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Global dominance through the emerging middle segment

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The rise of emerging markets in the coming decades will have huge implications for companies. Any multinational company that aims to be a global leader must know how to capture a significant share of the largest customer segment in countries such as China, India, Russia and Brazil. These new customers are the so-called middle segment. This article demonstrates that a successful approach to this critical segment requires an entirely new attitude from Western multinationals towards emerging markets. Without it they will not only fail to grow in emerging markets but also risk losing their position in their mature home markets.

There is no shortage of statistical forecasts demonstrating that the emerging markets will account for the bulk of the increase in global GDP in the coming decades. For example, Brazil, Russia, India and China – often called BRIC – will account for 50 % of global incremental GDP growth from now to 2030, compared with 26 %for North America, Europe and Japan combined. A statistic like this is not just of interest to macro-economists or geo-politicians. It also has huge implications for any multinational company (MNC) that aims to be a global leader. Unless you know how to capture a significant share of the largest customer segment in these countries, global leadership will evade you.

The largest customer segment in the emerging markets is the so-called "middle segment". It relates to consumer and business products with a good basic functionality but without the full range of differentiating features, yet at a highly competitive price. In China, for example, it accounts for as much as 60 to 90 % of the addressable market for MNCs.

Securing a strong position in the middle segment is certainly a challenge and probably a must for Western MNCs. It is a challenge because they have to find ways to outperform entrenched local middle-segment champions. It is a must because champions from emerging markets will otherwise use their locally gained strength to fund international expansion into the MNCs' profitable home markets.

In this article we will show how MNCs can go beyond their current globalization philosophy to counter local champions in the middle segment through a strategy we label fight-focus-simplify.

The need for a BRIC 2.0 strategy

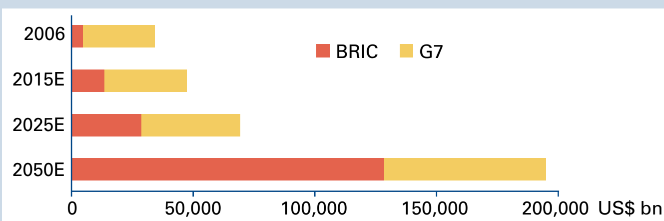
A business executive seeking to exploit the dazzling economic growth forecasts for the emerging countries (see box "Growth of the BRIC economies in absolute terms") has to look beyond countries into segments. The product positioning pyramid is a good starting point.

Growth of the BRIC economies in absolute terms

Goldman Sachs recently forecast the cumulative GDP growth rate for today's seven largest Western economies (G7 countries) at around 2 % per annum until 2050. This is low compared to the BRIC countries. China will have an annual growth rate that is over five times higher than that of the G7 countries. India's economy is predicted to grow by more than 8 % per annum.

This high growth leads to a strong shift in the relative importance of the economic powerhouses: whereas the combined GDP of the BRIC countries is a mere one-fifth of the combined GDP of the G7 countries today, it will be almost at par by 2025. By 2050 BRIC's GDP will have outgrown the G7's by more than double. This will make the BRIC economies three times bigger than the entire world economy today (see Table 1).

Table 1 **Expected GDP of BRIC and G7**



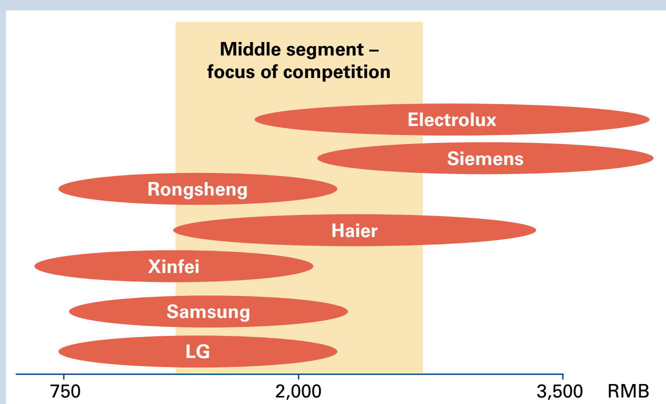
Source: Goldman Sachs

At a country-by-country level, this implies that six of the ten largest economies in 2050 will be emerging markets. Put differently, it means that the BRIC countries will represent 50 % of global incremental GDP growth (expressed in purchasing power parity) from now to 2030, compared to 26 % for North America, Europe and Japan. Within the BRIC countries, China takes the biggest chunk with 30 % of total growth. The bottom-line of this is that the absolute growth of the Chinese market over the next 20 years will be comparable to the growth of North America, Europe and Japan combined.

The product positioning pyramid in emerging markets is split into different segments. The premium segment at the top is characterized by globally renowned brands from mature markets with high-quality products, full-service support and premium pricing (sometimes with prices far higher than those in the manufacturer's home market). The segment at the bottom of the pyramid consists of offerings with limited functionality and service, and is dominated by local champions and low-cost products.

The segment in between, the middle segment, combines products with a good basic functionality, but without the full range of differentiating features, yet at a highly competitive price. But beware: the meaning of middle segment in emerging markets differs strongly from that in mature markets. While the middle segment means "value for money" in mature markets, the definition in emerging markets equates to "good enough" (see Table 2).

Table 2 **Price positioning for refrigerators in China**



Source: Arthur D. Little analysis

Until recent years the middle segment was a relatively low priority for most MNCs, which tended to focus on the premium segment. The reasons for their lack of enthusiasm for the middle segment include:

- Inability to compete on the same cost base as local players
- Unwillingness to jeopardise the premium product/service range

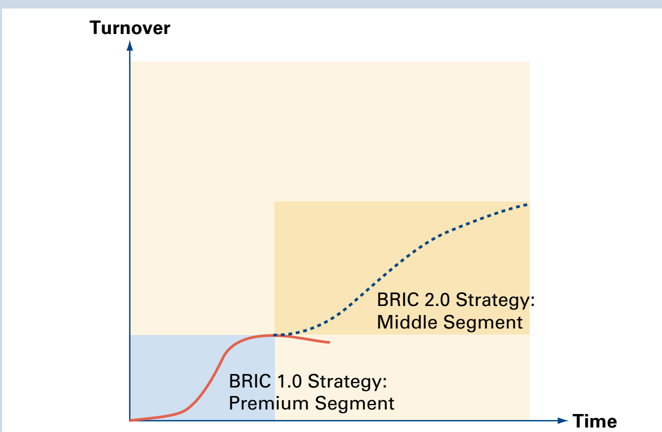
- Inability and complexity in providing products with basic functionality
- Lower profitability conflicting with margin focus (relative rather than absolute value)
- Perceived limited market size

The middle segment is key for MNCs. For example, in China the middle segment often constitutes at least 25 % and sometimes over 75 % of the overall market, thus representing 60 to 90 % of the addressable market (premium + middle segment) for MNCs.

In other words, most MNCs are still in what we call the BRIC 1.0 phase: exploiting the growth in the emerging markets' premium segment. Typical BRIC 1.0 strategies include: "de-engineering" global product offerings; go-to-market approaches based merely upon following global customers, thereby adopting the same strategies as in mature markets; and management driven by expatriates. Quite a few MNCs are currently reaching the limits of that strategy, with diminishing turnover growth in the premium segment in emerging markets.

MNCs therefore should develop a BRIC 2.0 strategy: focusing fully on addressing the middle segment (see Table 3). There are two reasons for them to do so. First, it enables them to exploit an immense local growth opportunity. Second, it protects their position in their home market by minimizing the threat of entry by emerging market champions. Let's look at these two reasons in more detail.

Table 3 **BRIC strategy of multinational companies**



Source: Arthur D. Little analysis

Exploiting the local growth opportunity

The middle segment is key for MNCs. For example, in China the middle segment often constitutes at least 25 % and sometimes over 75 % of the overall market, thus representing 60 to 90 % of the addressable market (premium + middle segment) for MNCs. This is true both in the consumer (B2C) and business (B2B) arenas.

The automotive market is an example in the B2C arena. While the premium segment covers 4% (and is served by MNCs), the middle segment covers 75 %. It consists of two sub-segments: the middle-to-premium with 55 % and the middle-to-low with 20 % (see Table 4). Many MNCs have entered this segment through various joint ventures since they regard participating in the middle segment as key to long-term success. Despite the fact that the middle segment can be under pressure in relative terms, its absolute growth makes it highly attractive.

Insulation materials are an example in the B2B arena. While the Chinese glass wool premium segment covers 15 % of the market (and is also served by MNCs), the middle segment covers 55 % (the middle-to-premium sub-segment 15 %, and the middle-to-low sub-segment 40 %), with no MNCs participating.

Table 4 **Automotive product positioning pyramid for China**

Share in total sales volume 2008	2012		Market	Segments	Characteristics
4.1%	4.1%	Dominated by foreign companies	Premium Market	**Premium** ■ Audi 'A8' ■ Mini 'New Mini' ■ Ferrari '430'	■ Global products ■ Mostly imported ■ High brand value ■ Low volume
55.4%	48.5%	Middle segment	Volume Market	**Middle-to-premium** ■ VW 'Jetta'/'Passat' ■ Toyota 'Camry' ■ Buick 'Lacrosse'	■ Adapted 'global' products ■ Partly local sourcing & manufacturing ■ High volume
20.2%	22.4%	Middle segment	Volume Market	**Middle-to-low price** ■ Geely 'Meiri'/Youliou ■ Chery 'QQ3'/'Tiggo' ■ BAW 'Qishi'	■ Fully localized product ■ Designed for Chinese market ■ Low cost ■ High volume
20.3%	25.0%	Dominated by local companies	Volume Market	**Low price** ■ Various indigenous producers ■ Zotyo 'Lybra' ■ Great Wall 'Hover'	■ Often copied design ■ High volume ■ Low cost ■ Low quality

Source: Global Insight

Increasing purchasing power, often measured by GDP per capita, is the main growth driver in the B2C arena. As GDP per capita in the BRIC countries is on the rise, so is the global middle class. The middle class in emerging markets are households with an annual income of $5,000-$15,000 (see box "How to qualify the 'middle class' in emerging markets"). Tapping into this market segment, which has income levels that are not even on the scale in the MNCs' domestic market, calls for a different approach, to which we will return later.

The drivers fuelling middle-segment growth in the B2B arena differ strongly from that in the B2C arena (consumers' higher disposable income). We distinguish five drivers, which together create a structural shift that is there to stay.

How to qualify the "middle class" in emerging markets

According to Goldman Sachs' predictions, the United States will remain the wealthiest large economy in terms of GDP per capita in 2050. Other currently developed countries will also remain in the top 10, with GDP per capita expected to range from $60,000 to $80,000. But the BRIC countries will have closed the gap significantly by 2050. Russia is expected to rally to third place. At around $50,000, Brazil and China are expected to have higher GDP per capita than all of the developed countries today.

As GDP per capita in the BRIC countries is on the rise, so is the global middle class. However, assessing the attractiveness of the "holy grail of consumption growth" requires a clear view on how to qualify the typical "middle class" in emerging markets. The simplified definition of "people who are not really poor and not really rich" leaves a lot of room for interpretation.

In developed markets, "middle class" means households with a median annual income of about $45,000. For people with a professional degree this figure increases to $100,000. Leaving school before your 15th birthday leads to a yearly household income of $20,000. By contrast, the upper income class in China is defined as having a yearly salary above RMB120,000, or slightly above $15,000. This means that top earners in emerging markets are comparable to the lower income brackets in developed markets. The middle class in emerging markets are households with an annual income of $5,000-$15,000. While the local spending power of the Chinese upper income class may be higher than that of the middle class in developed markets, increasing urbanization and higher structural inflation (e.g. soaring real estate prices in China's top 100 cities) are rapidly eroding part of this advantage.

In China, which represents the bulk of absolute GDP growth in the BRIC countries, there will be roughly 7 million households in the upper income class by 2015, roughly the same as in a country like The Netherlands. It is questionable whether this market size justifies the presence of nearly all leading global brands in heavy competition with each other. However, when expanding the addressable market to the middle class, the proportions are totally different. China's estimated 100 million middle-class households will already represent a large market by 2015.

The drivers fuelling middle-segment growth in the B2B arena differ strongly from that in the B2C arena (consumers' higher disposable income). We distinguish five drivers, which together create a structural shift that is there to stay.

Functionality and quality push. The most important driver is the B2B customers' push for more functionality and higher quality. Whereas this used to be driven primarily by international customers (Western companies sourcing products from BRIC countries), now domestic customers are also raising their requirements. Underlying drivers are continuously evolving sourcing strategies (Western firms sourcing complex products and systems instead of parts) and higher competitive intensity is forcing companies in emerging markets to differentiate – all of this, of course, at equal sales prices.

Total cost approach. Many industries in emerging markets experience the unusual combination of very strong growth and declining prices and margins. This increases the cost pressure and forces companies to think in a "total cost of ownership" logic. For example, logistics providers consider fuel efficiency, breakdown rates and maintenance costs when deciding which truck to purchase, and manufacturers include labor utilization, energy efficiency and servicing charges when deciding which machine to install. As companies enhance their management skills, they acknowledge the value of better quality and lower total costs.

Regulation. Norms and regulations concerning fuel quality are increasing, particularly in emerging markets. Whether inspired by environmental concerns, safety issues or public health motivations, regulatory changes often aim at achieving a specific functionality (e.g. better energy efficiency for production equipment), thus directly influencing the price/ quality pyramid.

In short, whether in the B2C or B2B arena, the middle segment in emerging markets represents an enormous opportunity. The premium segment, on the other hand, is often too small for all of the global leading MNCs to be successful and remain profitable, given their high overhead cost structure and orientation towards large volumes.

Technology. Emerging market players increasingly make use of advanced technology from developed markets (sometimes because of norms and regulations), which leads to products of better quality and naturally fuels the middle segment. However, this does not turn companies into "premium players" overnight, since they often lack the fundamental product and process innovation and know-how to become leading-edge in the short term.

Liability. In particular, companies dealing with US customers (or their international subsidiaries) are increasingly aware of product liability. As a consequence many B2B players in BRIC countries, particularly those that have gained size and thus exposure, gradually diversify their product offering into higher-quality products – the middle segment.

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Protecting positions in the home market

From the above, we have seen that an MNC that does not address the middle segment risks missing out on massive growth potential in emerging markets. However, the missed opportunity is only half the story. The other half is a threat with a longer-term structural impact: local champions from emerging markets expanding into global export markets and undermining the profitability of MNCs in their profitable home markets.

The entry of MNCs into the premium segment of emerging markets has provided local champions with a very valuable learning experience in multiple dimensions, including product and service offering, go-to-market approach and production and supply chain management. In addition, premium players' employees who have enjoyed all of the MNC's know-how transfer are often headhunted by these local champions, which are willing to pay a premium price. These companies have now grown into serious competitors. The continuous increase in the number of emerging-market companies from 47 in 2005 to 78 in 2008 on the Fortune Global 500 list illustrates this development.

Building on that learning experience, local champions from emerging markets are also targeting the mature markets. Driven by globalization and cost pressure, their products gradually slip into Western Europe, North America and Japan. Very often starting through a private-label route, hard discounters or a specific niche segment, the products gradually adopt their original home brands, gain market exposure and expand the range of variants in the catalogue. The list of examples is long, ranging from consumer white goods (e.g. Beko from Turkey or Haier from China – see box "Haier: Using Chinese experience to create a US footprint") through apparel to electronics. These entries represent a direct attack on the MNCs' leading premium brands and their margins.

An MNC that does not address the middle segment risks missing out on massive growth potential in emerging markets. However, the missed opportunity is only half the story. The other half is a threat with a longer-term structural impact.

The risk of such an attack depends on the degree of commoditization of a product category and the degree of technological pace within the product category. Product categories with strong brands and slow technology change, such as cosmetics or detergents, will be at low risk. Electronics, with a high degree of commoditization and fast technology pace, are already lost to emerging-market players, to a large extent. Next in line are low-profile industries like furniture, carpets, leather and possibly entry-level segments of high-tech categories such as cars.

Haier: Using Chinese experience to create a US footprint

Haier is the leading Chinese manufacturer of white goods, with a local market share of around 30 %. It has been exploring international markets for more than 20 years. About one third of its $15 billion revenues are now generated outside China. With Haier products distributed by leading retail chains such as Wal-Mart, Carrefour, Home Depot and Sears, Haier is already a serious threat to Western white goods manufacturers in all markets.

Haier initially had difficulties entering the US market, as it could only gain access to small independent retailers, while big retail chains were not interested in pushing an unknown Chinese brand. It took a customized product strategy for Haier to come onto the radar screens of the leading distributors and position itself next to the leading international players.

From its early sales, Haier learned that US students had special requirements regarding refrigerators. As well as having limited budgets, students also had limited space. Haier developed a small refrigerator attached to a computer desk, which became very popular among students and increased Haier's market share quickly enough to attract Wal-Mart's attention. Haier's cooperation with Wal-Mart started with this simple product, but gradually more and more products were included and more leading distributors followed.

Sears, another leading US retail chain, focuses on mid- to high-end products, selling its own exclusive national brands alongside a few leading brands such as GE and Levi's. Although reluctant to distribute rather unknown brands, Sears was attracted by a new type of mini-dishwasher developed by Haier. Normal US dishwashers were large and heavy, while the new Haier type was small and made of plastic. Sears was convinced that this product would win the favor of singles and students, and thus Haier gained its first footprint within Sears.

At present, eight of the top ten US retail chains sell Haier products. Starting with a niche player focusing on small refrigerators, it has firmly established a leading position in white goods in North America and beyond.

Li-Ning: Building an international presence

Li-Ning, founded by a former Olympic gymnastics champion, is the leading local brand of sporting goods in China. Before 2003 Li-Ning accounted for about half of the Chinese market. Since 2003 it has been surpassed by heavy investors in China, like Nike and Adidas, which have captured market share from Li-Ning. However, it is set to leverage its top position in China's second-tier cities to fuel its international expansion.

Avoiding competing head-on with the leading worldwide brands in China, Li-Ning focused on China's smaller cities, where competition with foreign brands is less intense and where the middle class able to afford running shoes at $20-$50 is growing rapidly. This strategy has paid off, and Li-Ning has been able to stabilize its position in China and look actively at overseas markets, now also with higher priced products.

Although Li-Ning's pockets were not deep enough to become the official Beijing Olympics sportswear provider (a role won by Adidas), it used the Olympics to pour large budgets into international marketing (e.g., Li-Ning has agreements with the Spanish basketball team, the Swedish Olympic Committee, the American basketballer Shaquille O'Neal and the Association of Tennis Professionals). Li-Ning now also cooperates with leading French and Italian designers to make its products more appealing to Western consumers.

However, Li-Ning still faces challenges. One of them is that its brand positioning is unclear. It is currently neither a low-cost brand nor a top brand. Furthermore, its products are associated with gymnastics, which is not among the most popular sports. As well as investing in a basketball, tennis and football line, Li-Ning aims to extend its gymnastics image to fitness and yoga, potentially a very interesting market.

Although Li-Ning's overseas activities are still at an early stage, it has the ambition to become a global top-five sporting brand by 2018. Its development will be closely followed by top executives at Nike and Adidas.

The strategy we propose for outperforming the local champions has three components: fight, focus and simplify.

Rather than passively suffering from these challengers' aggressive entries into premium mature markets, MNCs should confront these companies on their home turf: the middle segments in emerging markets. Just as the local champions have learned from Western companies in the past, MNCs should expand their activity into the middle segment by learning from the incumbents. This will enable MNCs to confront and attack current middle-segment players in their domestic markets (which is still where they make their profits), and to have their defences ready for the confrontation in their own profitable premium markets at home.

The Fight-Focus-Simplify strategy

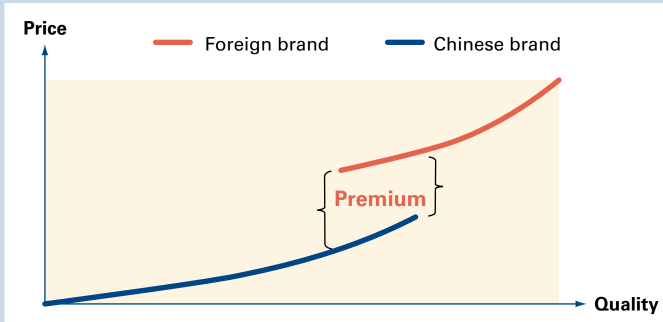
The double rationale for MNCs to address the middle segment in emerging markets should be clear by now: to exploit the immense local growth opportunity and to protect their position in their profitable home market. But, when doing so, they have to find ways to outperform the entrenched local champions currently serving the middle segment. In addition to a strong historic position on their home turf, these incumbents also benefit from a very low cost structure. The strategy we propose for outperforming the local champions has three components: fight, focus and simplify.

1. Fight

MNCs should link their international brand power with emerging-champion go-to-market approaches to win the fierce fight for share in the middle segment of the BRIC markets. In the middle segment, quality is not the key distinctive factor. International companies need to combine their international brand reputation with doing business "the local way". In many cases a "steal with pride" approach, enriched with selective marketing and sales elements from mature markets, creates a winning formula for competing on a par with local champions.

Chinese customers, for example, are in general still willing to pay a premium to foreign brands for products at a similar quality level as local ones. MNCs should use their successful marketing skills to establish and boost this effect (see Table 5).

Table 5 **Go-to-market approach for international MNCs**



Source: Arthur D. Little analysis

Another example is Unilever in India. It has introduced the "Wheel" detergent brand to go beyond Unilever's traditional approach and adopt some of the key business principles of the local challengers.

Nokia has been very successful at deploying a "fight" strategy in the mobile phone handset market in China. In 2003 this market was led by both domestic and international players (i.e. Bird, TCL, Motorola, Nokia and others), each holding a market share around 10 %. With high demand for mid- and low-end mobile phones, the domestic brand seemed to have the best competitive starting position. Nokia, perceived as a premium product, wanted to leverage its key strength (the brand) and combine it with the go-to-market approach of the domestic players in terms of product (functionality and quality), channel strategy, pricing, etc. Nokia decided to vastly expand its product offering, providing at least as much variety as the incumbents. At the same time, it launched a "multi-channel distribution" campaign just like those of the Chinese incumbents, reaching consumers via mobile operators, national dealers, home appliance chain stores, specialized mobile handset outlets and IT channels. And its mid-end product prices are comparable to those of domestic brands. Nokia's "fight" strategy is paying off: it holds the clear market leader position with a 35 % market share in 2007, which is more than double that of the second player, Motorola.

Another example is Unilever in India. It has introduced the "Wheel" detergent brand to go beyond Unilever's traditional approach and adopt some of the key business principles of the local challengers. One critical element was product availability: India's 627,000 villages are spread over 3.2 million square kilometers, and finding the 700 million Indians who live in rural areas is not easy. Over the years, Unilever's Indian subsidiary has built a strong distribution system that helps its brands reach all corners of the rural market. To service remote villages, stockists use auto rickshaws, bullock carts and even boats in the backwaters of Kerala.

2. Focus

"Focus" is the second component of a successful middle segment strategy for MNCs in emerging markets. They should select and invest with priority in regional clusters that can still provide dominance potential. Once a strong market position (number 1 to 3) is established in one regional cluster, it can serve as a rollout platform to others. The rollout roadmap has to be defined with care, selecting geographies (e.g. for China, tier two and three city clusters, or specific regions around tier one cities) on the basis of their attractiveness and the ability to attain a leading position there (see Table 6).

Table 6 **Rollout roadmap approach**

Source: Arthur D. Little analysis

One renowned example is that of the chicken restaurant chain KFC Corporation. Beijing served as the initial platform for KFC's operations in China. Beijing is the centre for most of China's political activity and provides the necessary access to government agencies and business regulatory bodies. Furthermore, it has a large population. The numerous universities located in the city educate people with foreign ideas and, more importantly, plenty of Western tourists come to Beijing's many tourist attractions, increasing the potential for generating foreign-currency sales. KFC later expanded into other high-flying areas such as Shanghai and Guangzhou. It grew very quickly afterwards and achieved solid growth success from this platform in China. The number of outlets reached 100 in 1996, 1,000 in 2004, and 2,000 in 2007.

3. Simplify

"Simplify" is the third component of a successful middle-segment strategy for MNCs in emerging markets. One complicating factor for Western MNCs is that products typically focused at the middle segment in their mature home markets are positioned somewhere between the middle and premium segments in emerging markets. As a consequence the MNCs' traditional product/service portfolio has a very limited target clientele – being successful in the middle segment in the emerging markets requires more creative ways than copying or de-engineering.

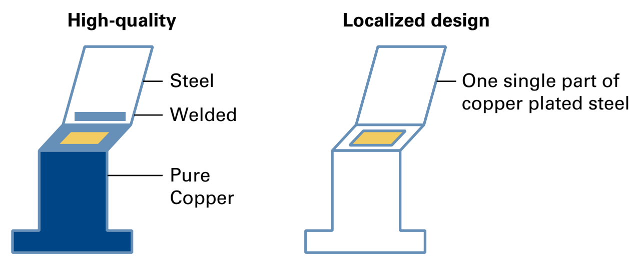
MNCs, rather than "de-engineer" international products, should develop fully localized platforms for emerging middle segments "inside out". The definition of middle-segment products in emerging markets is different from the concept in developed markets.

The Chinese heavy truck market is a case in point. China is the world's largest market for heavy trucks. Domestic companies are overwhelmingly dominant, with a total market share of 98 %. Until now Western companies have been unable to compete in terms of costs, and are restricted to small niches in the premium segments. In an effort to increase their market penetration, MNCs are trying to introduce simple, low-priced truck models. For example, Volvo currently holds 0.3 % of the Chinese heavy truck market and wants to achieve a 10 % market share by launching a low-cost truck by 2012 at the latest. Chinese incumbents price their trucks at around US$ 40,000 whereas Volvo's current prices range between US$118,000 and US$135,000. Volvo's new vehicle should be positioned at half the current price range, with differentiation from the premium models coming from less equipment, fewer horsepower and less technical refinement.

MNCs, rather than "de-engineer" international products, should develop fully localized platforms for emerging middle segments "inside out". The definition of middle-segment products in emerging markets is different from the concept in developed markets. The value proposition can be described as "good enough", compared to "value for money". By means of full localization of product design, sourcing and production, the company's offering can be simplified in order to meet local market expectations and become a cost leader. Offering localized products that address local buying criteria is key.

Table 7 shows an example of how an international MNC succeeded in capturing almost the entire Chinese market for thermal relays by making a product design according to the demands of the local market, allowing a 50 % price reduction.

Table 7 **Localization approach for thermal relays in China**



Source: Arthur D. Little analysis

Insights for the Executive

Growth forecasts for the emerging markets in general and the BRIC countries in particular continue to be dazzling. Traditionally, multinational companies (MNCs) from North America, Europe and Japan have exploited emerging-market growth by targeting their premium segments. That strategy is reaching its limits now, forcing MNCs to turn their sights from the premium to the middle segment: consumer and business products with a good basic functionality but without the full range of differentiating features, yet at a highly competitive price.

First of all, the premium segment is rather small and becoming a very crowded place. Secondly, the middle segment in emerging markets has massive growth potential, typically accounting for between 60 and 90 % of the addressable local market. Combined with the sheer size of the economies of emerging markets, this means that an MNC that aims to be a global leader cannot afford to miss out. Thirdly, if local champions in emerging markets are allowed to grow through their dominance of the middle segment there, they will use the skills and resources gained to fund international expansion into the MNCs' profitable home markets.

In order to succeed in the middle segment in emerging markets, MNCs have to beat local champions at their own game through a fight-focus-simplify strategy. "Fight" means linking their international brand power with the go-to-market approaches of the local champions. "Focus" means investing selectively in geographies (city clusters or regions) with a potential for market dominance. "Simplify" means going for fully localized products that address local buying criteria instead of "de-engineering" international products.

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