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Moscow School of Management

OPERATIONAL CHALLENGES FACING EMERGING MULTINATIONALS FROM RUSSIA AND CHINA

SKOLKOVO RESEARCH

SIEMS MONTHLY BRIEFING
SKOLKOVO INSTITUTE FOR EMERGING MARKET STUDIES
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IN THE WAKE OF THE GLOBAL ECONOMIC DOWNTURN

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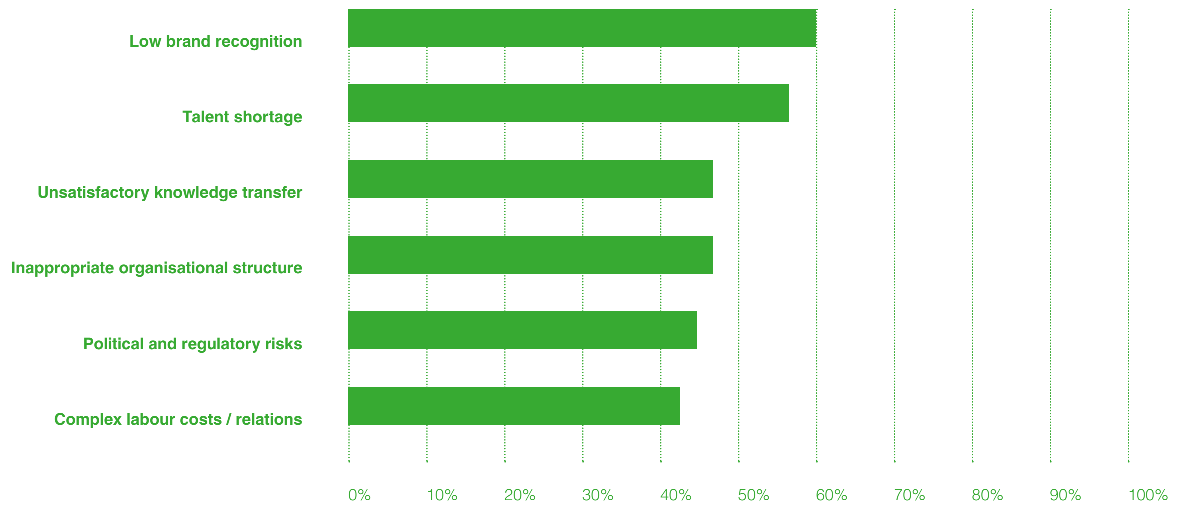
In the wake of the global economic downturn, emerging multinationals have both suffered (from their own excesses) and gained (at their competitors' expense). A better look at the current state of affairs (see our previous report – Global Expansion of Emerging Multinationals: Post-Crisis Adjustment.) shows that although they have been severely hit by the financial crisis and the fall in demand, the vast majority of emerging multinationals have, so far, survived the test and prevented the collapse of their newly built global structures.

While firms from the emerging markets continue their pursuit of international expansion, they are faced with a bigger, long-term issue – whether they will be able to manage their accumulated assets efficiently on a global scale. In so doing, they face a number of serious challenges. Some of them stem from country-specific factors, some from cultural differences, and some from the relative inexperience of emerging market companies in international management. While facing specific challenges in different industries and countries, emerging multinationals often encounter common difficulties.

After analysing the cases of 92 Chinese and 55 Russian multinationals, we have identified six key challenges (see Figure 1) and effective ways to deal with them. The objective of this particular briefing is to concentrate on issues specific to the international expansion of emerging multinationals, rather than any general, widespread management problems, or those of international trade. Moreover, we will concentrate on post-deal operational issues, rather than those concerning the preparation and closing of an international investment deal. Nevertheless, being aware of those post-deal implications before shaking on any agreement may be essential to our focus enterprises for the ultimate success of their cross border growth.

FIGURE 1 / Key Operational challenges



% of Studied Emerging Multinationals

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TALENT SHORTAGE

THE ISSUE

Despite their abundant labour supply, many emerging multinationals see their international growth as limited by the lack of qualified staff. The host countries' restrictions on expatriate personnel are often a problem, but even when that is settled, many companies struggle to find the right people. That is not to say that they lack talented employees. However international expansion requires cultural awareness, in addition to specific skills. Hisense, a large Chinese electronics company, named talent deficit as their largest challenge in internationalisation. Youngor, one of the world's largest menswear manufacturers, is globally seeking international design and distribution experts. When TCL, another producer of electronic appliances, entered both the US and European markets by way of large acquisitions, only 3-5% of its employees were capable of handling international business. TCL had to shorten the training of expatriate managers from 3 years to 1 in order to secure an adequate number of professional personnel. "We didn't even have anyone who spoke English when we first started out on the international market," remembers Eugene Buyakin, COO of Kaspersky Lab, a fast-growing Russian provider of security software. Anton Telegin, Commercial Director for the CIS at VympelCom, a leading Russian telecom group, also points at human resources as the key organisational concern when expanding abroad.

RECOMMENDATIONS

Promote local talent

VympelCom has made it a policy to gradually involve local talent in management, replacing Russian expatriates – despite the fact that successful local staffs often see the job in a multinational as a chance to leave the country. Such policies are not very characteristic of young multinationals. Leaders of emerging global players from emerging countries often tend to appoint their compatriots to top executive positions even after the company itself has gone way beyond the borders of its home country in terms of both holdings and financing. In a sample of large Russian multinationals last year, we have found on average only 10% of top managers (first level from the CEO) of non-Russian nationality, while 28% of directors were foreigners and the average share of foreign assets was 17%. To some extent, this tendency makes sense: to remain in control of a collection of far-flung units, CEOs need people they can intuitively trust and understand. However, the loyal expats take years to develop a deep understanding of the market and are sometimes unaware of regulatory pitfalls. In addition, a managerial team consisting solely of expats may create a perceived cultural divide within the company, undermining the motivation of managers down the hierarchy. On the contrary, promoting local managers is sending a good signal to their compatriots about their career opportunities. For instance, VympelCom has made it a strategy to gradually involve local talent in management, replacing Russian expatriates.

Create an international team

Empowered foreign employees may also bring expertise to the company that may not necessarily be available at home. Lenovo, by acquiring IBM's PC business, was able to quickly build a global workforce with over ten thousand employees. Geely, a Chinese automaker, hired the former R&D director of Daewoo and other top auto engineers. Those experts helped the company develop its own engine and transmission technologies and thus significantly lower its production costs. Kaspersky Lab hired a whole developer team from a Romanian software firm after Microsoft acquired the firm but let go the team, and the team helped the Lab add new features to its core product within record time and cost. Today, a third of both the Board and the top management of Kaspersky are foreigners, and the company has enjoyed yearly growth rates over 50% for several years thanks to its international expansion. It should be noted that creating an international team requires significant adaptation from both home country and foreign personnel – not only learning some foreign language, but also learning to communicate differently, day-to-day, within the organization. Such adaptation may not be easy for everyone, but it is necessary to create a truly international team.

INAPPROPRIATE ORGANIZATIONAL STRUCTURE

THE ISSUE

Many large companies in both China and Russia have inherited the bureaucratic structures of their original state-owned enterprises, which may become obstacles for overseas expansion. For instance, China Mobile follows the government hierarchy of nation-province-city-town. When the company tried to acquire Millicom, a European firm that operates in 16 countries, it was not able to develop an effective control system and later gave up the deal. Such traditional structures may also limit firms' ability to manage overseas operations. Sinopec, one of the largest oil company in China, is composed of a dozen large regional subsidiaries. Due to their separate political and economic interests, those subsidiaries used to expand internationally on their own, which resulted in a lot of repetitive investments and cannibalization. Eventually, in 2003, the company had to create an international business unit and centralize the control of overseas operations. Although many former state-owned enterprises have gone public or been privatized, they are criticized for still thinking and behaving like state-owned local enterprises and lacking a global vision.

Family-run enterprises, another major part of emerging market landscape, can also have organizational structures that stifle international expansion. Lifan, a Chinese motorcycle company, maintained control within the family and was unable to attract outside talent to pursue internationalization. Similarly, small and medium sized firms often need to redesign their structures for foreign expansion. Kaspersky Lab had tried for years to penetrate foreign markets through trade representatives, without fundamentally changing its flat, family-controlled, start-up-like corporate structure. "The old structure wasn't scalable, that was its main shortcoming" – explained founder Eugene Kaspersky at the end of 2007, when the company finally decided to restructure radically.

Moreover, due to unfamiliarity with international markets and the lack of managerial capability, many emerging multinationals failed to incorporate effective control systems within the organization. For instance, TCL suffered greatly from losing control after their merger with Thomson, a French electronic firm. Although the headquarters of the company was in China, their European divisions largely operated on their own. According to the CEO of TCL, Chinese executives had no control over the procurement, production, R&D, and even finance of their European operations for at least a whole year. Some executives even signed contracts without knowing how the money would be used.

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RECOMMENDATIONS

This concern echoes the remarks of Leonid Melamed from 2006, when he was CEO of MTS, a leading Russian mobile operator. At the time, he was taking the rapidly expanding MTS through a reorganization that created a four-level geographic structure. "As the business grows, this managerial functionality is easily scalable", he stressed. Indeed, scalability is crucial to emerging multinationals, to which double-digit international growth is the norm rather than an exception.

Build a scalable structure

At the top level, MTS was divided into three geographic business units plus a corporate center. According to Melamed, that "enabled to separate strategic functions from operational ones, and to create a simple and transparent structure, increasing the business unit managers' motivation to achieve goals." At the same time, while endowing local managers with full responsibility, the new structure made sure that corporate goals – such as leveraging scale or pooling knowledge and talent across the group – are not lost from sight. It is noteworthy that Kaspersky came up with a similar structure involving a corporate HQ and five regional headquarters, each providing support and oversight to local offices. The key point is that managers in remote subsidiaries should have enough decision-making power to adapt to the various environments, and be accountable for results. At the same time, the corporate center should have sufficient authority to harness potential synergies, failing of which would not create additional value.

Specify local and corporate responsibilities

COMPLEX LABOR COSTS/ /RELATIONS

THE ISSUE

While Chinese and, to a lesser degree, Russian companies are used to cheap labor, they often find it difficult to absorb the labor costs in developed countries. In 2005, recognizing the demand for windshield glass in the US, Fuyao Group set up a factory in South Carolina. Despite low land and utility costs, tax benefits, and savings on tariff and shipping, Fuyao was not able to sustain the operation because of high labor costs. The production was eventually shut down and only a sales office remained. Similarly, Alcatel's cell phone business had looked attractive in 2004 with only 700 employees and no manufacturing, but the acquirer, China's TCL, later realized that salary and benefits could reach 10 000 euro per person per month.

Moreover, since labor relations can be highly country-specific, emerging multinationals' efforts to reduce labor costs overseas often run into troubles. When Russian hi-tech equipment manufacturer Sitronics decided to lay off 400 employees in the Czech Republic, local regulations resulted in unexpected additional expenses. Haier was not able to implement a policy that has bad performers make reflections in public, one of their best practices in China, to their US operation because of strong resistance from local employees. Even in low-cost Vietnam, several Chinese companies encountered labor strikes because of salary disputes. One of the companies claimed that they increased worker salary by 20% within half a year, but with local living expenses constantly increasing, many employees were still unhappy. Rusal, the aluminum group, has encountered numerous problems when applying in foreign countries its proven strategy of outsourcing noncore units and cutting personnel costs. In Armenia, for instance, the president of the country in person expressed concern about layoffs after Rusal acquired a factory there.

In addition, since strong independent unions are still unusual in both Russia and China, emerging multinationals are not always quite prepared to deal with powerful labor organizations. In December 2008, newly elected union leaders of SsangYong accused their Chinese parent company, SAIC, not fulfilling investment commitments and demanded Chinese managers to be laid off. At Rusal's facility in Guinea, unions started a strike, requesting the company to double their salaries in the midst of a severe downturn, despite the fact that Rusal provides significant social infrastructure to the community. In Europe, nearly every venture by emerging-market multinationals has experienced some difficulties with unions.

RECOMMENDATIONS

There is no magic bullet to deal with differences in labor relations between countries. Not only are they embedded in legislation, but often also rooted in national culture. For instance, Chinese traditional philosophy emphasizes the spirit of dedication and collective interest, and the acceptance of overtime work improves the efficiency of Chinese companies. In other countries, however, particularly in Europe, working overtime is much less acceptable. Dealing with labor disputes by sheer persistence may not yield expected success, but in many cases is very likely to alienate the workforce and intensify cultural tensions.

Differentiate human resource policy

On the other hand, adapting human resource management to the local context and conducting a dialog with unions can produce favorable changes, as the experiences of Haier and Severstal North America have shown. Haier changed its focus from addressing bad performance to encouraging good performance in its US factory. The new policy was widely welcomed and eventually improved local employees' working attitude significantly. When Severstal, a large Russian steel company, first started to acquire assets in the U.S. in 2004, it was met with the usual suspicious reserve. By last year, however, Severstal's reputation as an employer improved so much that when Wheeling Steel was put on sale last year, the plant's union itself designated Severstal as the preferred bidder. While it did not, in the end, entirely shield Wheeling's workforce from the consequences of the economic downturn, it certainly helped Severstal acquire the plant, winning over Indian competitors who did not have such an employer record in North America.

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UNSATISFACTORY KNOWLEDGE TRANSFER

THE ISSUE

In recent years, many Chinese and Russian firms turned to international investment for knowledge acquisition. This stems largely from dissatisfaction with emerging-market-based joint ventures: while hoping to exchange technologies for markets, foreign companies are reluctant to share core technologies with their emerging-market partners. For instance, although SAIC has joint ventures with both GM and Volkswagen, the key parts of their collaborative production are mainly imported. So SAIC acquired Korean SsangYong in order to obtain such technologies as hybrid engines. In addition to acquisition, a few emerging multinationals have been actively building research centers overseas. For instance, Konka, a Chinese TV manufacturer, has a R&D center in the US, and plans to build several more in Japan, Korea, France, and India.

Nonetheless, due to cultural barriers and the complexity of knowledge management, in many cases the benefits from those takeovers or greenfield overseas R&D centers fail to materialize. One such example is the acquisition of LDV, a British van producer, by the GAZ Group of Russia in 2006. Again, the main expected value lied in adapting the British van for emerging markets, allowing GAZ to leapfrog the technological divide separating its vans from pricier competing products. In early 2009, however, GAZ abandoned the plan, citing the "specific and not very modern" design of LDV's product and announcing the intention to create a new van model on its own – which is expected take considerably more time and lead to uncertain results. Konka built overseas R&D centers in order to customize products for different markets. While such efforts are commendable, the efficiency of their R&D still is not very satisfactory. The company acknowledged that, despite large R&D investment, their technology is still far behind industry leaders.

RECOMMENDATIONS

Successful knowledge transfer from overseas companies is certainly achievable. For instance, Lenovo successfully gained notebook computer technology with the purchase of IBM's PC business. The deal provided not only IBM's patented technology but also their R&D team and capability. However, such transfer often requires a significant effort to change knowledge management in the "source" company. CTV, a Russian equipment manufacturer, faced this issue after it had acquired Silvatec, a Danish producer of forestry machines. The main goal of the deal was to scale up production of Silvatec's harvesters and forwarders, and customize them for the Russian market. But it turned out that engineering at Silvatec was done on an ad hoc basis. "You could just as well consider every one of those Danish harvesters as unique", commented CTP President Mikhail Bolotin in an interview [HBR Russia, 2008, #6 (39)]. CTP had to standardize processes and sort out technical documentation before it was able to benefit from its new affiliate's R&D. The key is to figure out how to bring out the knowledge embedded in the overseas subsidiary.

Make tacit knowledge explicit

Certainly, not all knowledge can be formally articulated, and the 'tacit' part is sometimes the most valuable one. Usually, the tacit form of knowledge is best transferred through intensive communication, such as visits and meetings. According to Erik Eberhardson, who had led GAZ through the integration of LDV, two of his main takeaways from the LDV integration were that "one must 'mix' people more actively" and that "one should pay more attention to internal communication". In fact, once teams from across borders are sufficiently 'mixed', articulating knowledge may become unnecessary.

In order to effectively absorb and integrate knowledge, the organization at home has to change too. "In fact, barriers within a company's organization may inhibit the effective transfer of skills over the longer term. Moreover, such a company often lacks the necessary knowledge-sharing mechanisms (including the flexibility to rotate its employees in and out of the foreign ventures) to absorb the lessons from international partners," - explained McKinsey partners Vincente Assis et al. in an article on the international expansion of oil companies from emerging markets [McKinsey Quarterly, 2005].

Foster organizational learning

The people at home need to have the learning skills to absorb new information from outside, which may require learning a foreign language as well as understanding de-facto standards of a different context. "Our engineers have solid knowledge", points out CTP president Mikhail Bolotin, "but they are not used to designing equipment using a modern computer-based environment – which is a basic skill for European engineers". Eberhardson of GAZ agrees and adds: "Few Russian technical specialists speak fluent English, and that impedes understanding and effective transfer." Only when teams have such learning skills and the right organizational infrastructure, can a learning organization be created.

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POLITICAL AND REGULATORY RISKS

THE ISSUE

It is generally believed developed markets present fewer political and regulatory risks than developing countries. However, due to their lack of experience and the intensity of competition in developed countries, many emerging multinationals favor other emerging markets. They are expected to have lots of experience in dealing with cumbersome and sometimes corrupt bureaucracies. In reality, while a familiar bureaucratic environment may be a competitive advantage, a foreign one can definitely be a problem. For instance, when ZTE from China first explored Indian telecommunication markets, they had to pay a 12.5% delay penalty due to their unfamiliarity with local testing process.

Regulations become a much more serious threat when they are manipulated by the authorities in order to expropriate foreign-owned assets. In 2004, PetroChina's and Sinopec's investments in Ecuador were taken into state ownership. Guinea's new government threatens to confiscate from Rusal a facility which has cost the Russian company over US $300 million in purchasing expense and upgrading investment. Another major Russian group has recently had to deal with a similar situation in an African country.

RECOMMENDATIONS

In most cases, regulatory risks are reduced simply by learning the local intricacies, and such risks become less of a problem as the specific knowledge is accumulated. For ZTE, India has now become a rather stable market, with sales of $2.4 billion. There are also markets and situations where simply following the formal regulations is not enough. The traditional recommendation in those cases is to find a local partner with the right connections. More extended experiences demonstrate, however, that it is even more important not to rely too much on a particular connection or group. Some officials and government agencies do have an annoying tendency to change, and neglecting that is a sign of wishful thinking that is all too often shown by expatriate managers.

Be informed and be prepared

LOW BRAND RECOGNITION

THE ISSUE

Although both China and Russia are today among the world's top ten exporters, there are not many global brands from either country. In particular, despite China's undisputed status as "the world's factory", Chinese brands are still relatively weak in many markets. This was recently illustrated by Chery, a Chinese automobile manufacturer. Preparing its entry into Mexican market, Chery hired a local consulting firm to test the market. First, when the firm covered the cars' brand plates and logos, local respondents gave relatively high evaluation score and offered a high price; however, after the Chery logo was uncovered, evaluation and price dropped dramatically. "Made in China" is still often associated with low-cost, low-quality, low-end products.

Most manufactured goods sold in developed countries by emerging market companies are made under OEM agreements. For instance, although Gree, an air conditioner manufacturer, now accounts for nearly 20% of global production, most of its exports carry other brands. The same has long been true for Kaspersky Labs, the Russian security software producer, which had to sell its OEM technology to competing European vendors because they had established trademarks. The company has had to spend several years developing its brand internationally and adapting it to various markets before it managed to take a significant market share in the end-user market. For many companies, the lack of a strong brand induces a pricing 'race to the bottom' and stifles profitability growth.

RECOMMENDATIONS

Develop your own brand

To achieve global success, emerging multinationals need to learn the art of branding. Simply acquiring a well-known brand does not work, as the example of TCL has clearly shown. In 2003, this Chinese electronics company has acquired two-thirds of the loss-making TV set manufacturing business of the French company Thomson, in order to conquer Western markets. Soon afterwards, it entered into a similar arrangement with Alcatel, another troubled French electronics conglomerate, to produce and market mobile phones. Explaining this strategy, Vincent Yan, CFO of the joint venture with Thomson, said, "It's not just realistic to build a new brand in a mature market like North America. You just don't have the kind of profit margin for that." However, the strategy proved to be a disaster, driving the whole corporation in the red. Yan had to admit that the challenge to turn around Thomson's operations was "a lot bigger than expected". As of the end of 2005, when the restructuring of both ventures should have been long over, TCL Corporation recorded a net loss of RMB 320 million (about USD 40 million), mostly due to problems with the two acquisitions.

While several factors contributed to the failure of TCL's mid-2000s expansion strategy, branding issues were among the most damning ones. The Thomson and Alcatel brands had an upscale image and a well-off customer base, while TCL's products were mostly low-cost models with little cutting-edge technology. Efforts to introduce the TCL trademark in the West while at the same time integrating French brands led to cannibalization rather than market share growth. Consumers saw the changes less as an upgrade of TCL and more as a deterioration of Thomson and Alcatel. After a few disappointing years, TCL had to buy out the French partners' stakes and ended up closing most of the European operations.

A contrasting example is offered by Konka, another Chinese TV set and mobile phone manufacturer aggressively expanding abroad. Unlike TCL, it chose to try and penetrate overseas markets without taking over established trademarks. Today, Konka now sells 80% of its exports under its own brand, which has become almost a household name in Australia, Middle East, Southeastern Asia, and Africa. As Li Rucheng, chairman of Youngor Group, puts it, to develop a company's own brand means to "master its own fate".

Target emerging markets

An important feature of Konka's strategy is that it focuses largely on developing markets. For emerging multinationals, branding is an uphill battle against competitors with superior recognition and often times larger budgets. In the many industries where marketing is paramount, it is therefore important to choose 'battlefields' where this initial disadvantage is less pronounced. Consumers in emerging markets are often less loyal to major established brands, and usually more price-conscious, which is of course a plus for low-cost producers. TCL now seems to recognize this advantage, and is currently entering India with its handheld products.

A similar change of focus is taking place at another electronics giant, Lenovo. After acquiring the ThinkPad brand from IBM, Lenovo was not able to sustain IBM's market share in the US and Europe, and have decided to focus on emerging markets. “If I could do it again, I would have started focusing on emerging markets in 2006,” - former Lenovo CFO Ma Xuezheng said in an interview. The company is also pushing its own new notebook trademark, IdeaPad, and actively promoting its umbrella brand, which helped make Lenovo well known in offices around the world.

In conclusion, to achieve successful international operations, emerging multinationals need to pay close attention to the above-mentioned challenges. They should:
actively seek and develop talents with multiple approaches. No simple approach can fix the shortage of skilled workforce for international operations. Firms should use all available approaches to secure and retain qualified personnel.
devise appropriate structures for international expansion. Organizational structures and controls should be redesigned to incorporate foreign operations and cross-border interactions.
entangle complex labor issues with innovative policies. Especially for those from a low-labor-cost and low regulation background, it is critical to prepare for unfamiliar labor requirements and strive to be socially responsible.
develop meaningful R&D capabilities. While seeking collaboration and acquisition of technologies, emerging multinationals need to actively utilize and integrate their own R&D resources.
develop risk management mechanisms. To prevent loss of foreign investments, they need to not only build deep understandings of host countries but also devise effective exit and protection mechanisms.
actively promote brand image. They need to try their best to change negative perception of their products and brands by improving product quality, meeting global standards, and creative marketing.

Moscow School of Management SKOLKOVO is a joint project by major Russian and international business leaders, who combined their efforts to create from scratch a new generation of business school. While providing students with practical skills, SKOLKOVO looks to develop a new type of managers -- leaders who will use their professional knowledge in the conditions of rapidly changing global markets. SKOLKOVO is distinguished by its vision based on a unique mix of three dimensions: entrepreneurial leadership, fast-moving economies and experiential learning.

The SKOLKOVO project is being realized in partnership with the government of the Russian Federation and is part of the national priority projects programme, funded exclusively by private business. President of the Russian Federation Dmitry Medvedev is the Chairman of the SKOLKOVO International Advisory Board.

Since 2006, SKOLKOVO has been conducting short-term Executive Education programmes for high- and mid-level managers. These programmes have the form of an open format, as well as specialized, complex modules created by specific company requests. Since January 2009, Executive MBA Programme has been conducting courses and the admission process for the January 2010 class has already begun. SKOLKOVO Full-time MBA programme is currently finishing the admission process to its first class due to begin studies in September 2009. The unique SKOLKOVO campus will open its doors for visitors in September 2009.

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