The Economist

A special report on innovation in emerging markets

Grow, grow, grow

What makes emerging-market companies run

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THE view from the 87th-floor lobby of Shanghai's Grand Hyatt hotel is a wonder to behold (if you can behold it through the ever-threatening smog). Lesser skyscrapers glow with the logos of global giants such as Citi and HSBC. The river carries ships loaded with the riches of the world's workshop. High-rise housing projects stretch into the distance: the city's population, already 19m, is forecast to grow to 45m by 2025.

The emerging world is enjoying the most spectacular growth in history. Its share of global GDP (at purchasing-power parity) increased from 36% in 1980 to 45% in 2008 and looks set to grow to 51% in 2014. Emerging-market consumers have been outspending the Americans since 2007; by last year their share of global consumption had gone up to 34% against America's 27% (see chart 4).

This dynamism shows no signs of waning. Emerging countries are shaking off the recession as developed countries continue to struggle. In the last quarter of 2009 Thailand grew at an annual rate of 15.3% and Taiwan at 18%. Many economists expect growth in emerging markets to be four percentage points higher than growth in the rich world for at least the next five years.

Thanks to such rapid advances, many of the developing world's champions have risen from zero to hero in just a couple of decades. In 1990 Mittal was an unknown producer making steel in Indonesia. Today, as ArcelorMittal, it is the world's largest steel company, bigger than the next three combined. Lenovo, which did not exist in 1990, bought IBM's personal-computer business five years ago and is now the world's fourth-largest PC-maker, after Hewlett-Packard and Dell. South African Breweries in 1990 was a local brewer confined to its home country by anti-apartheid laws. Today it is one of the world's three largest beer companies.

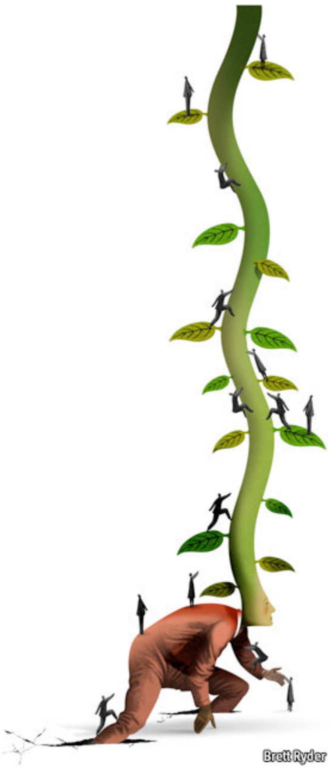
That sort of growth is not confined to local champions. The current boss of L'Oréal's Chinese operations, Paolo Gasparrini, arrived in the country in 1996 with just a briefcase full of cosmetics. Now L'Oréal's Chinese operations represent $150m-worth of investment and the company treats China as a manufacturing hub, producing cosmetics for most of Asia, as well as one of its most important markets.

Growth shapes the outlook of the corporate world. There is a buccaneering spirit abroad that is rare in the West, born from a mixture of optimism and arrogance. The business news buzzes with stories of acquisitions and start-ups. The corporate go-getters love to explain that if you can make it here, despite the poverty, the dismal infrastructure and the unpredictable politicians, you can make it anywhere.

The growth is driven as much by companies' internal dynamics as by the abundance of opportunities. The importance of volume means they have to keep expanding in order to justify their investments. The ambitions of their relatively youthful workforce push in the same direction. Their up-and-coming managers have never experienced anything but hypergrowth, and their lower ranks are staffed by young men in a hurry who expect to be given their heads.

To flourish in this atmosphere, it helps to have the spirit of a frontier settler, not a corporate bureaucrat. Companies are obsessed with grabbing their share of the frontier, both geographical and technological, before somebody else does. This puts a premium on both speed and flexibility. But businesses also sometimes engage in lateral moves that make little sense to Western managers. A property company, say, might suddenly move into computers. Rather than worrying about synergies or core competences, they see opportunities and seize them.

The pursuit of growth is forcing firms to engage in relentless innovation, nowhere more so than in two of the basic building blocks of corporate management: mergers and acquisitions (M&A) and recruitment and retention. Even as Western companies reeled from the recent recession, emerging-market giants went on a shopping spree. India's Tata Consultancy Services bought Citigroup Global Services, the outsourcing division of the American bank, for $512m in October 2008. HCL, another Indian technology group, snapped up Britain's Axon Group for $672m two months later. Reliance Industries, yet another Indian company, is pursuing LyondellBasell Industries, a chemical company, in a $14.5 billion bid, and Bharti Airtel is in the process of gobbling up Zain, a leading African telecoms company, for $9 billion.



Nirmalya Kumar, of the London Business School, says that two things are allowing emerging-market giants to rewrite the rules of M&A: money and flexibility. The combination of rapid growth and extensive internal restructuring has left many companies with plenty of cash in their pockets. Profit margins of 10% are common, double the average in the West. And because ownership is concentrated, companies find it easier to take risks. Business families and founding entrepreneurs, with large shareholdings in their companies, are willing to make long-term bets on growth and do not have to worry about losing control of their companies if their stocks take a nosedive.

Reverse M&A

Mr Kumar points out that emerging-market firms have a different approach to M&A from their Western counterparts. They are less interested in cutting costs—through synergies, greater efficiency and lower head count—because they know that they can deal with those issues by plugging their acquisitions into their low-cost production machines at home. What is much more important to them is to acquire the skills, brands and distribution channels that will enable them to join the club of world-class companies. In many ways this is "reverse M&A" to complement reverse innovation: instead of Western companies buying cheap manufacturing in the developing world, emerging-market companies are buying sophisticated corporate machinery in the West.

India's Hindalco is a good example. The aluminium company used a succession of well-planned acquisitions to turn itself into a global force, boosting its revenues from $500m to $15 billion in seven years. It was not just trying to achieve rapid growth (which it already enjoyed) or deal with overcapacity (which was not an issue). Instead it identified internal weaknesses and systematically eliminated them.

Perhaps Mr Kumar is being a tad bullish. The Tata Group's two big acquisitions of British companies—Jaguar Land Rover for $2.3 billion and Corus Group for $12 billion—have not lived up to expectations. The company paid too much at the height of the boom. Some emerging-market acquisitions are driven by a combination of hubris and frontier mentality. Bharti Airtel bid for Zain because it was looking for virgin territory for its low-cost business model as the Indian market became saturated. But with emerging markets continuing to surge, local champions will be on the prowl for more acquisitions.

Touting for talent

The maharajah's palace in Mysore is one of the architectural wonders of southern India, built to awe the local population as well as to delight a succession of princes. Yet it is tiny compared with Infosys's 335-acre campus nearby, which houses one of the world's largest corporate universities. It has a permanent faculty of 250, trains some 10,000 new "Infosysians" a year and provides advanced instruction for thousands of existing employees. It is awash with swimming pools, gyms, tennis and badminton courts, a multiplex cinema, a cricket pitch, an enormous laundry and 5,000 bicycles.

Everything about the campus is designed to underline the company's claim that it is world-class, not just an Indian company that happens to have had a good run. Its mantra is "No caste, no creed, only merit". The buildings are a strange mixture of international styles. One of the training centres looks like a Disneyland version of Washington's Capitol, and the multiplex resembles a giant glass golf ball. The Taj Mahal meeting room sits next to the John Pierpont Morgan lecture hall. To a young Indian on the way up all this says that the world is his oyster. No wonder most Infosysians like to bring their extended families to tour the campus.

Infosys grasped from the start that to challenge global companies such as IBM it would have to attract India's best and brightest. In 1993 it decided to go public, even though it did not need the cash, in large part in order to be able to build a campus that could rival anything America could offer. It not only paid more than its rivals, it was also one of the first Indian companies to issue stock options to its employees, so they had a much better chance of becoming a millionaire than if they worked for a foreign multinational.

This investment in talent has paid huge dividends over the past two decades of pell-mell growth. The company's workforce has swollen from 10,000 in 2001 to more than 105,000 today, and its market capitalisation has risen to $35 billion. Other companies are now imitating its model. India's office parks and electronic cities are full of training campuses churning out the bright and ambitious citizens of a new and more meritocratic India.

Emerging countries in general, and China and India in particular, boast a huge number of relatively cheap brainworkers. Between them these two countries produce twice as many people with advanced degrees in engineering or computer sciences as the United States every year (more if you allow for the fact that 50% of American engineering degrees are awarded to foreigners, most of them Indians or Chinese). This is one of the main reasons why Western companies have started to move their R&D activities to the emerging world—and why companies such as Infosys and Huawei are challenging the Western giants.

Yet staff turnover in India and China's high-tech sector has continued to average 25-30% during the recession. One reason is that companies are growing much faster than the education infrastructure. Infosys and Huawei increased their sales by more than 40% last year. Another reason is that the region is so new to world-class competition: challenging the West on quality is much harder than on price. Moreover, the available talent pool is much smaller than the raw numbers suggest. Senior managers of high quality are rare because the Indian economy was closed until the early 1990s and China sacrificed an entire generation to the Cultural Revolution. Many of the millions of graduates churned out by the local universities lack the skills to compete with the world's best. McKinsey reckons that only 25% of India's engineering graduates, 15% of its finance and accounting professionals and 10% of those with degrees of any kind are qualified to work for a multinational company.

Emerging-market companies are thus confronted with two huge interconnected problems: recruiting and retaining workers at a time of rapid growth, and producing a world-class workforce virtually overnight. This is producing a flurry of innovation in what is infelicitously known as "human-resource management". Companies not only need to think more imaginatively about recruitment than Western companies do, they also have to devote more effort to continuing training. The combination of rapid growth and high staff turnover means that they are always in danger of losing the very skills that have made them successful.

Companies have made vigorous use of two tried-and-trusted tools—sticks and carrots—to turn themselves into world-class employers. Everybody has heard stories of Asian bosses who stopped the conveyor belt and smashed the products coming off it to show that they would not tolerate substandard output. But there are also plenty of stories of extravagant bonuses being handed out freely.

China's Haier is a market leader in the vigorous use of sticks and carrots. The company has made pay 100% performance-related. It also makes extensive use of naming and shaming. Photographs of local managers are prominently displayed in every workplace and marked with a magnetic badge (a red smiley face for good performance, a yellow frowning one for doing badly). The company also celebrates outstanding innovators in public ceremonies and names new products and business innovations after the people who think them up.

Other companies reach deep into local traditions to motivate their workers. Brian Gu left school at 16 and started repairing air-conditioning systems. He is now the boss of Yongguan, one of China's largest shelving companies. One of his biggest problems when he started his business in 1988, he recalls, was the attitude of his workers: they spat on the floor and generally behaved in a disrespectful manner. Mr Gu used a combination of relentless exhortation and Buddhist philosophy to make them more disciplined.

Now they listen to Western classical music as they work. Posters list the times of the next quality-circle training sessions. The walls are plastered with improving notices such as "Quality is our life" and "Concept innovation leads to innovation in management". The factory is laid out according to *feng-shui* principles, with the buildings arranged so that they are full of sunlight. Mr Gu's *pièce de résistance* is the Buddhist garden next to the factory. The best workers have trees planted in their name. Poor performers are sent to spend time in a temple to contemplate a giant statue of the Buddha.

The best companies in emerging markets treat "talent" as a supply chain that needs to be relentlessly managed, not an isolated problem that can be solved on a piecemeal basis. The glitzy training centres are only the beginning. Firms also invest heavily in creating "educational ecosystems". They dispatch managers to give speeches at universities. GE, for instance, has charged each of its top ten managers in China with cultivating relations with a particular university. They spot bright youngsters and treat them to tours of their campuses and scholarships.

This enthusiasm for education and training is not limited to high-tech companies. Pantaloon, a huge Indian retailer that is opening new shops at the rate of one a week, invests in local business schools. Nor is it confined to first-tier cities such as Shanghai and Bangalore. Intel decided to deal with the problem of labour shortages by setting up an operation in Chengdu, an industrial city that has not so far attracted brain-intensive companies, and improving the quality of local education. The company works closely with the schools and universities in the area. The price of high growth is continuous investment in human capital.