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PROFITABLE GROWTH: AVOIDING THE "GROWTH FETISH" IN EMERGING MARKETS

IEMS EMERGING MARKET BRIEF

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Author:
Dr. Nan Zhou, Senior Research Fellow

Editor-in-Chief:
Dr. Seung Ho "Sam" Park, Executive Director

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I. Introduction

Aiduo was a Chinese VCD (Video Compact Disc) manufacturer in the 1990s, when the VCD market in China was growing rapidly. Aiduo promoted its initial success by heavily investing in marketing. In 1996, it paid 4.5 million RMB, approximately one year of the firm's profits, to hire famous movie stars to represent its products. These marketing efforts paid off, and sales increased from 0.2 billion RMB to 1.6 billion RMB in 1997[i]. In 1998, the firm paid 0.21 billion RMB for a five-second slot of advertising on China Central Television. To further acquire market share from competitors, Aiduo initiated price wars by aggressively reducing its products' prices. Aiduo's only strategy at that time was to grow bigger and bigger. Although it achieved tremendous growth in a few years, profitability declined when market growth began to slow down. Moreover, since the core technology of VCD was controlled by foreign firms, domestic Chinese firms, such as Aiduo, were not in a position to raise prices. In 1999, Aiduo encountered a debt crisis; it was unable to repay the heavy debts it accumulated during periods of rapid growth and during its ill-timed price war. In December 1999, the firm declared bankruptcy. It only took four years–a relatively short time–for Aiduo to rise as a star and then disappear from public view.

Growth is clearly desirable, if not a mandate, but what type of growth? An overemphasis on firm growth can lead to a "growth fetish," where growth is unqualified and is seen as an end in itself

Growth is clearly desirable, if not a mandate, but what type of growth? An overemphasis on firm growth can lead to a "growth fetish," where growth is unqualified and is seen as an end in itself, as illustrated by the failure of Aiduo. This type of growth can easily lead to overextension and is particularly acute in emerging markets because manufacturing facilities, managerial talents, and physical infrastructure–all requisites that support growth–are limited by underdeveloped market institutions[ii]. In this briefing, we advance the case for "profitable growth," which integrates high sales growth with profitability, we examine the correlates of firms that have successfully pursued this particular growth trajectory, and we present recommendations for firms in emerging markets.

II.
Not All Growth Is Necessarily Good In Emerging Markets

Although GDP growth provides firms in emerging markets the opportunity to grow rapidly, achieving sustained growth is not an easy task. Unlike larger multinationals in developed countries, firms in emerging markets have fewer years of experience operating in a market-based economy because most of them arise in the past two to three decades after economic liberalization. Hence, growth is associated with the unleashing of pent-up market demand, new consumers, and evolving market segments. Much like treatises of growth in developed economies, larger size is equated with market power[iii].

In our view, however, sustained growth in emerging markets does not mean an unqualified pursuit of more sales, assets, or revenues to gain market dominance

Conventional wisdom that can be derived from the Profit Impact of Market Strategy (PIMS) study stipulates that market share is inextricably tethered to profitability. High market share might initially lead to lower profits if it is acquired by lowing prices, but with scale and scope economies resulting in lower unit costs over time, profitability will ultimately materialize[iv]. This occurs, in large part, because of the tangible and intangible benefits that accrue from market dominance. The PIMS study indicates that market leaders, for example, have lower advertising unit costs, lower variable costs, lower research costs, even lower labor costs, as they are able to allocate such costs over large market segments.

In our view, however, sustained growth in emerging markets does not mean an unqualified pursuit of more sales, assets, or revenues to gain market dominance. Certain issues relating to managing growth are more pronounced in emerging markets because increased size alone can also lead to greater need for coordination and management control problems . Nevertheless, this appears at odds with the populist press worldwide, which regularly celebrates firm growth, partly because large size oftentimes attracts attention and visibility.

Firms that overemphasize growth at the expense of profitability are ultimately blindsided by ensuing management control problems, if not by smaller and more nimble competitors. This lack of control is exacerbated in emerging markets, where few professional managers and talents are available to adequately address this problem. Specifically, excessive growth in a relatively short time can be dysfunctional if corresponding resources and capabilities, such as manufacturing facilities and managerial competencies, are absent or cannot be developed. Moreover, unless economies of scale are achieved with growth, expenses will exceed revenues and lower profits (if not losses) will occur. Thus, the key to achieving sustainable growth is not growth per se, but profitable growth over time.

III. Managing Sustainable Growth

In this briefing, we advance the case for "profitable growth" or the simultaneity of both high profits and high sales growth as the condition of sustainability. This favorable condition is borne from the experiences of successful firms operating in emerging markets that differ significantly from developed economies. Accordingly, we argue that emerging markets can sustain high growth only to the extent that they are able to produce a continuing stream of high-performing firms over time. But the path of sustained high performance for firms depends in large part on their ability to effectively manage both sales growth and profitability.

We advance the case for "profitable growth" or the simultaneity of both high profits and high sales growth as the condition of sustainability

market share, hoping that profits will catch up later. By limiting its expenses in order to maintain a desired level of profits, a profit-oriented firm might forego opportunities to expand its market share (for other differences, see Table 1).

Table 1. Key Differences between Profit- and Sales-Oriented Trajectories

Description	Profit-Oriented	Sales-Oriented
Objective	To demonstrate a steady and reliable flow of profits for both external and internal operations.	To harness a formidable market position by attaining a targeted market share.
Focus	Return on sales; cost efficiency; emphasis on operational activities.	Market share; sales growth; unit cost economies; can include acquisitions that broaden market scope.
Key Performance Criteria	Return on invested capital.	Sales growth; market share; relative market share.
Requirements for Success	Cost control; high profit margins to cover operational and non-operational expenses.	Scale and scope economies; effective marketing corresponding to segment needs.
Favored Growth Trajectory	Related diversification; vertical integration.	Related and unrelated diversification; acquisitions.

In emerging markets, how should firms achieve profitable growth? Based on secondary information and further informed by interviews, we ascertained that firms make their initial decisions based on growth strategy: to be sales-oriented or to be profit-oriented.[1] Typically, such decisions are formulated in terms of a trade-off. With a focus on sales growth, a firm might initially sacrifice profits–particularly in maturing markets–in order to attain higher

Although both growth-oriented and profit-oriented strategies could lead to profitable growth, they require different resources and capabilities. Growth-oriented strategies require firms to be able to sense and seize opportunities in the external environment, while profit-oriented strategies require firms to be more internally focused and exploit their existing resources and capabilities. Given the fact that firms in emerging markets are young[2] and have limited resources and capabilities, there is a trade-off be-

1/ This is oriented toward outcomes, as opposed to processes. Extant studies of growth in developed markets also focus on entrepreneurial activities. In this study, however, our treatment of entrepreneurship is oriented more toward the process of attaining growth, and not the end in itself.

2/ Most firms in emerging markets arise in the past two to three decades after economic liberalization. For instance, the average age of Top 500 private firms in China is only 15.63 years.

tween growth and profit-oriented strategies, at least at the early stages of firm development.

After exploring the trade-offs between sales growth and profit maximization, we visit some key questions: facing limited resources, in which direction should firms go when they pursue growth? Should they sacrifice growth for profitability or vice versa? What is the optimal path to achieve profitable growth? In the first part of this briefing, we examine the experiences of a large sample of firms from the BRIC countries (Brazil, Russia, India, and China) to see how firms manage to achieve profitable growth. In the second part, we examine different trajectories and draw conclusions from the experiences of 70 sustainable high-performing firms from the BRIC countries.

IV. Examining Growth Trajectories In BRIC: Four Scenarios

To what extent does this mandate for profitable growth apply to emerging markets? To examine this question, we classified firms along two dimensions: sales growth and profitability. This juxtaposition leads to four scenarios presented in Table 2.[3]

As a thought-exercise, let us postulate for the moment that Cell I (Profitable Growth-The Ideal State) is the most desirable place where every firm wants to be. Not every firm is able to reach such a favorable position, which is why it is an ideal state. The relationship between sales growth and profit in this cell is a complex one that is contingent on many factors, such as a favorable stage of industry evolution, prescient strategic analysis, and flawless execution. In contrast, firms in Cell IV (Declining Firms-Vacuous Growth) are clearly firms in decline. They are neither able to sustain sales growth nor achieve profitability. Hence, any market presence can be considered to be vacuous.

Of interest are the intermediate cells, Cell II (Firms on the Margin-Unprofitable Market Leaders) and Cell III (Firms in Waiting-Low Growth but High Profitability). Much like the BCG Growth Matrix, both are intriguing because any future strategic choices on their part will determine whether they migrate to a favorable cell (Cell I) or an unfavorable one (Cell IV). Although both sales growth and profitability are important, firms have to prioritize one over the other when they elect to expand.

Building further on this matrix, we examine the possibility of migrations, and their consequences provide the motivation for empirical tests. Going back to Table 2, firms could migrate to Cell I from Cell II, or to Cell III, or even to Cell IV. If a firm moves to Cell I from Cell II, it is interpreted as pursuing a sales growth-oriented strategy first; if it moves from Cell III to Cell I, it is seen as following a profit-oriented strategy first. Although a firm may not consciously choose a sales growth or profit-oriented strategy, the preference towards sales growth or profit can be manifested in the strategies that it deliberately chooses.

For perspective, both a sales growth-oriented and profit-oriented strategy could lead to profitable growth. There is no preordained path. If a firm adopts a sales growth-oriented strategy at its early stages, it will be profitable to the extent that it becomes a market leader and exercises its market dominance. Relative market share, which is defined as a firm's total revenue divided by that of its largest competitor, is achieved by significant economies of scale, as stipulated in the PIMS study, in which unit costs are sufficiently reduced, resulting in high profitability. However, such cases do not typically arise, and we discuss this process and present examples in the later part of this paper. Alternatively, a profit-oriented strategy could ultimately lead to higher sales growth and market leadership as well. High profits usually come hand-in-hand with the cost efficiency arising from cost reduction, a disciplined management culture, and a focus on a standardized as opposed to a differentiated product. The ability to deploy these resources and capabilities in other businesses through careful expansion can lead to significant growth.

Although both growth-oriented and profit-oriented strategies can lead to profitable growth

Table 2. Four Scenarios of Growth and Profitability

	High Profitability	Low Profitability
High Sales Growth	I. Profitable Growth-The Ideal State	II. Firms on the Margin-Unprofitable Market Leaders
Low Sales Growth	III. Firms in Waiting-Low Growth but High Profitability	IV. Declining Firms-Vacuous Growth

3/ Most firms in emerging markets arise in the past two to three decades after economic liberalization. For instance, the average age of Top 500 private firms in China is only 15.63 years.

over time, they also require different resources and capabilities. This ability to develop competences distinguishes the level of firm performance, and depending on this ability, different migration paths to growth can occur. To understand the migration patterns, we compiled firms' data in key sectors (including industrial goods, consumer products, financial services, energy and utilities, technology, media, transportation, infrastructure, and life science) in each of the BRIC countries from 2002 to 2011, totaling 105,260 firms. The source of the data is ORBIS, a global database that compiles information on over 60 million companies. From the data, we determined the initial decisions made by these firms relating to how to grow, either through sales or profits, depending on their intent and circumstances. The overarching question of this research is: Which path leads to sustained growth over time?

To examine performance, we divided the time period into two phases: phase I (2002 to 2006) and phase II (2007 to 2011), and classified firms in each phase into four scenarios: high sales growth-high profit (HH), high sales growth-low profit (HL), low sales growth-high profit (LH), and low sales growth-low profit (LL). Sales growth is measured by the difference between sales in the last year and sales in the current year as a percentage of the sales of last year. Profit is measured by ROA (return on assets), defined as the ratio of net operating profit to the firm's start-of-year assets. High or low sales growth and profit are determined using the average industry sales growth and profit during each phase as the baseline.

We then track the transition of firms in terms of the four cells. Which strategy has a better prospect of leading to profitable growth in emerging markets? Table 3 summarizes the growth trajectories in these two stages.

Table 3 reveals different patterns for sus-

Firms that adopt a profit-oriented strategy in phase I are in a much better position to attain high sales growth; conversely, firms that initially adopted a sales growth strategy are less likely to reach high profitability over time

Table 3. Growth Trajectories

Phase I (2002–2006) Status	Phase II (2007–11) HH	Phase II (2007-11) HL	Phase II (2007–11) LH	Phase II (2007–11) LL
High sales-high profit (profitable growth), HH	36.7%*	16.9%	31.1%	15.3%
High sales-low profit (sales-oriented strategy), HL	9.5%	40.5%	8.4%	41.6%
Low sales, high profit (profit-oriented strategy), LH	35.3%	13.2%	36.2%	15.3%
Low sales, low profit, LL	11.5%	34.3%	10.8%	43.5%

*Numbers in parenthesis depict percentages of firms.

taining performance. Firms that adopted a sales growth-oriented strategy in phase I are more likely (41.6%) to fall into the low growth-low profitability category in phase II. For firms that adopted a profit-oriented strategy in phase I, they are likely (71.5%=35.3%+36.2%) to retain their high profitability in phase II, and less likely to fall into the low growth-low profitability category (15.3%). From the data, we infer that it is harder for firms to switch from a sales-growth-oriented to a profit-oriented strategy. Only 8.4% of sales growth-oriented firms are able to do so.

In terms of moving into the idealized high growth-high profitability category (Cell I), 35.3% of firms in the profit-oriented category in phase I achieved this goal, while the number of firms in the sales growth-oriented category in phase I is much lower at 9.5%. On this basis, firms that adopt a profit-oriented strategy in phase I are in a much better position to attain high sales growth; conversely, firms that initially adopted a sales growth strategy are less likely to reach high profitability over time.

V.
Cross Country Differences In Growth Paths

Although many emerging markets share certain common characteristics, such as rapid growth and relatively weak institutions, there are cross-national differences. Next, we focus on such differences. To examine these migration paths in detail, we present Figures 1 to 4 that depict the movement of firms from phase I to II in terms of their growth strategies. We only considered firms that adopted a sales growth-oriented strategy or a profit-oriented strategy in phase I because we wanted to compare these two strategies to ascertain their long-term effect. Figures with suffix "a" represent firms that adopted a sales growth-oriented strategy in phase I, while figures with suffix "b" represent firms that adopted a profit-oriented strategy in phase I. The pie charts in these figures represent the distribution of firms in phase II.

China

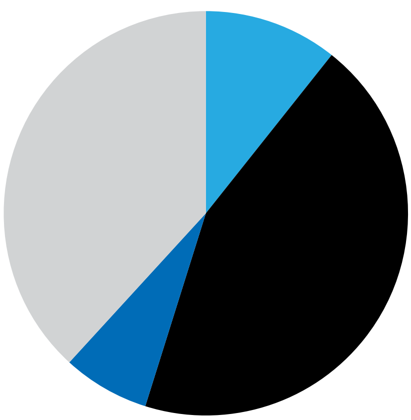
In China, firms that adopt a growth-oriented strategy in phase I are more likely to fall into low growth-low profit status in phase II (38%) than firms that adopt a profit-oriented strategy in phase I (14%), while firms that adopt a profit-oriented strategy in phase I are more likely to achieve profitable growth status in phase II (37%) than firms that adopt a growth-oriented strategy in phase I (11%). Compared to firms in Russia and India, the probability of achieving high growth-high profit in phase II is the highest for both growth- (11%) and profit-oriented firms (37%) in phase I in China. Similarly, the probability of falling into low growth-low profit in phase II is the lowest for both growth (38%) and profit-oriented firms (14%) in phase I in China. In general, the fast economic growth and stable policy environment in China provide Chinese firms better opportunities to achieve profitable growth than firms in Russia and India.

Russia

The situation for Russian firms is similar: only 9% of firms that adopt a growth-oriented strategy in phase I achieve profitable growth in phase II, while the number of firms that adopt a profit-

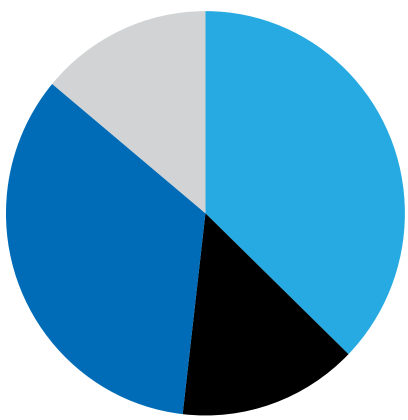
Figure 1. China

1a:
Phase II Distribution of Growth-oriented Firms in Phase I



HH	11%
HL	44%
LH	7%
LL	38%

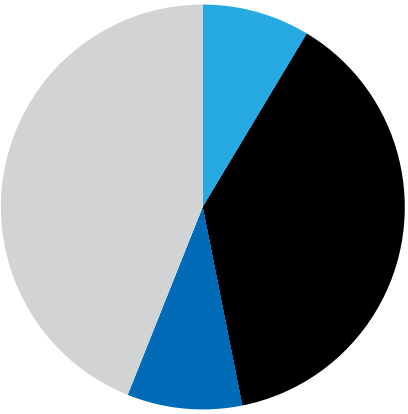
1b:
Phase II Distribution of Profit-oriented Firms in Phase I



HH	37%
HL	15%
LH	34%
LL	14%

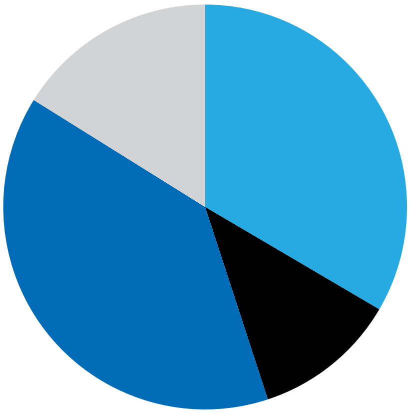
Figure 2. Russia

Figure 2a: Phase II Distribution of Growth-oriented Firms in Phase I



	HH	9%
	HL	38%
	LH	9%
	LL	44%

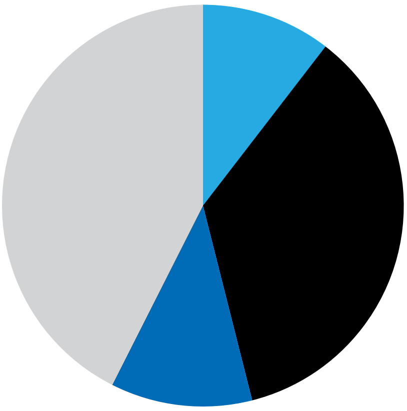
Figure 2b: Phase II Distribution of Profit-oriented Firms in Phase I



	HH	33%
	HL	12%
	LH	39%
	LL	16%

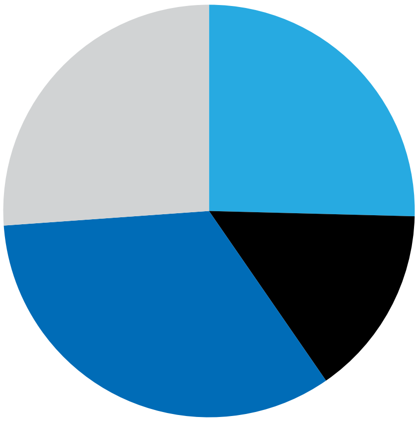
Figure 3. India

Figure 3a: Phase II Distribution of Growth-oriented Firms in Phase I



	HH	10%
	HL	36%
	LH	11%
	LL	43%

Figure 3b: Phase II Distribution of Profit-oriented Firms in Phase I



	HH	25%
	HL	15%
	LH	34%
	LL	26%

oriented strategy in phase I is 33%. Forty-four percent of firms that adopt a growth-oriented strategy in phase I fall into the low growth-low profit category in phase II, while the number of firms that adopt a profit-oriented strategy in phase I is only 16%.

India

For Indian firms, the probability of profit-oriented firms in phase I moving to profitable growth in phase II is lower than other countries (25%), while the probability of falling into low growth-low profit status is higher (26%). The result suggests that profit is hard to sustain in India, perhaps because there are fewer state-owned enterprises (SOEs) in India than in China and Russia. SOEs usually enjoy monopoly positions in profitable industries. With fewer SOEs, profits in India seem to be hard to sustain.

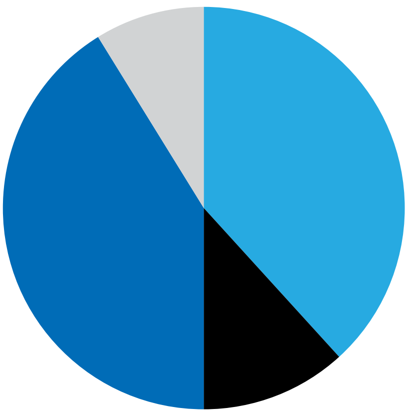
Brazil

Finally, for Brazilian firms, their pattern is different from the other three countries, due to a much smaller number of firms available for study: only 34 growth-oriented firms and 230 profit-oriented firms were identified. Therefore, the pattern may not be generalizable. Even so, the general pattern still holds: profit-oriented firms in phase I are more likely to achieve profitable growth and less likely to fall into low growth-low profit status in phase II than growth-oriented firms in phase I.

To summarize, Figures 1 to 4 suggest that for firms in BRIC countries, an initial profit-oriented strategy is better than an initial sales growth-oriented strategy in terms of achieving profitable growth over time. In addition, these firms are less likely to fall into decline (Cell IV, low growth-low profit). What are the reasons behind this? How does this pattern inform what we know from the PIMS study of developed firms? In the next sections, we address these questions with reference to extant theories and our case studies.

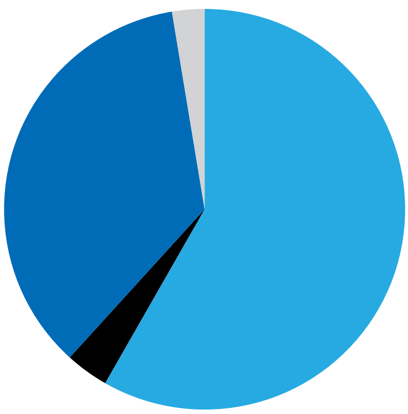
Figure 4. Brazil

Figure 4a: Phase II Distribution of Growth-oriented Firms in Phase I



HH	38%
HL	12%
LH	41%
LL	9%

Figure 4b: Phase II Distribution of Profit-oriented Firms in Phase I



HH	58%
HL	3%
LH	36%
LL	3%

VI.
Why Profitability Matters In Emerging Markets

The importance of profitability takes on a special significance in emerging markets. In developed economies, profitability is important in that it validates the firm's objective of maximizing shareholders' equity and interests. In classical management theory, the ultimate goal of a firm is to get the highest return to its shareholders, and the source of high investment return is profit. Measures such as ROA and profit margins are ingrained in financial reports and investor analysis reports as key indicators of firm performance. They are also the key indicators of managerial performance. For this reason, managers are typically evaluated in terms of returns on equity, assets, and sales.

Unlike firms in developed economies, those in emerging markets are not as beholden to shareholders. Even so, this fact does not abrogate the need for profitability. In fact, the absence of shareholders enhances the need for profitability because profits harvested from internal operations become the source to fund future growth. Even in cases where firms rely on external capital by participating in limited capital markets, raising capital is restricted by the lack of reliable information required by most investors. Specifically, potential investors would not invest in businesses in which they are not familiar; neither will they invest if they are fearful of being misled by incorrect information. In contrast, in the more advanced institutions of developed economies, reliable financial reporting and an independent financial press are able to redress this particular shortcoming redress this particular shortcoming[vi].

What then distinguishes firms that have successfully attained profitable growth? In order to understand how firms in emerging markets achieve profitable growth, we identified a group of sustained high performing firms that are superior to their peers, i.e., Top 500 private companies in each of the BRIC countries. This identification process relied primarily on a five-step process. The first of these steps was intentionally broad, using multiple high-level measures of business performance, such as revenue growth, market share, profitability, and efficiency.[4] Details about the data sources are included in Appendix 1. Second, we put the hundreds of high-performance companies that made the first cut through a more detailed, multi-tiered set of screens, including comparisons with comparable firms in the 2009 Top 500 list of global companies and in-depth frontier analyses of each company's resource-allocation efficiency. Details about this screening process are included in Appendix 2. Companies that met those standards advanced to the third step, in which we employed secondary data sources to help generate a template for what sustainable, high performance firms should look like. And finally, for the fourth test, we hit the road to conduct extensive field interviews with many of the selected firms, enhancing our understanding of their strategy, history, and potential.

With that, we had our preliminary list of exemplary firms, but we wanted to make sure

We found that high performing firms achieve profitable growth through competence-based or competence-enhancing growth, continuous product diversification, and organic growth. In the succeeding sections, we detail these three requisite factors based on an analysis of these successful firms

4/ Efficiency measures how efficiently a firm is able to transform inputs into outputs, in comparison with the most efficient firm in a sample.

we didn't lose a firm because the technicalities of our process hid it from view. Therefore, we consulted with Ernst & Young on the validity of the data we used and solicited their expert feedback on the companies' management and strategic prowess. Based on this assessment, we added five firms–one in Russia and four in India–that field experts regarded as the best companies in their sectors. And there you have it: after closely inspecting hundreds of companies and personally visiting dozens of them, we finally mined the 70 most-promising exemplary firms–16 Chinese firms, 16 Russian firms, 22 Indian firms, and 16 Brazilian firms.

For each of the 70 exemplary firms, we collected qualitative information about many aspects (such as initial advantages, core competencies, product diversification, and internationalization) through various sources including annual reports, Internet searches, company websites, and interviews. We found that high performing firms achieve profitable growth through competence-based or competence-enhancing growth, continuous product diversification, and organic growth. In the succeeding sections, we detail these three requisite factors based on an analysis of these successful firms.

VII.
Profitable Growth Through Core Competencies

Sustainability is inextricably related to the firm's ability to develop core competencies, which are the key drivers of profit. This is true for both developed country firms and emerging market firms. However, the core competencies of these sustainable high performing firms draw from their deep knowledge of local markets and conditions. Our study shows that they attain profitable growth primarily through building competencies that lead to operational excellence in the following areas:

Stringent Quality Assurance. Quality assurance is important in many emerging markets such as BRICs because of their relatively weaker contractual institutions. With trust built through providing a quality product, firms can charge premium prices to cover differentiation costs and increase profits.

Integrated Logistics and Supply Chain Management. Because the overall logistics systems and related infrastructure are seriously underdeveloped in many emerging markets such as India, causing high vulnerability along the supply chain, integrated logistics, particularly the timely application of vertical integration, is a critical requirement for success in many emerging markets.

Collaborative Learning and Innovation. With labor costs beginning to increase in emerging markets, firms have to develop technological competence through R&D, typically by collaborating with foreign institutions, and hiring local scientists and researchers.

Customer Responsiveness and Market Inclusiveness. High performers excel in responding to customers' changing needs, nurturing local connections, building differentiation advantages, and consolidating previously fragmented market niches.

Agile and Cohesive Management Systems. Management systems adopted by sustained high performing companies tend to have three distinctive characteristics–flexibility, agility, and a cohesive management team–that are underpinned by strong and supportive structures and resilient corporate cultures.

In studying these exemplary firms, we found that investing in R&D and developing innovation capability is the most typical way to build core competence for future growth. Linyang Electronics, a Chinese manufacturer of smart electric meters, is one such example. Linyang first enjoyed high growth due to the increasing demands for electric energy meters in most cities in China. During the period of rapid growth, the firm paid much attention to developing competitive advantages. It established R&D centers in several cities in China and invested over 5% of revenues in R&D each year. Twelve percent of its employees are dedicated to R&D. It also participated in several national research projects. As a result, the firm owns 61 patents, eight software copyrights, and several non-patent technologies. In addition to R&D, the firm also tried hard to build a reputable brand by ensuring product quality in every possible aspect: raw materials, equipment, and employees. The defect rate of its products is far lower than the national standard. The firm also set up a quality feedback system to track its products. In this particular case, Linyang first pursued profitability, which it channeled to profitable growth over time. As a result, the firm moved to the high growth-high profit category in phase II.

Another successful case is Cimento Itambé, a Brazilian cement manufacturer. The firm enjoyed initial high profits due to its low-cost, high-quality products and close relationships with large customers. In fact, the company is the first cement factory in the country to obtain an ISO 9001 certification, adding to its reputation of producing cement with reliable quality. The firm reduced costs by burning industrial waste in its kilns, and today it is one of the six in Brazil with an environmental permit to incinerate waste as alternative fuel. The ash remnants from burning are incorporated into the raw materials for cement. This fuel supplies 15% of the energy needed to power Itambé's ovens. Moreover, the firm is selective when choosing its customers. They seek the type of clients for whom quality makes a difference. A third of Brazilian demand for cement is generated by large consumers. For Itambé, the portion is 70%. All these competitive advantages resulted in high profits for the firm, and the firm then funneled these profits toward future growth.

Economies of scale are important for the cement industry and Itambé has not stopped expanding. It increased the capacity of its plant continuously and invested in a new plant. Over the years, Cimento Itambé maintained its position in Southern Brazil, with shares in the south being around 16%.

While core competencies are generally lauded, they are not preordained in actual operations. As depicted in the above cases, staking a position in new market niches is risky and requires bold action and visionary leadership. Oftentimes, it involves creating and consolidating demand, as opposed to meeting demand, as is so often the case in developed economies. Firms differ in their intent and abilities to develop them, which explains part of the reason why migrations in growth paths occur.

VIII. Profitable Growth Through Product Diversification

A second way of achieving profitable growth is through successful product diversification. Rather than growing within the same industry, product diversification means entering into a new business in search for new growth opportunities. Product diversification is an important component for both the growth-oriented strategy and the profit-oriented strategy. For a sales growth-oriented strategy, a firm can enhance growth by entering into a business that increases its product footprint. Similarly, for a profit-oriented strategy, a firm may increase profits by entering into a more profitable business than its current business. Successful product diversification will not only increase the size of a firm, but also improve the overall operational efficiency of a firm by allocating resources effectively along the value chain.

One of the most critical decisions managers need to make when they implement a product diversification strategy is the choice of direction, which directly influences the effectiveness of the product diversification strategy and further determines whether a firm is able to achieve profitable growth through product diversification. Box 1 explains the different types of product diversification by direction.

Table 4 summarizes the direction of product diversification for exemplary firms in terms of the three types of product diversification.

For this subset of exemplary firms, product diversification is a major way to achieve profitable growth. Over all, more than 80% of these firms diversified into at least one other business. In each country, at least 70% diversified into another business. Fifty-one percent diver-

BOX 1: DIFFERENT TYPES OF PRODUCT DIVERSIFICATION

	Related Diversification		Unrelated Diversification
	Horizontal-related diversification	Vertical integration	
Definition	Entering into a business that is closely related to a firm's current business	Entering into the business of a firm's upstream suppliers or downstream buyers	Entering into a business unrelated to a firm's current business
Rationales	Exploiting existing resources or capabilities into technology or customer-related markets	Ensuring stability of supply and demands; Reducing transaction costs	Utilizing slack resources; Leaving current business to compete in markets with more potential; Risk reduction

Table 4. Product Diversification of Exemplary Firms

	Total diversification	Related diversification		Unrelated diversification
		Horizontal diversification	Vertical integration	
China	100%	69%	69%	50%
Brazil	94%	69%	56%	19%
India	72%	36%	52%	16%
Russia	70%	30%	50%	0%
Total	81%	51%	57%	22%

sified into horizontal-related businesses and 57% diversified into vertically integrated businesses, while 22% diversified into unrelated businesses, more than half of which are Chinese firms.

Vertical integration is consistent with profitable growth in emerging markets because of the potentially high transaction costs arising from relatively underdeveloped market institutions

Because horizontal-related diversification exploits existing firm resources and capabilities, it requires a minimum of resource accumulation and capability building, and this mode of diversification is generally considered to be the safest and most efficient strategy among the three. However, upon closer examination, only 23 out of the 55 diversified firms opted for related diversification as their first move. Instead, 25 of them selected vertical integration first, reflecting the importance of vertical integration in firm growth. In each of the four countries, more than half of the firms diversified into vertically integrated businesses and did so early on.

Vertical integration is consistent with profitable growth in emerging markets because of the potentially high transaction costs arising from relatively underdeveloped market institutions. Laws or regulations that ensure contract enforcement are lacking, and even when they exist, they lack enforcement power in emerging markets such as BRIC. To overcome this difficulty in doing business with outsiders, successful firms tend to internalize their transactions, which explains their high level of vertical integration, compared to firms from developed countries.

Besides transaction costs, another reason to conduct vertical integration is to effectively manage the vagaries of inbound and outbound logistics. Coordination issues are particularly challenging in many emerging markets because distribution channels are underdeveloped, creating logistical inefficiencies and vulnerable supply chains. Oftentimes, in addition to building physical scale, successful firms promote their own sales networks and collaborate closely with distributors to ensure their products are delivered to customers on a timely basis.

A good example of vertical integration is Jinglong, a Chinese manufacturer of solar cells and solar- and semiconductor device-grade silicon products. Defying small investments, the firm embarked on a complete, dominant industrial chain of "crystal pulling-ingot cutting-wafer slicing- solar cell producing." While competitors found the strategy risky and avoided the market, this strategy worked well for Jinglong.

Another example is Godawari Power & Ispat Ltd, an integrated steel manufacturer in India, which started as a steel manufacturer, but later became vertically integrated to reduce its logistics costs. In 2004, it began to integrate backwards into the mining business by acquiring licenses from the Ministry of Mines for iron ore mining at Borio Tibbu and the Ari Dongri Area in Chattisgarh. The graded reserves in these areas exceeded 100 million tones. In the

Besides transaction costs, another reason to conduct vertical integration is to effectively manage the vagaries of inbound and outbound logistics

same year, Godawari started a captive power station. The 73 KW captive power plants generate the entire energy requirement of its facilities. Forty-two out of the 73 MW of power is generated using waste-heat (recovered from the manufacture of sponge iron), contributing to substantial savings in fuel costs. Today, the firm has managed to traverse the entire value chain of steel wires, emerging as an end-to-end manufacturer of steel wires and making it one of the lowest cost producers.

Product diversification constitutes the second way in which successful firms combine high profitability with high sales growth. Again, the emphasis here is on efficiency in transactions. The sequence from vertical integration to related product diversification reflects a more conservative route to market growth. In developed economies, firms that are able to aggressively grow through unrelated diversification often do so because they have strong business models and abundant resources. In contrast, firms in emerging markets, particularly new upstart firms, still need to build their competencies on an incremental basis, and this is reflected in their choices of future products and markets.

IX. Profitable Growth: Integrating Profitability With Organic Growth

Regardless of the type of product diversification, high performing firms prefer Greenfield as their primary mode of growth

Given that profitability matters, how is it that firms that initially pursued profitability are able to also achieve high sales growth, while those firms that opted for initial high sales growth are not as successful in attaining high profitability? From our research, the answer is the firm's ability to grow, but not necessarily in the manner that is suggested by conventional theories. In the mainstream strategic literature, high growth firms succeed to the extent that they are able to benefit from economies of scale and scope[vii]. Such a strategy is typical in industries characterized by a commodity product in relatively maturing industries, such as steel and cement. Moreover, this presumes that a prospective entrant also has adequate resources that can offset entry barriers.

In the case of emerging markets, however, only a small portion of firms has the ability to achieve profitable growth by adopting a growth-oriented strategy first. Typically, market dominance has already been established with state supported firms. Analyzing exemplary firms reveals they obviate entry barriers by entering market niches and segments that were previously ignored or unattended by the market leaders. Timing becomes a critical part of the strategy because the aspiring firm might have to build capacity ahead of demand.

We also found that successful firms use profits to grow organically, or by building on internal competencies, not necessarily mainly through acquisitions. When firms grow, they

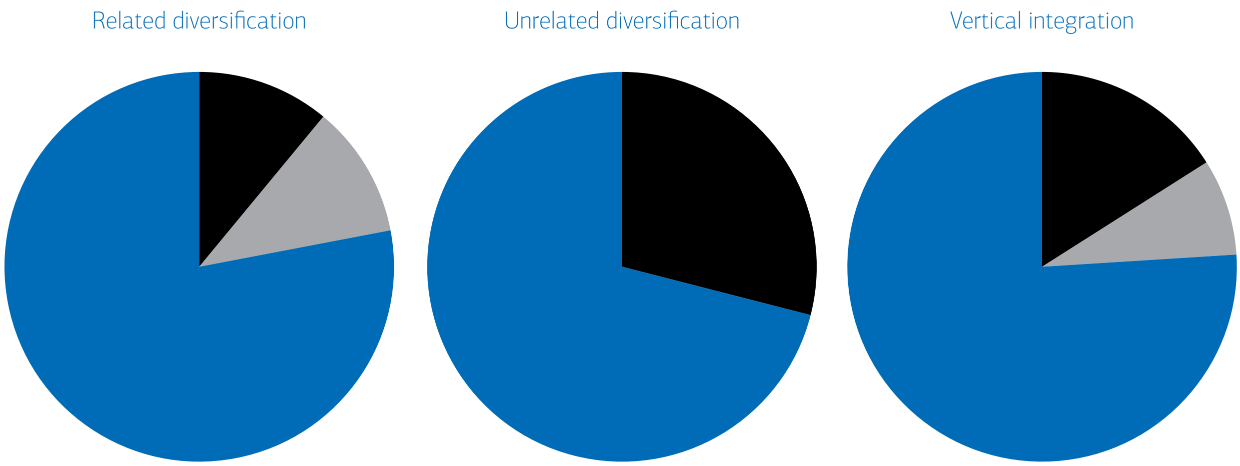
BOX 2: DIFFERENT ENTRY MODES

	Greenfield	Merger & Acquisition	Joint Venture[5]
Definition	Building a new plant by oneself	Merge with or acquire an existing firm	Build a new plant with another firm
Advantage	Complete control over the new plant; No need to search for targets or partners; No risk of technology/ knowledge leakage	Fast; The possibility of paying a low price for valuable assets	Pooling resources from two parties to achieve large scale; Benefiting from complementary assets from partner; Risk reduction
Disadvantage	Slow; Requires a large amount of resource inputs	Post M&A integration; Search for available targets; Risk of over-paying	Search for partners; Risk of technology/ knowledge leakage; Conflicts with partners about how to manage the venture

Each entry mode has its own distinctive advantages and disadvantages. The selection of entry mode depends on a firm's own needs and there is no general rule that guides the selection. As a result, managers need to think carefully about the benefits and costs of each entry mode when they make this choice. Choosing the wrong entry mode will jeopardize the entire diversification strategy.

5/ Joint venture can be either Greenfield investment or merger and acquisition. However, it is a distinctive type of entry mode because of its unique features as described in Box 2. In this study, we regard a subsidiary as a joint venture if it has shared ownership of two or more parties

Figure 5. Type of diversification and entry mode



Related diversification		Unrelated diversification		Vertical integration	
MA	11%	MA	29%	MA	16%
Greenfield	78%	Greenfield	71%	Greenfield	76%
JV	11%	JV	0%	JV	8%

can select from a range of modes. Box 2 explains the different types of entry modes when firms conduct product diversification.

Figure 5 summarizes the selection of entry mode by sustainable high performance firms in BRIC countries.

Figure 5 shows that regardless of the type of product diversification, high performing firms prefer Greenfield as their primary mode of growth. This is consistent with the fact that the level of trust is low and the transaction cost is high in many emerging markets such as BRIC countries. Since mergers & acquisitions and joint ventures involve dealing with another party, these firms want to avoid uncertainty by adopting the Greenfield mode.

For perspective, growth is important and necessary in developed and emerging markets. In developed economies, both high sales growth and the resulting market share are critical for establishing market dominance. In the case of emerging markets, however, high growth is necessary for three other reasons. First, high growth signals stability and presages future success. It is not unusual to see a flurry of governmental programs oriented at enhancing growth because growth is aligned with employment targets and even anticipated tax revenues. Second, the size of large firms in emerging markets provides a cushion for funneling funds to smaller firms. In effect, much like the cases of Japan's keiretsu and Korea's chaebol, this funneling of funds functions like an internal capital market[viii]. Third, large firms are seen as providing the necessary institutional safeguards, specifically legal and contractual enforcement, that might not otherwise be provided by the country's legal infrastructure.

For these reasons, high sales growth in emerging markets is desired, not necessarily for sheer market dominance (although this is not rejected nor eschewed), but for the benefits and consequences, as discussed above, that accrue from having large size based on internal competencies. To the extent that already profitable firms can turn the corner by orienting their strategies to capitalize on these benefits of larger size, they are most likely to attain the much-coveted profitable growth as well.

X.
Managerial Implications And Recommendations

The study underscores three key findings: first, different paths are taken by firms to sustain performance, specifically the imperative to build internal profits ahead of sheer market share by maximizing sales growth; second, sustaining performance cannot be enabled without also developing requisite competencies; and, third, there are several ways in which successful firms are able to attain profitable growth over time. Accordingly, implications for firms currently operating in emerging markets, or seeking to do so in the foreseeable future, include the following:

1. Do not pursue growth without considering profit in emerging markets, because rapid growth does not guarantee high profits.

Although emerging markets are growing rapidly and provide opportunities for growth, firms should not blindly pursue rapid growth without considering how future profits can be funneled into new investments. Our results show that almost half of the firms that initially pursued a sales growth-oriented strategy eventually lose sales and profits in a later phase. To be sustainable, it is critical for firms to develop the necessary competencies. Profits and competitive advantage are tied together; their union reflects the horse that pulls the growth cart rather than the other way round.

2. Becoming vertically integrated is an important way to achieve sustainable growth in many emerging markets.

In many emerging markets such as BRIC, vertical integration is one of the most important avenues for sustainable profitable growth. Vertical integration is not only a means to achieve growth; it also reduces transaction costs in many emerging markets. Efficiency results when firms are able to guarantee high product quality and timely delivery, both of which are keys to building competitive advantages in emerging markets. In our study, more than half (57%) of exemplary firms became vertically integrated. We should note, however, that a firm cannot conduct vertical integration on a continuous basis. After it has completed integrating its value chain and securing control, it will have little room for further vertical integration.

3. When conducting product diversification, do it on your own.

Selecting an appropriate entry mode influences the success rate of product diversification. Our results show that regardless of the type of product diversification, exemplary firms prefer the Greenfield mode rather than M&A or JV. In fact, more than 70% of product diversification conducted by successful firms are Greenfield investments. Given the high transaction cost and low level of trust in many emerging markets, and limited knowledge about potential M&A targets or JV partners, it is much safer to do it by oneself when conducting product diversification.

Finally, our study indicates that sustainability of performance in emerging markets is more multifaceted than what is conventionally depicted. Sustained growth in these markets will unquestionably depend on macroeconomic conditions, industrial evolution, and government policies that create future winners in global competition. Nevertheless, the ability of these high performers to experience enduring success will, in turn, be based on their ability to achieve profitable growth and requisite competencies over time.

We should note, however, that the success stories of exemplary firms only illustrate how they leverage their resources and capabilities to achieve profitable growth. Following their growth pattern (for example, pursuing vertical integration or adopting a Greenfield investment mode) will not guarantee that a firm will achieve profitable growth. A firm needs to decide its own growth strategy according to its internal resources and capabilities, as well as external market conditions.

Do not pursue growth without considering profit in emerging markets, because rapid growth does not guarantee high profits

Appendix 1. Data Sources of Sustainable High Performing Firms in BRIC

Quantitative Data Sources

The first step was to determine appropriate data sources to use. China, Russia, Brazil, and India were selected because they are among the largest emerging markets in the world. These countries have undergone rapid economic growth in the past decades and have the legacy of state ownership in their economies. We also selected manufacturing industries because they are regarded to be the generative engines of the economy in emerging markets.

We then focused on the Top 500 private firms in each year. For Chinese firms, we identified a list of the Top 500 firms by sales value each year from 2000 to 2009. For Russian and Indian firms, we identified a similar list each year from 2001 to 2009. For Brazilian firms, the time period is from 2003 to 2009, due to data availability. Our objective was to determine the best performers among the Top 500 firms across the years. Although not all large firms are high performers, we believe the best performers are among the larger ones. Because high performers have the ability to grow continuously, they eventually rank among the Top 500 firms over a given time period.

Secondary Sources

The data for Chinese firms was sourced mainly from the Database of Industrial Firms in China, an annual industrial firm census conducted by China's National Bureau of Statistics (NBS). The China Statistical Yearbook offers aggregate statistics at the provincial and industry levels. The census data include all manufacturing enterprises except small, often family-run, businesses at the village level. The annual survey database contains key financial indicators and demographic information, including the firm's name, manager's name, and year of establishment. The NBS reports that the accuracy of the information in the census, and in particular the financial data, has been carefully checked.

The data for Russian and Brazilian firms were obtained from ORBIS, a global database that has information on more than 60 million companies. The information is sourced from more than 40 different information providers, all experts in their regions or disciplines. As well as descriptive information and the company financials, ORBIS contains other details such as news, market research, ratings and country reports, scanned reports, ownership, and M&A data. Raw data reports are available for listed companies, banks, and insurance companies, as well as major private firms.

The data source for Indian firms was obtained from CMIE (Prowess). The coverage in Prowess of Indian firms is significant, as it covers a fairly large proportion of the business conducted in India. For example, the total income of all companies in the Prowess database is about 78% of India's GDP. The output value of all the manufacturing companies included in Prowess accounted for 79% the total output value for the country's entire registered manufacturing sector during 2008-09. Prowess companies cover more than half of India's external trade. They cover about 62% of India's exports and nearly 82% of India's imports.

Appendix 2. Selection Criteria of Sustainable High Performing Firms in BRIC

1. The firm should be a privately-owned (non-foreign, non-government owned) company in the manufacturing sector with at least 10 years of history;
2. The firm should be included in the 2009 Top 500 largest private company list;
3. The firm's 10-year average of efficiency score (calculated from frontier analysis) should be higher than the average of the annual Top 500 firms during the same period;
4. Its 10-year average sales growth rate should be higher than the average of Top 500 firms;
5. Its 10-year average profitability should be higher than the average of Top 500 firms;
6. Its annual sales growth rate should not be lower than the Top 500 yearly average for more than three years;
7. The firm should be one of the top 10 private companies in terms of sales in each market sector (defined by its four-digit SIC code) in 2009; and
8. Not more than two companies were selected from the same sector to avoid industry effects (defined by the sector's four-digit SIC code).

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Moscow School of Management SKOLKOVO
Novaya ul. 100, Skolkovo village, Odintsovsky district,
Moscow region, Russia, 143025
Phone.: +7 495 580 30 03
Fax: +7 495 994 46 68
E-mail: info@skolkovo.ru
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Unit 1608 North Star Times Tower
No. 8 Beichendong Rd., Chaoyang
Beijing, China 100101
Phone: +86 10 6498 1634, Fax: +86 10 6498 1634 (#208)

IEMS Moscow
Moscow School of Management SKOLKOVO
Novaya ul. 100, Skolkovo village, Odintsovsky district
Moscow region, Russia, 143025
tel: +7 495 580 30 03, fax: +7 495 994 46 68

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