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# Emerging markets set the risk standard

Years of operating in an uncertain environment have given companies in emerging markets valuable insight into the importance of managing risk. Western managers would do well to heed the lessons

**W**estern executives look to countries such as China, India, Brazil and Russia as large and growing markets. For example, China's gross domestic product is forecast to increase by 9.4 per cent in 2005 compared with an anaemic 1.5 per cent for the Eurozone.

But although they offer great potential rewards, emerging markets are also rife with potential dangers that are rare in more developed countries. Risks endemic to emerging markets include rapid and dramatic fluctuations in exchange and interest rates, political turmoil, murky intellectual property regimes, unpredictable flip-flops in industrial policy, exposure to volatile commodity prices and uncertain access to capital.

For example, imagine you were a Brazilian executive during the 1990s. You would have endured hyperinflation (exceeding an annual rate of 2,000 per cent in some years), followed by an abrupt price stabilisation that ended overnight the practice of passing cost inefficiencies through to customers. You would have paid your bills in four separate currencies and have experienced dramatic swings in exchange and interest rates.

You would also have survived wild swings in industrial policy (to use that term loosely). For example, in a single year President Fernando Collor de Mello eliminated tariffs and domestic content requirements in the automobile components sector, causing 19 of the country's top 20 suppliers to file for bankruptcy or sell to multinationals. Then you had to cope with the presidential impeachment of Mr de

Mello in 1992, energy rationing and recession. Of course, this volatility comes on top of the technological, competitive and customer uncertainty that keep life interesting in more stable markets.

Over the past seven years, my collaborators and I have conducted in-depth research on companies in emerging markets across a wide range of industries. This research – published in two books and over 20 cases and articles – typically paired a successful company with a less successful peer to analyse how opportunities should be seized and to survive life-threatening jolts in developing countries. One of the most consistent differences between the successful and less successful companies was how they managed risk. The lessons from these emerging market leaders offer insights into managing risk in any unpredictable market, and are particularly relevant for managers expanding into emerging markets from more predictable competitive domains.

## ◆ Upside and downside risk

Western managers generally view risk management in purely negative terms as a set of mechanisms to minimise the probability and/or cost of undesired outcomes. However, one finding from our research is that executives in unpredictable markets typically view risk more broadly – based on long experience, they recognise that the volatility inherent in their domestic markets entails both potential hazards and opportunities.

A more surprising finding is that successful managers in emerging markets rely on the same five mechanisms – anticipating contingencies, sharing risk, keeping a reserve, diversifying and picking the right people – both to

help minimise the probability and cost of undesirable outcomes and increase the probability of seizing potential opportunities.

This reliance on the same mechanisms to capture upside and manage downside risk strikes many western managers as strange. But this results more from our convention of using separate categories, such as innovation and entrepreneurship, to discuss opportunity pursuit, while describing adverse events in terms of risk management. The remainder of this article introduces the five mechanisms and explores how they position companies to seize opportunities and manage threats.

**Anticipate:** Managers in emerging markets must advance into an unpredictable future, with multiple variables influencing their ability to create, capture and sustain value. But while they cannot predict the long-term future with great precision, executives can take steps to anticipate emerging threats and opportunities.

Companies in emerging markets explicitly scan their environment by gathering data from multiple sources, conducting studies and discussing scenarios. Brazil's Banco Itau, for example, regularly invites economists from Brazil and abroad to discuss how macroeconomic scenarios might unfold. Management creates task forces to explore the potential impact of major policy shifts, such as deregulation or privatisation, on the bank.

Similarly Qinghou Zong, the founder of Wahaha, China's leading beverage company, spends approximately 200 days each year on the road gathering first-hand information through customer visits. He also belongs to the Communist Party, and membership has its privileges. Frequent interaction with government officials provides him with advance notice about (and potentially influence over) impending policy changes.

Managers can also run small-scale experiments to explore possible opportunities and threats. Consider Guangdong Galanz, today the world's leading microwave oven producer. In 1993, it was a goose down producer looking for new markets to offset declining sales in its core. To explore potential demand for microwave ovens, Galanz executives negotiated a limited technology licence with

Toshiba, produced a trial run of 10,000 ovens and sent senior executives to a Shanghai department store to pitch personally the new appliances to sceptical consumers. Galanz rapidly scaled nationally after this initial experiment supported management's hunch that the microwave oven market was poised to take off.

Western executives often put too much faith in tools such as scenario planning or simulations. Emerging market executives harbour more realistic expectations for anticipation, generally limiting their exploration to events that are likely, even if their timing or precise implications are unclear.

For example, the founders of the Brazilian cosmetics company Natura anticipated that the government would eventually tame hyperinflation. They prepared for this eventuality by studying how such policies affected cosmetics sales in other emerging markets, such as Mexico, and developing a plan to respond when Brazil followed suit.

**Share:** Executives generally consider risk sharing in narrow terms of transferring a potential downside to another party – for example, by using insurance contracts or currency hedges. However, it can also enable companies to seize opportunities.

Most obviously, managers can forge partnerships that transfer downside and upside risk to other stakeholders. In return, they secure the resources required to seize an opportunity swiftly and effectively. For example in the mid-1990s, Wahaha's Mr Zong recognised that demand for bottled water in China was about to increase. However, his fledgling company lacked the resources needed to seize the moment. But a joint venture with Danone provided Wahaha with the capital and technology it needed to establish nationwide market leadership ahead of other competitors.

Shifting non-critical activities to partners that specialise in them can also enable companies to focus on core activities, thereby increasing their odds of successfully seizing an opportunity. Consider Brazil's Embraer, which today is the fourth largest jet producer in the world. When the company developed its second-generation



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regional jet, it increased the number of partners responsible for developing entire subsystems from four to 22 (while eliminating over 300 components suppliers). These subsystem contractors – known as “risk-sharing partners” – consisted of specialist companies from around the world that provided state-of-the-art subsystems to Embraer. They bore approximately two-thirds of the total development costs for the new jet. Working with risk-sharing partners in this way allowed Embraer to focus on managing relationships with customers and designing an overall systems architecture to meet its needs.

Of course, risk sharing imposes costs as well as benefits. Companies must often give up a percentage of the upside to induce partners to bear some of the downside risk. Wahaha ceded a 51 per cent stake in its bottled water joint ventures to Danone and other investors, while Embraer sold 20 per cent of its voting shares to a consortium of French aviation and defence companies.

Shifting risks to a partner increases a company's dependence on that company for resources – capital and expertise in the case of Wahaha and technology in the case of Embraer. The mutual dependence stemming from risk transfer is fine so long as the parties' interests remain aligned. In unpredictable markets, however, interests can diverge – often quite abruptly. In these situations, a risk-sharing partner can constrain a company's ability to respond effectively.

**Diversify:** Diversification protects companies against unforeseen events that threaten one of their core businesses, but it also exposes them to a broader range of opportunities. For example Galanz recently expanded into air conditioner production to hedge against potential shocks to demand for its core product.

This process comes at a cost, however. Entering multiple businesses increases organisational complexity and can spread constrained resources (including management attention) too thinly. In turn, complexity and diffuse resources may limit a company's ability to compete effectively against more focused rivals. Investors, moreover, generally prefer that their portfolio companies remain focused and leave the diversification to them.

Nevertheless, there are several practical steps that managers can take to reap at least some of the rewards of diversification without spreading themselves too thinly. First, they can follow the rule of two. Many of the companies we studied have pursued two markets simultaneously, which provides some diversification while minimising the problems associated with complexity and resource diffusion. Embraer produced both military and commercial aircraft, while Galanz added air conditioners to microwaves. Two businesses, according to this rule of thumb, are better than one (but also better than three).

Managers can also diversify geographically while retaining a tight industry focus. Global steel industry

leader Mittal Steel, for example, has acquired assets in highly volatile markets, including Kazakhstan, Bosnia and China. Many of the opportunities and threats confronting these operations are country- or region-specific, and can be diversified away through a portfolio of global assets. Other threats, of course, remain, such as raw material prices or currency contagions that influence multiple emerging markets.

Companies can also diversify around a set of competencies. Wahaha, for example, has extended its well-known brand and distribution system into related products, including a cola that has surpassed Pepsi in the Chinese market.

**Reserves:** Recent strategy theory tends to focus on specialised resources, such as brand, technology or distribution as a company's primary source of sustainable competitive advantage. On

resources are required to seize the moment. Mittal Steel's comparatively healthy balance sheet allowed the company to take advantage of opportunities that were beyond the reach of other steel companies.

Building a reserve of cash is particularly important in contexts where the cost and availability of capital is subject to wide swings. In developed countries, good opportunities typically find funding and sound companies facing temporary setbacks can raise the cash required to tide them over. However, this efficient market view bears little resemblance to the reality of fundraising in emerging markets. In these countries, funds are least likely to be available precisely when a company hits a setback – recall the Russian rouble crisis, for example, which deprived even healthy companies of required funding. Even if financing is available, the fundraising process demands time

companies in volatile markets require a cadre of managers who can quickly and effectively deal with new challenges, rather than doing the same thing over and over again. Managers who excel at these activities tend to share a few characteristics: they take initiative; enjoy autonomy; and have a diverse history of assignments in terms of functions, regions and tasks.

Consider Haier, which rose in 20 years from a bankrupt collective enterprise to China's largest appliance maker. Over those years, Haier faced a series of threats and opportunities. The company thrived in large part because it had general managers who could switch between building a new industrial park and integrating an acquisition or opening a foreign subsidiary – without missing a beat.

Haier has taken several actions to develop this cadre of elite managers. It moves executives to a new position on average every three years, typically between different products, regions or functions. These rotations are inefficient to the extent that they prevent managers from leveraging their functional skills or product expertise by



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the upside, competitors cannot easily or quickly imitate specialised resources – imagine the cost of duplicating BP's oil reserves or EasyJet's brand. On the downside, investments in specialised resources are difficult or impossible to reverse or undo.

In contrast to specialised resources, cash is fungible – it can be deployed against most contingencies. Fungibility is a particularly valuable attribute in markets where it is difficult to predict which resources will confer future sustainable competitive advantage. Cash functions like troops that a general keeps in reserve until he sees an opportunity to win a battle or defend important ground.

Like the other four mechanisms, reserves apply equally to downside and upside risk. With the strongest balance sheet among its competitors, Embraer could absorb the fallout from the September 11 attacks, when customers refused delivery on \$500m worth of aircraft. By contrast, rival Fairchild Dornier went bankrupt.

On the upside, cash allows companies to invest in whichever specialised

and management attention, and capital raised under duress generally comes at a high price in terms of valuation, preferences and control.

While a large reserve provides a powerful hedge against uncertainty, there are obvious disadvantages to stockpiling cash. Managers may get sloppy and squander funds on fancy buildings or stupid acquisitions. Building a war chest can also diminish a company's autonomy, since capital providers generally demand control in return for their money.

**People:** Employees can play a vital role in a company's ability to manage risk. The obvious example occurs when a company faces a clearly defined opportunity or threat, and hires someone with experience in that area. Consider Sina.com, China's leading internet portal, which faced a meltdown after the internet bubble burst in 2001 and replaced its CEO with a venture capitalist experienced in restructuring and dealing with investors.

To succeed consistently at dealing with unexpected contingencies,

“Cash functions like troops that a general keeps in reserve until he sees an opportunity to win a battle or defend important ground”

rising through a single unit. They are, however, effective at producing general managers with a broad view of interrelationships among the various parts of Haier and who are expert in quickly assessing a new situation and executing objectives.

Haier also brings its most senior executives together every Saturday morning for a training session. Executives work in diverse teams to brainstorm ways to achieve their individual business objectives. Then, during the week, they experiment with these techniques and report back to teammates.

In addition to the obvious benefits of networking, the scope of opportunities and threats that executives see while deepening their ability to formulate action plans enables them to deal effectively with risks on the upside and downside.

Of the five general mechanisms introduced in this article, many western companies rely primarily on one or two and underutilise others. The five are interrelated. For example, diversification may expose a company to new opportunities, but without a war chest the company may not be able to seize them.

Emerging market executives, inured to the vicissitude of volatile markets, generally mix and match among these approaches to manage the full spectrum of risks that might come their way.