Companies are slashing prices to reach the global mass market. But it is harder than it looks.

Price Cutting at the Bottom of the Pyramid

by Victoria Griffith

A**t the end of April,** the pharmaceutical company AstraZeneca surprised the markets by announcing an 11 percent jump in revenue, compared with the first three months of the previous year. The reason for the better-than-expected performance? A 19 percent increase in sales to emerging markets.

That same month, the consumer goods company Procter & Gamble celebrated a 7 percent surge in first quarter sales, thanks to a strong performance in guess where? Emerging markets. Household products company Unilever echoed the good news, with a 4 percent rise in sales, despite a tough market. Management cited a solid demand in emerging markets as the reason.

Sensing a pattern?

Smart companies know that their success depends on reaching consumers in developing nations. The numbers are compelling. The combined gross domestic product of emerging markets now exceeds that of developed countries, up from one-third in 1990, according to the International Monetary Fund. Western markets are increasingly saturated, with little growth potential, while emerging country consumers are hungry for new products. Even sectors like the drug industry and high technology, which once focused on upscale items better suited to wealthy countries, are experiencing a strong surge in demand from poorer nations.

Pharmaceutical sales in China, for instance, will exceed those in France and Germany next year, according to the research company IMS Health Incorporated. Sales of drugs in Brazil will be greater than those in Britain. Last year, emerging markets represented 37 percent of that

Michael Austin (all)

industry's growth. Other sectors are looking at similar figures. Developing market sales accounted for the biggest sales gain of any Kraft Foods division between 2007 and 2009, at 33 percent annual growth, for example.

Yet selling to emerging markets is a huge challenge for Western multinationals, mainly because consumers in those markets will not accept the price points of consumers in the developed world. "It's not an exaggeration to say this is the most pressing management issue that will face corporations over the next two decades," said Michael Chui, a consultant on global information technology with McKinsey & Company.

Cutting prices is not just a question of printing up new price tags. The point is to cut prices without drowning in red ink. Some companies are making inroads. Unilever, for instance, has figured out that by offering shampoos, soups, detergents and other items in small sachets, poor consumers might be better able to afford its products. Procter & Gamble

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came up with lower-tech cleaners, its "Basic" line, to better suit more restrained pocketbooks.

Jeff Immelt, CEO of General Electric, and Vijay Govindarajan, professor of international business at Tuck School of Business at Dartmouth, call this phenomenon "reverse innovation" — considering the needs of poorer consumers and working backward to create a product at a price they will find appealing. Corporations do this, in part, by simplifying. G.E.'s hand-held electrocardiogram unit, for instance, designed specifically for India, has just four buttons and a tiny printer that spits out the quality of image you get on a supermarket receipt.

The focus on simplification will continue. But to achieve the revolutionary price cuts that will be necessary to shore up emerging markets, managers will need to look beyond product design and re-examine their processes. To understand how disruptive this can be, consider a few historical examples.

Early in the last century, Henry Ford turned the car industry upside down by using assembly lines to create Model T's for the masses. In the 1990's, Dell took the computer industry by storm when it used a "just-in-time" inventory approach to streamline costs and build much cheaper computers. Wal-Mart Stores created a retail revolution by leveraging supplier relationships to chop prices for shoppers. To succeed in developing countries, multinationals have to pull off these kinds of paradigm shifts. Managers are questioning the cost of everything, from research and development to distribution channels.

"It's not going to be enough to lower input costs, such as labor and raw materials," warned Peter Williamson, a professor at the Cambridge Judge School of Business and a leading thinker on the subject. "Western companies are going to have to change their processes, and that's why it's problematic for them. It upsets their whole business model."

The challenge has been made more pressing by the rise of domestic corporate powerhouses within the emerging markets. Bharti Airtel of India, for instance, has in a remarkably short time come to dominate the telecommunications business in that country. Western multinationals hoping to break in now may find it is a little late; they will confront a fierce homegrown competitor.

Some corporations in developing countries have even reached the point that they are threatening Western multinationals on their own turf. It turns out that consumers in Western nations are more price sensitive than previously thought. Hard economic times and stagnant incomes at the lower end of the scale are boosting demand for cheaper products.

Two years ago, the Indian automotive company Tata Motors introduced to the domestic market what was billed as "the world's cheapest car," the Nano, priced at $2,500. Within the next couple of years, the car is expected to be available in Europe and the United States, albeit at a somewhat higher price, perhaps $8,000, to meet local safety standards. The success of companies like Tata and Bharti has served as an alarm for Western multinationals. "Every CEO in the West is now thinking about cutting prices," said Jack W. Plunkett, CEO of Plunkett Research. "If they're not, they shouldn't be CEO."

In many cases, corporations in emerging markets may have the leg up on price. Western companies are burdened with what are often referred to as "legacy systems," a "We've always done it this way, so why change?" attitude. "CEOs want to change things," said Williamson. "The problem is getting everyone else in the company to go along with it."

Multinationals' past successes in emerging markets give them little to go on. Traditionally, they focused on aspirational goods — such as Nike shoes or Gillette razors — for the small demographic segment of emerging markets that could afford them. Now, they are going after emerging countries' mass markets. And that is quite a different ballgame.

Bob McDonald, CEO of Procter & Gamble, sees the global mass market as the company's future. He wants to reach one billion more consumers in poorer nations over the next decade. Last year, he changed the company's longstanding slogan to reflect the new thinking. Instead of "Touching and Improving Lives," the corporate motto is now "Touching and Improving More Consumers' Lives in More Parts of the World." The company currently sells its products to about 60 percent of the Chinese population; it wants to reach 100 percent.

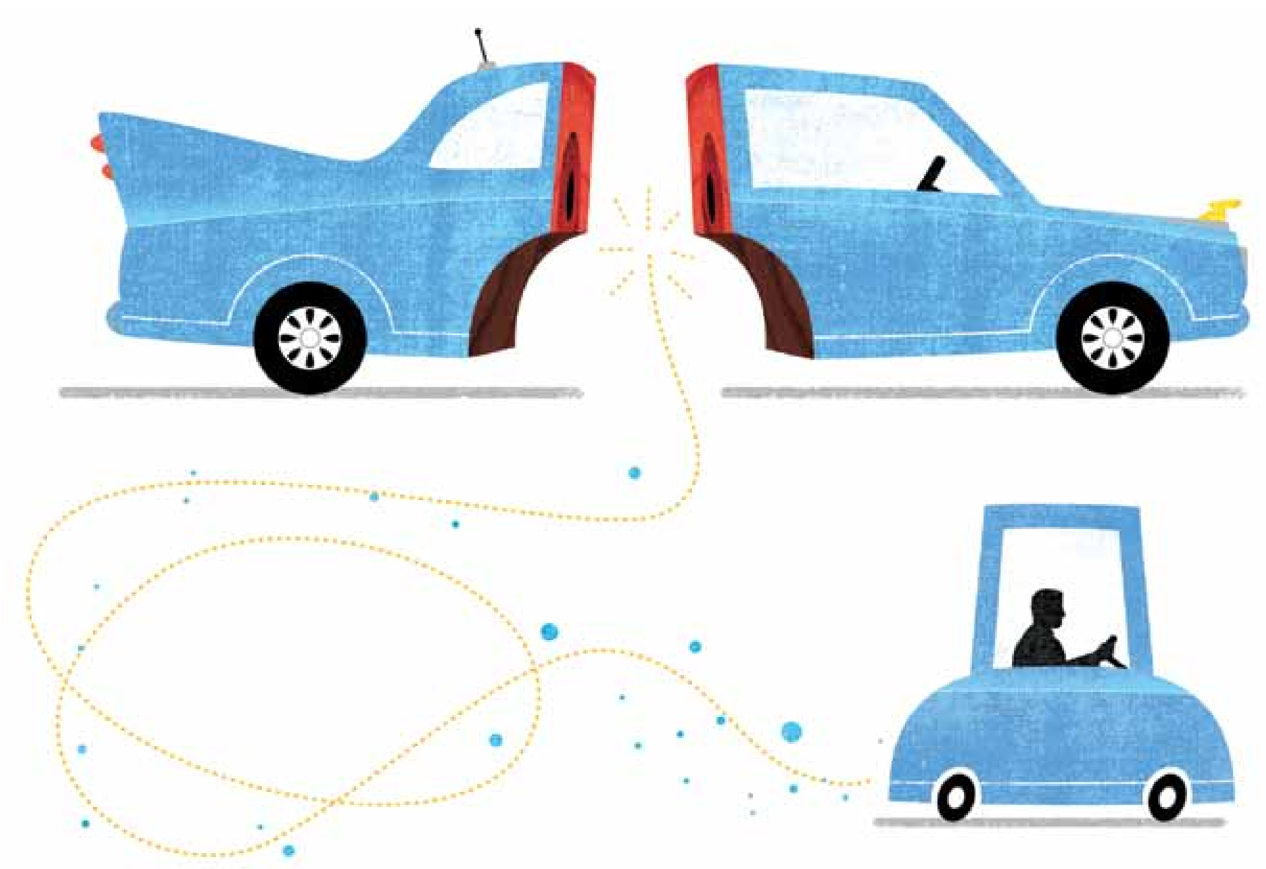
Other corporations have similar aspirations, and the shifting goals are reverberating around boardrooms all over the world. It is a radical departure; most Western companies are simply not used to the type of customers they are now pursuing. Most of the world's population still lives well below the level most Westerners would consider middle class. The average per capita income in the United States is just over $46,000, according to the International Monetary Fund; in China, it is less than $4,000, and in India, about $1,000. Two-thirds of India's population of 1.5 billion lives in remote, rural village areas.

The race for the bottom of the consumer market is turning traditional management thinking on its head. Multinationals, for instance, have traditionally striven not for cheaper products, but for better products. Gillette's two-bladed razor morphed into the three-bladed razor, which eventually became the Mach3.

The high-technology sector has historically introduced new products to early adopters at a high price, and then gradually moved the product down the consumer chain. This formula does not work for the world's mass markets. "By the time the product is cheap enough to reach consumers in the villages of India, it may be obsolete," said Williamson. "Emerging market buyers want cheap products, but not outdated ones." Chui agreed, adding that products developed for Western consumers may not have the durability, reliability and portability necessary for them to compete in the emerging world. What is needed are new cheap products, not old cheap products.

Western corporations may also have a bias toward product over process innovation. John Seely Brown, former chief scientist for Xerox Corporation, calls this a fascination with "big bang" innovation. The tendency for multinationals to focus on the next big idea — from supercomputers and blockbuster pharmaceuticals to alternative energy and nanotechnology — will ultimately prove harmful, he argues. Instead, corporations should focus on improvements in process, and on smaller, incremental breakthroughs.

Corporations need to make the distinction between the world's poor and the world's very poor, said Martin Fisher, co-founder and CEO of KickStart, a nonprofit that sells $100 water pumps to farmers in Africa. The economic situation of very poor consumers is distinct from that of the less poor. They have uneven cash flow. During harvest time, for instance, very poor farmers get a lot of money in at once; when it comes time to pay school fees for their children, they have a large outflow of funds. Trying to sell them something when they have no cash is probably pointless. Marketing products that



can save them time will probably also be fruitless, because time is something many of the world's poorest have in abundance, said Fisher.

Even in the most poverty-stricken corners of the world, however, people do buy things. And because what they buy is often relatively expensive and of low quality, there is an opportunity to make inroads. "They buy salt, cooking oil, cosmetics and other goods," Fisher explained. "If you can access those markets, you can make money." Chui believes it is a mistake to treat all emerging markets as one but that even the poorest consumers cannot be ignored. "I was speaking with someone in the Sudan the other day, and he told me even people without an address, without a home, have cell phones," he observed.

Despite the challenges, some companies, based both in emerging markets and developed nations, are breaking new ground in the race to produce inexpensive goods appealing to poor people. Their ability to reach poor consumers effectively is intensifying competition. It is also providing a road map to those savvy enough to pay attention.

Following are some of the ways these companies are succeeding in this endeavor.

Simplify, Simplify

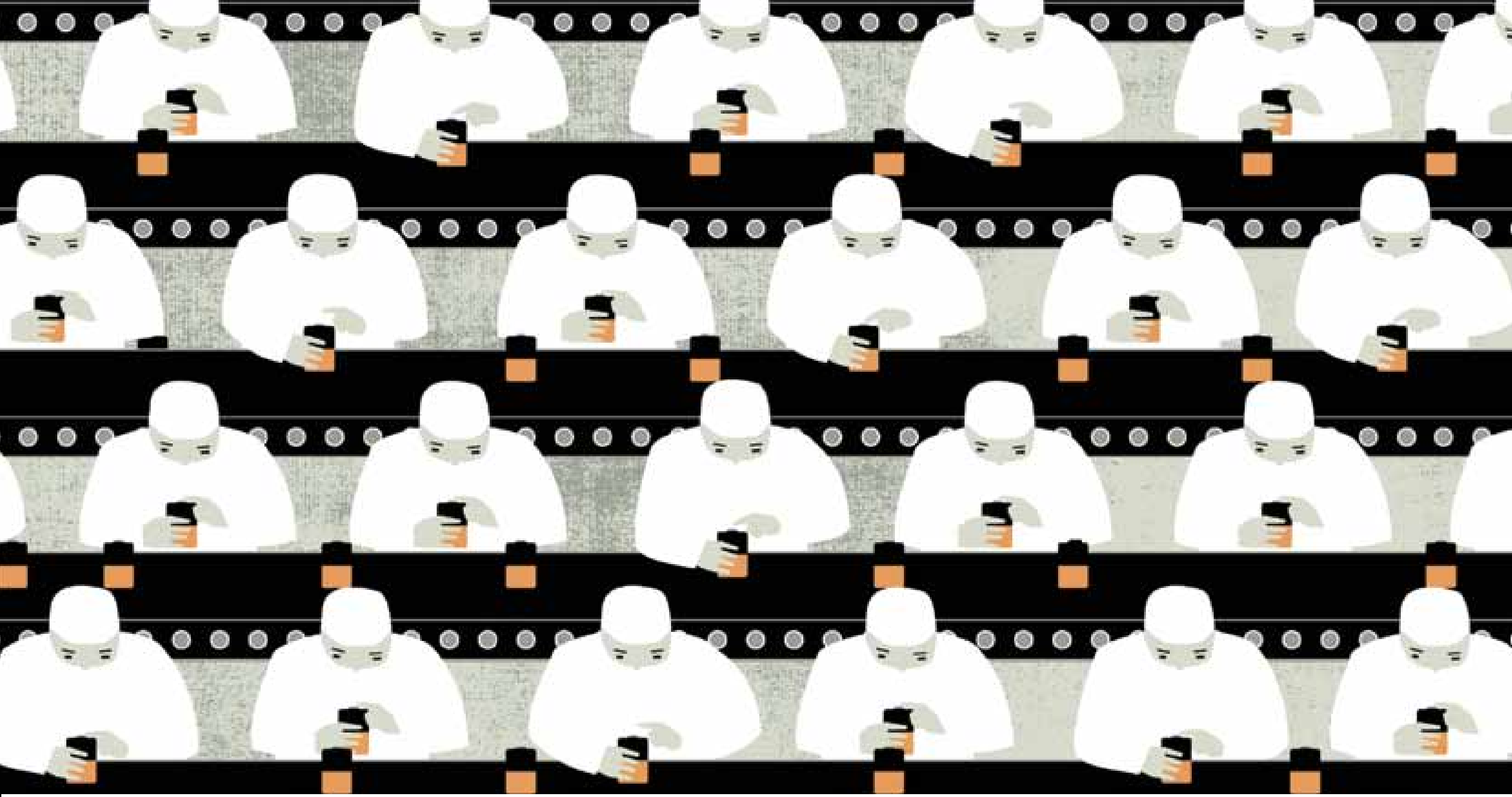
Earlier in the decade, teams of Procter & Gamble researchers spent time with — in some cases actually lived with — average Brazilians to figure out why they were not using the company's products. The main finding, unsurprisingly, was that Procter & Gamble's goods were just too expensive. But the researchers also made another observation: cleaners that homeowners in the West might turn up their noses at would go a long way toward improving the domestic lives of most Brazilians.

For instance, most people could not afford "new and improved" Tide, with all its cutting-edge cleaning abilities. Yet the alternative was to spend hours pre-scrubbing dirty clothes. Armed with this knowledge, Procter & Gamble introduced a new line of simplified products, including a detergent that still eliminated the need for pre-scrubbing. As a result, Procter & Gamble quickly grabbed a bigger market share.

Procter & Gamble calls this strategy "simplification," and it has become commonplace across a broad range of sectors. In April of this year, for instance, Vodafone worked with the Norwegian browser maker Opera Software to come up with a browser equipped to run on the low-end voice handsets commonly used in emerging markets. General Electric is now selling a hand-held electrocardiogram that sells for a fraction of the larger model's price. A variety of companies, including Unilever, are also offering products in more affordable packages, e.g., cell phones that calculate usage by the minute rather than the hour and small sachets of soaps and cleansers.

Designing a product specifically for a developing market is not a new concept. Corporations have been thinking "glocally" for years; Colgate-Palmolive sells tea-flavored toothpaste in China, for instance, and McDonald's offers lamb burgers in India. What is different now is the focus on price. Lamb burgers and tea-flavored toothpaste may not have widespread appeal; cheaper electronics do.

While the concept of reverse innovation has received a lot of attention, Williamson believes even greater — and largely untapped — potential lies in "horizontal innovation."



One thing all developing nations have in common is the need for cheaper goods. A well-priced product that does well in one emerging market is likely to do well in another.

Bargain Research and Development

Research and development can account for a large chunk of the cost of a new product. Cutting down on such expenditures has therefore become vital to achieve innovation on the cheap. A few companies, such as the pharmaceutical giant GlaxoSmithKline of Britain, are trying to reduce their overall amount of research and development so that they can pass the savings on to consumers in the developing world.

"In the drug industry, we'll probably see companies bringing in products from smaller biotechnology groups, in licensing kinds of deals, rather than try to do it all in house, which is very expensive," said Vishal Manchanda, senior equity analyst at the pharmaceutical research company Mehta Partners.

Corporations can also slice budgets by moving research operations to emerging markets. More pharmaceutical companies, for example, are looking into conducting clinical trials — drug testing in humans — outside of the developed world. The new Bangalore facility of the computer company Cisco Systems is expected to take on half of the company's research and development functions over the next few years. "There are a lot of talented people in emerging markets, and the talent there is generally cheaper," said Chui.

Low-Cost Manufacturing

In the mid-1990's, most battery manufacturers would have laughed at the notion that a Chinese operation could become an industry competitor. Battery manufacturing was considered a capital-intensive process, involving, among other things, $100,000 robotic arms. Emerging markets have cheap labor, but they have traditionally been short on funding for capital investments.

Wang Chuanfu, a Chinese entrepreneur who founded the BYD Company in 1995, questioned this notion. For the cost of a few robotic arms, Chuanfu reasoned he could afford to hire thousands of employees. Westerners countered that these workers would be too low-skilled to replicate the work of robots. Adapting for his employees' low skill set, Chuanfu divided the battery manufacturing process into more than 100 small steps. The steps are so specific that in the charge and discharge phase, for instance, a single group of workers loosens tape on the batteries before sending them to another group of workers, which removes the tape entirely. Chuanfu also instituted strict quality controls and tests at each step to ensure that the final product would be up to par.

By 2002, the BYD Company had become the second-largest rechargeable battery maker in the world. Two years ago, Warren E. Buffett took a large stake in the company, which is now moving into the manufacture of electric cars. Manufacturing breakthroughs remain BYD's focus. Just one-third of the company's research and development budget is allocated to product innovation; the other two-thirds are used to come up with ways to cut costs on the manufacturing line.

Outsourcing on Steroids

When Bharti, the Indian telecom company, opted to outsource its information technology functions to I.B.M. in

2004, it was not considered a radical move. Companies have been outsourcing functions, after all, for decades. But Bharti broke new ground by taking the concept of outsourcing to extremes. Early on, the company decided it would keep only sales and marketing in-house. Bharti splits network operations between Nokia and Ericsson, and it recently handed the management of its landlines and broadband access to Alcatel-Lucent. This strategy has permitted the company to build a massive operation quickly with minimal investment. Bharti now has 131 million customers served by just 30,000 employees.

Outsourcing "allows us to focus on our business processes, on our organizational construct and how it is we really bring to bear what it takes to deliver services to our customer," said Jai Menon, director of information technology for Bharti. The company is now accepting bids to outsource management of its fiber-optic cables, which transmit voice and data between cities.

New Distribution Channels

In the 1990s, the cosmetics company Avon Products was in a funk. Nobody seemed to want the company's products anymore, and its marketing and distribution strategy — remember the "Avon calling" commercials — seemed out-of-date. The company considered scrapping its "Avon girls" sales force, ordinary people who worked strictly on commission, and moving into department store sales.

Instead, the company banked on the developing market, with resounding success. In Brazil, for instance, women with little access to the traditional job market warmed instantly to the Avon girl model. This intrepid, low-cost sales force is able to penetrate areas traditional sales representatives would shun. Avon representatives sell their products everywhere, from the highest-crime, urban areas in the country to remote areas of the rain forest. Last year, Avon revenue in Brazil hit $1.67 billion, exceeding sales in the United States.

Nokia has hit on a similar strategy in emerging markets. To more efficiently obtain access to emerging markets, the Finnish company markets its handsets through more than 300 distribution centers. The company has become adept at reaching isolated consumers. In India, for instance, representatives bump along rutted country roads in easy-to-recognize blue vans, stopping in rural villages to explain to potential customers how to use the product. The strategy has helped Nokia grab a 37 percent market share of mobile phone sales worldwide.

Marketing on the Cheap

Advertising and marketing are perhaps the most difficult areas in which to innovate to reduce costs in developing countries. Consumers in these markets do not have the same level of brand loyalty as their Western counterparts. One study, for instance, by Kenneth G. Lieberthal, a senior fellow at Brookings, and C.K. Prahalad, a professor at the University of Michigan until his death earlier this year, noted that the average Indian consumer samples more than three times the number of new brands as the average consumer in the United States.

To be effective, marketing must be highly differentiated. Television commercials, for instance, are probably a good bet in Brazil, where most people at least have access to a television. But they are likely to fall flat in rural Africa, where people's main source of information and entertainment is likely to be a radio. Multinationals are experimenting. For instance, Pfizer has formed alliances with physicians in Venezuela to get them to prescribe its medications.

Fisher of KickStart believes some of the techniques used in the 1950s in the United States are relevant to developing markets now — think Tupperware parties and product demonstrations at the local store. To sell its irrigation pumps, for instance, KickStart sponsors competitions at local fairs, handing out a free pump to the person who gets the most correct answers in a game show-like format.

And persistence pays off. The Coca-Cola Company, for instance, lost money for years in Africa. But its operation there has finally turned profitable. And it is predicted that its sales in the region will rise 10 percent annually over the next few years, a nice reward for a long-term investment.

Overhauling Organizational Structure

Corporations are searching for low-cost ways to gain a foothold in emerging markets. Joint ventures and partnerships, in particular, have become popular, and it seems a new one is announced every day in the financial press.

But the expertise residing within the individual collaborators may not be as easily leveraged as managers hope. Williamson of the University of Cambridge believes the winning formula, instead, will be wholly owned subsidiaries that can take on some of the management tasks traditionally performed in the West. A few companies are making this radical shift. Koninklijke Philips Electronics' television business, for example, is effectively run out of China now. Cisco is transferring much of its research and development — and some of its top executives — to its new base in Bangalore, India.

This kind of power shift will not be easy to pull off though. "In many cases, it makes sense to let emerging markets subsidiaries run entire divisions," said Williamson. "But this is hard for Western managers to accept. The instinct is to want to run everything from headquarters."

Chui thinks there is room for partnerships and joint ventures as well as subsidiaries. But he says the size of a company's commitment matters. "The bigger the investment, the more the corporation is likely to learn," he observed.

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