves **scaling up**. Companies reduce unit costs by centralising their manufacturing and producing long runs of standardised items. But centralised production adds expensive layers of bureaucracy, and it is hard to make it work in emerging markets where populations are often widely scattered and distribution systems abysmal.

The Boston Consulting Group notes that a growing number of entrepreneurs in the emerging world are replacing scaling up with **scaling out**, which means involving a wider range of people in the process of production and distribution, something that has been made much easier by mobile phones and the internet. The most successful examples of this are clinics on wheels, but there are plenty of others. Nutriset, a French manufacturer of fortified food for malnourished children, has outsourced production to local franchises in Africa. The company maintains quality control and the franchises are close enough to the children to make distribution quick and easy. Kenya's Child and Family Wellness Shops offer shares in the company to the nurses who operate the clinics, which encourages them to serve more children and helps stem the brain drain from rural areas.

A second business model takes an equally contrarian approach to production. John Hagel and

John Seely Brown, who run Deloitte's Centre for Edge Innovation, argue that Western companies have spent the past century perfecting "push" models of production that allocate resources to areas of expected demand. But in emerging markets, particularly those where the Chinese have a strong influence, a very different **"pull" model** often prevails, designed to help companies mobilise resources when the need arises. Hong Kong's Li & Fung or China's Chingquing Lifan Group can use their huge supply chains to produce fashion items or motorcycles in response to demand. Taiwan's Quanta and Compel can produce cheap computers and digital cameras for a fashion-conscious digital marketplace.

These pull models fundamentally change the nature of companies. Instead of fixed armies looking for opportunities, firms become loose networks that are forever reconfiguring themselves in response to a rapidly shifting landscape. Such models are not peculiar to emerging markets: Dell builds computers to its Western customers' specifications, and Western management gurus have been advocating networks for decades. But according to Messrs Hagel and Seely Brown they are far more widespread in emerging countries.

The developing world's most innovative business model may be the **application of mass-production techniques to sophisticated services**. This started with India's outsourcing firms, which demonstrated that economies of scale and scope could be reaped from services that used to be highly fragmented and geographically rooted. These outsourcers are still expanding and moving upmarket. Indian consultancies are now challenging Western ones in complex services, not just dealing with customer complaints.

Emerging-market entrepreneurs want to apply these techniques beyond IT and the back office. For example, they see a huge market for legal services requiring a high level of expertise. Dr Shetty is only one of many Indians who are applying Henry Ford's principles to health care. LifeSpring has reduced the cost of giving birth in a private hospital to $40 by looking after many more mothers. Aravind, the world's biggest eye-hospital chain, performs some 200,000 eye operations a year. It takes the assembly-line principle literally: four operating tables are laid side by side and two doctors operate on adjacent tables. When the first operation is done, the second patient is already in place.

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