Tomorrow's Global Giants

Not the Usual Suspects

by Pankaj Ghemawat and Thomas Hout

Changes in demand, market power, and business models are starting to produce surprising winners in big emerging markets.

WESTERN COMPANIES' INTEREST in emerging markets, especially China and India, is reaching a new level of intensity. Usual suspects such as IBM and Unilever, of course, are aggressively expanding their presence there, but so are nippy newcomers like Orbea, a $100 million Spanish manufacturer of ultralight carbon fiber bikes. At the same time, developing countries are pulsating with companies that think of themselves as the next multinationals, pushing outward from their home bases to establish global presence if not dominance.

What will happen when these two wave trains collide head-on? Which kind of multinational – established or emerging – is eventually going to prevail globally? It depends: So far the evidence strongly suggests that industry characteristics will sort the winners from the losers. At least in China, established MNCs continue to dominate knowledge- and brand-intensive businesses, whereas Chinese companies hold an advantage in industries where production and logistics matter most, and are successfully moving outside the home market.

But is industry always destiny? Can a company break the pattern? It can if it rides rapid customer growth in a large

Guy Billout

market, manages cost convergences, or carves out new space by reworking the industry's value chain.

Our purpose here is to explore ways to take advantage of such opportunities. We describe how some established multinationals in production- and logistics-oriented businesses have started to beat local players at their own game and how some emerging-market challengers are outperforming their supposedly more sophisticated competitors in knowledge- and brand-intensive industries. From their experiences we have drawn strategic and management lessons that will enable you to make the right decisions for your company – whether as the CEO of an emerging multinational struggling to compete in a field dominated by giants or as the leader of an established multinational faced with apparently insurmountable disadvantages in costs and local knowledge.

IDEA IN BRIEF

» In emerging markets, Western multinational corporations typically dominate R&D- or brand-intensive industries, whereas local players usually win in businesses where logistics or production savvy is key. But smart companies can break that pattern.

» There are a number of ways to overcome industry disadvantages. For instance, established MNCs can compete on costs or develop unconventional partnerships, and aspiring MNCs can parlay core strengths when making overseas acquisitions or use local knowledge to create targeted offerings at home.

» Both types of competitors face organizational challenges. Established MNCs need to be more responsive to local customers without losing the advantages of global know-how. Aspiring MNCs must compensate for their relative inexperience in cross-border coordination by tapping the expertise of giants – which can mean collaborating with them or even hiring away key personnel.

Exploiting Segment Evolution

In emerging markets, established multinationals typically take the early lead in the high-end consumer and high-performance industrial segments, and local companies do so in the low-end and low-performance segments. But as the economy develops, both customers and competitors evolve. Some customers want more (or fewer) features, services, bundles, and price options, and the number of segments up and down the market grows. The MNC or local competitor that can quickly follow – or better, anticipate – this segment evolution will be well positioned to invade others' territory.

Being close to the market can make up for product-related weaknesses, especially if local customers have unique consumption habits. Google and eBay were early leaders in search and auction in China but have been overtaken by local sites Baidu and Taobao, even though Google has more global content than Baidu and eBay screens counterfeit products better than Taobao; Amazon similarly trails Dangdang in e-commerce. China's governmental interference with some of the U.S.-based websites plays a role in this reversal, but local competitors have also reacted more quickly to changes in Chinese internet behavior and have more successfully navigated the practical problems of delivering services in an emerging market. Baidu noticed Chinese users' comfort with a busier screen and a free, advertising-driven model. It marketed itself cleverly by placing its logos on ATMs throughout China and was the first search engine there to self-censor its servers, winning goodwill with the government. Dangdang adapted to China's poor credit-card payment infrastructure by developing the best cash-settlement system. Today, U.S.-based sites are now in the unusual position of fighting to regain a leading position.

Knowledge of customers also helps you spot opportunities to bundle ancillary services and products in which you do have an advantage. Perhaps the most striking example is provided by Suzlon Energy, Asia's largest and the world's fifth-largest wind turbine maker. Founded in 1995 in India, Suzlon now competes internationally in a capital intensive, technologically sophisticated industry. Demand for wind energy is growing rapidly in India, putting power generators under pressure to provide it fast. Suzlon leverages its local knowledge and networks to offer an end-to-end, turnkey approach to selling: It helps to acquire permits for wind farm land, to deliver and maintain the farms, and to sell the power generated. Profits from these parts of the business can be higher than from the turbines themselves. Despite Suzlon's current product problems, its bundling strategy remains a huge plus.

But market evolution does not always favor the local company. Established MNCs can apply pressure by aggressively moving into new, fast-growing segments. Otis Elevator, the industry leader globally, has dominated China's elevator business from the start of the high-rise boom. Elevators are a mid-tech industry in which local contacts and ubiquitous service presence usually win the contract. Such an environment should have favored Chinese companies, but Otis arrived early and beat the locals in building out a service network.

Procter & Gamble, Nokia, and several Western banks are also extending distribution deep into China's countryside. P&G is the country's largest advertiser; has used lower-cost local practices and materials; and regards itself, much like Toyota in the United States, as a local player that can follow growth nearly anywhere. P&G China now offers products designed for different local market segments – in laundry detergents, for example, an advanced-country formulation for the premium tier; a modified product for the second (economy) tier, which won't pay for water softeners and perfumes; and a very basic product created from scratch for the third (rural)

tier, where it has set its sights on the traditional segment leader, Diao Pai.

P&G China has been so successful because it can do things Chinese competitors can't yet do. It has the ability, for example, to send local product developers to global R&D facilities to work with experienced technical specialists on creating better segment-specific products for China. Consequently, P&G, which is already the overall (all segments combined) leader in China in nearly all of the 16 product categories it competes in, will most likely continue to increase its presence in the country's lower-tier segments, where local companies have always held an advantage.

Established multinationals can also use technology and capital to accelerate segments' growth. The labor-intensive television set business offers an example. Over the decades, it followed a classic pattern of competitive advantage moving from high-cost to low-cost countries. In recent years, flat-screen technology gave established multinationals a new high-price, high-performance product segment as Chinese producers swarmed the market for cost-driven conventional TV sets. The likely scenario was that the Chinese would control conventional TVs and the Koreans and the Japanese would dominate flat screens until the pace of technology advances leveled off, at which point the Chinese would dominate both. But Samsung, Sharp, and others surprised Chinese producers with vicious flat-screen price competition, which collapsed the demand for conventional TV sets much faster than anticipated, bottoming out Chinese profits and accelerating the growth of the flat-screen segment.

MNCs trying to adapt and innovate in a big emerging market have to display tactical imagination to compensate for the local relationships native companies naturally enjoy. As a result, a number of established companies have embarked on rather unexpected partnerships. Ogilvy China broadened its understanding of consumer needs by working with the Communist Youth League of China, an organization of 70 million people. The Indiana-based diesel engine maker Cummins faced a shortage of well-trained engineers in India, so it teamed up with Maharshi Karve Stree Shikshan Samstha – a 112-year-old women's educational institution in Pune – to create a new women's engineering college.

It would be nice if there were a formula for exploiting segment evolution across the globe, a way of "rolling out" to other markets lessons learned in earlier wins. However, every upset of a multinational or a local company in its customary domain is fairly distinct. A competitor can build cross-border networks, share learning, transfer experienced people, and incentivize new departures, but in fact the tactics used by Baidu,

IDEA IN PRACTICE

MULTINATIONAL COMPANIES FROM developed and emerging economies alike can gain a competitive advantage by moving outside their industry comfort zones.

» When new segments emerge…
Established MNCs should project where growth will be and go there, leverage their global capabilities, and use price and brand to accelerate the shift of demand.

EXAMPLE By slashing prices on flat-screen TVs, Samsung, Sharp, and others accelerated the segment's growth and undercut demand for conventional TVs, leaving Chinese producers high and dry.

Emerging-market MNCs should exploit local knowledge, ride home-product strengths into niche segments overseas, and avoid entering high-cost games they can't win.

EXAMPLE E-commerce site Dangdang edged out Amazon in China by recognizing the country's poor credit-card payment infrastructure and developing the best cash-settlement system.

» When cost structures can converge…
Established MNCs should mirror the best local players' cost structures as closely as possible, hire local talent, and internationalize senior manager positions.

EXAMPLE IBM and Accenture are ramping up operations in India and absconding with much of the local talent by paying more for it – simultaneously lowering their own costs and raising those of Indian rivals.

Emerging-market MNCs should anticipate losing their cost advantage over time, build capabilities to compete at the next level up, and use core operating strengths to acquire and turn around distressed businesses overseas.

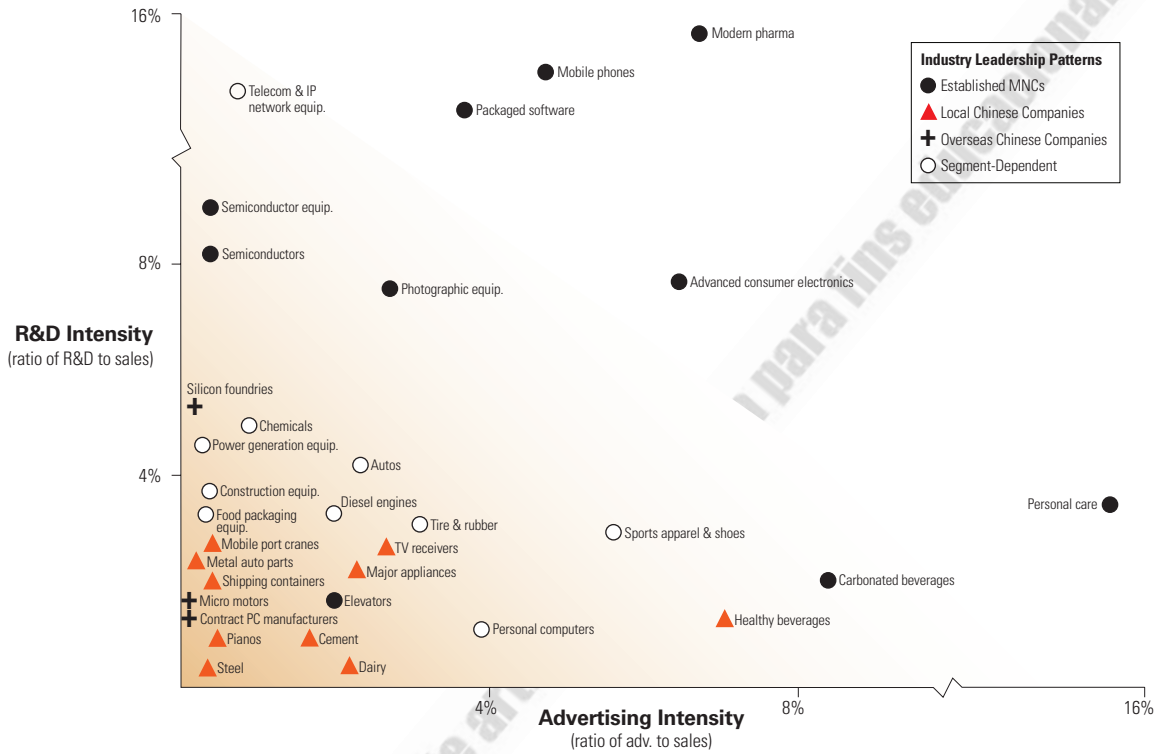
EXAMPLE Chinese auto parts company Wanxiang has used the materials, design, and factory management know-how it gained in China to acquire and revive a number of U.S. producers.

» When the value chain can be rearranged…
All MNCs should place parts of the value chain in their most advantageous locations, partner with specialists, and make new start-ups as multinational as possible in their operations and management.

EXAMPLE Bharti Airtel has built up the largest mobile-services operation in India by specializing in a small part of the value chain – customer care and the regulatory interface – and outsourcing most everything else.

Industry Still Matters: China's Industry Landscape

Although it's possible to buck your industry, never underestimate its power. So far, industry characteristics have been very accurate predictors of whether dominant global players are established- or emerging-market multinationals, as the data from China indicate. Established MNCs lead in businesses with a relatively high percentage of revenues going to R&D and advertising, and Chinese companies lead in those with lower percentages.



● **ESTABLISHED MNCs** lead in industries that are brand intensive and in those with rapidly changing technology and customer demands. That's because these industries reward new technology and product development, depth of knowledge about customers and different applications, brand management, and the ability to manage across borders – the strong suits of MNCs from developed countries. Apple and Sony, for instance, are at the top in advanced consumer electronics; Procter & Gamble and L'Oréal in personal care products; Johnson & Johnson and AstraZeneca in modern pharmaceuticals.

▲+ **CHINESE-OWNED COMPANIES** typically win in industries where a relatively high proportion of cost structure and capital goes to production and logistics and where product functionality, design, and customer needs change less frequently. These industries reward low costs in labor and materials and the ability to manage large-scale production facilities as well as local political-power structures – areas where the Chinese companies are strongest. For example, Haier and Rongsheng are leaders in home appliances; Baoshan and Hualing in commodity steel; Mengniu and Yili in dairy products.

○ **WINNERS IN SEGMENTED BUSINESSES** (with no overall leaders) depend largely on industry segment traits. Volkswagen, General Motors, Honda, and Toyota lead in higher-end, fully featured autos, whereas China's Chery and Geely lead the lower end. And despite Huawei's rising strength as a challenger in high-performance telecom and IP network equipment, Ericsson, Alcatel-Lucent, and Cisco head up most cutting-edge segments, whereas Chinese companies control the more mature product areas.

Sources: DTI's 2006 R&D Scoreboard, UK; Schonfeld & Associates Ad/Sales report; 10-Ks; China literature search; authors' analysis

P&G, Otis, and others were location specific and grew from the management teams' particular combinations of imagination and aggression.

Managing Convergences in Costs

Cost advantage no longer automatically stays with the emerging-market challenger – and this change is accelerating a race up the value ladder. For example, early Indian and Chinese successes overseas, by companies such as India's Bharat Forge in auto forgings and China's Haier in compact home appliances, have usually come in industries where low-cost niche products differentiate a brand. But established multinationals and other factors are eroding that cost advantage, which in turn is pushing emerging players to respond with higher-value offerings and better customer service and to move their production bases to other low-cost emerging markets.

The software-services industry provides a good example of this competitive dynamic. The Indian company Tata Consultancy Services (TCS) has always had a pretty clear profit formula: inexpensive, English-speaking software engineers; discipline in software coding and maintenance; and minimal capital investment. In addition, TCS has low defect rates and delivers services on budget. But its engineers' compensation has gone up 15% a year over the past three years, other Asian companies are trying to steal its customers, and it needs to understand its overseas customers better. Further, IBM and Accenture are aggressively building up their Indian operations, hiring tens of thousands of sought-after Indians by paying more, thereby lowering their own costs while raising those of TCS.

TCS and the other Indian leaders are responding by investing in U.S. and European operations to get closer to and defend their positions with their customers around the world. They are also acquiring new low-cost capacity in locations outside India, such as Latin America, and they have greatly expanded their education and training pipelines in India.

The speed of this process varies by industry. In software services and auto parts, the Indians' move to higher-value offerings has been fast; in pharmaceuticals, where technical and regulatory demands are severe and labor cost advantages are smaller, it has been far slower. Huge hurdles sometimes appear, especially in high-differentiation industries. Ren Zhengfei, the CEO of Huawei, China's leading telecom equipment producer and exporter, observed several years ago that his company's R&D productivity was only one-sixth of IBM's (the benchmark's), so he pushed Huawei's R&D up to 10% of sales, a level at that time unheard of in China. Another Chinese high-tech player, Lenovo, saw this hurdle and, deciding that the R&D route was too risky, bought IBM's personal computer business.

But as Chinese and Indian companies evolve in this way, they necessarily dilute their initial cost advantages. At the same time, India's and China's openness to foreign investment allows incumbent multinationals to lower their own cost bases. So as locals move up the ladder, established MNCs can move down it. Accenture and IBM aren't the only ones investing heavily in Indian operations. Nokia, Samsung, P&G, Siemens, and others are localizing cost structures, moving management decision making to China and India, and bringing more operations to those countries.

Consider the cell-phone business. In 2004, Ningbo Bird looked ready to displace Motorola and Nokia, the early leaders in China. Ningbo Bird had a low cost base, a broader distribution network, and, most of all, designs that were hot among China's young smart set. Nokia, for which China is easily now the largest single market, reacted aggressively across the board. It developed new, far more appealing cell phones for the Chinese market and, in order to sell them, radically expanded its sales and distribution network and developed proprietary IT platforms to help guide field sales and marketing. And it expanded its Chinese production facilities, neutralizing any cost disadvantage against local competitors. After two years, Nokia was on top again and Ningbo Bird had fallen back.

The limits to a cost-arbitrage advantage are even clearer when an emerging-market multinational tries to enter developed markets, as the U.S. experiences of Haier illustrate. The company tried to follow up its success in compact refrigerators with entry into midsize refrigerators. However, these were too bulky to ship efficiently – the ocean freight costs wiped out China's cost advantage over U.S. producers – so Haier built a factory in South Carolina to serve the U.S. market. It shipped into its U.S. factory components from low-cost, high-quality sources all over the world, such as compressors from Brazil and electrical parts from China. The problem was that U.S. producers could do the same thing – buy the best-value components from all over the world and ship them to the United States

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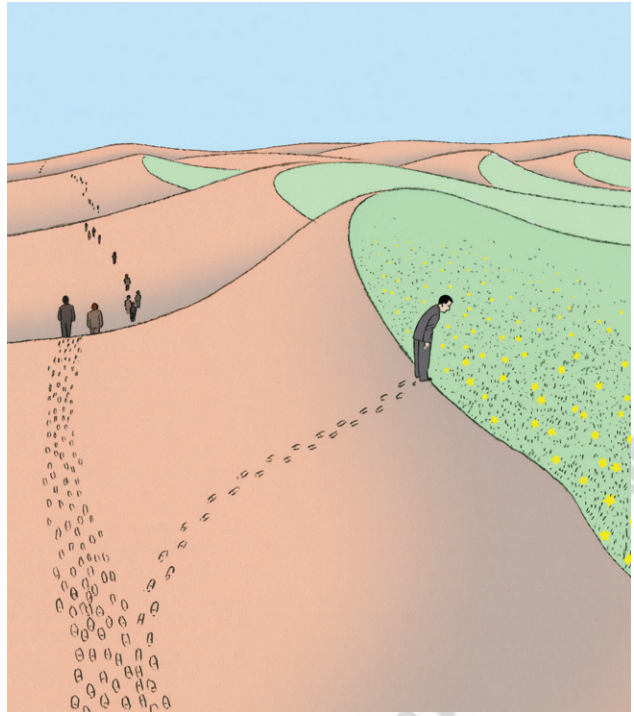
or Mexico for assembly. So Haier gained no cost advantage in the United States or Europe for any product made there, which is why its U.S. market share in midsize refrigerators is only 3%.

If Chinese and Indian companies are to compete with established MNCs globally, they have to learn how to aggregate their knowledge about designing, innovating, and managing across borders. Even the most profitable emerging multinationals to date have not worked this out, and indeed, Chinese companies are especially challenged here because of a lack of experienced international executives. That said, there are lesser-known, focused-product companies – such as CIMC in marine shipping containers, Wanxiang in auto parts, and Pearl River Piano – that followed up success in exporting from China by acquiring and reviving foreign companies, using materials, design, and factory management know-how gained in China. Wanxiang has rolled up a number of small troubled Midwestern auto parts producers in the United States and rationalized production among them. It now has equity positions in more than 30 companies worldwide. CIMC turned around a maker of truck trailers in Indiana. Pearl River purchased a faded, up-market German piano brand and retooled it. These are unglamorous, small steps up the ladder, taken by leveraging management and operating strengths. The strategy of going abroad and seeking turnaround opportunities differentiated these companies more than their Chinese industries allowed.



Reworking the Value Chain

A growing number of emerging players are building global leadership positions in their industries by creating focused, vertical businesses. They are spotting opportunities to pull apart and reconfigure existing value chains in order to deploy capital more efficiently. Rather than dominate a well-defined industry, they concentrate their efforts on the gaps and pockets, around the edges, and across the boundaries, often collaborating with instead of competing against established multinationals. The differentiation and profit potential of these businesses varies – but again, many do offer potential for significant value that savvy companies can parlay into global leadership.

Some companies simply specialize in a limited part of the value chain and outsource the rest. That is how Bharti Airtel has built up the largest mobile-services operation in India – and the fastest-growing one in the world, in terms of subscribers – despite initially trailing better-funded competitors. Its recipe: radical outsourcing of IT services to IBM and of the development and management of its telecom network to Ericsson, Nokia, and Siemens. These changes freed up Bharti's capital, made its cost structure much more variable, and allowed the company to target pricing levels of 1.5 to 2 cents per minute, versus levels as high as 20 cents per minute in advanced markets, all of which fueled rapid market growth and penetration. Bharti has used the capabilities it concentrates on – customer care and the regulatory interface – to enter businesses such as retailing, where it is Wal-Mart's local partner.

There are manufacturing examples as well. China-based producers assemble most of the world's laptop and desktop computers, and nearly all of that work is done by Taiwanese-owned and -managed factories – for instance, Hon Hai, Quanta, and Asustek. These engineering and manufacturing specialists are contracted by Dell, Hewlett-Packard, and other multinationals. Their business model is to do assembly and test work in China; build huge scale (Hon Hai is the biggest of these specialists, with global revenues of $51 billion and net earnings of $2.3 billion, and a Shenzhen campus that employs 270,000 people); and stick to a narrow value-add focus, adding less than 5% of the product's total cost. These specialists also manufacture cell phones and other electronic consumer goods.

Specialization is a powerful tool. It confers a competitive advantage over local companies. For example, the transplantation of Taiwanese contract producers into China has made it more difficult for local Chinese companies to scale up and progress technically. The rise of specialists has also helped level the playing field for established multinationals competing against emerging ones. The incumbents can focus their differentiation efforts on their businesses' front end (marketing, design) and on their underlying platforms (systems, customer-connected processes) – areas where they already hold advantages. The back-door risk for established MNCs is that specialists eventually broaden their business and become

effective competitors of their customers. Acer in the PC business, for instance, started as a contract manufacturer and is now a major global brand.

Some companies have differentiated by piecing together and managing value chains across developed-world companies from all sorts of industries seeking to enter big emerging markets. Li & Fung, the world's largest contract supply-chain-management firm, manages front-end design, marketing, sales, and corporate governance in Hong Kong and production in China. Li & Fung can, for example, source product anywhere in the world for Western retailers that simply provide the brand, or it can go further and manage the brand for the client, as it does for Levi Strauss in Asia.

Management Challenges

Established MNCs and emerging local players bring different management strengths and vulnerabilities to their markets. Established MNCs work hard at coordinating actions and relieving tensions between the center and country organizations. They try out new management structures and ways of being more responsive to local customers without losing the advantages of global know-how. Their biggest short-term vulnerabilities are slower movement and higher costs – both company overhead and local operating costs – than local players have. Longer term, they face an even more dangerous set of trajectories: A survey by the Boston Consulting Group (conducted before the recent slowdown in the West) found that emerging markets accounted for 35% of the established MNCs' anticipated growth over the next five years but for only 15% of their employees and 7.5% of their top 200 managers. As if this arithmetic weren't bad enough, rapid turnover adds to the problems, as do the difficulties of freeing up senior managers from other parts of the organization to work in economies that in the foreseeable future are likely to become as important as the home market.

What management structures and mechanisms will help MNCs best navigate the converging competitive world we have been describing? P&G in particular has worked effectively on the problem of decision-making conflicts between global product groups and local (country/region) marketing and sales organizations. Its approach can be summed up as follows:

- Decision makers are clearly identified for most types of situations.
- All lines of the organization receive the same information on all aspects of the business.
- Senior people are colocated; each product group has an office in each region.
- Explicit tie-breaking rules, usually giving the global product unit the final say, prevent protracted impasses.
- In order to get promoted, an executive must have worked for both a product group and a geographical organization.

Strategic alliances are an important factor in any company's global growth. When deciding whom to partner with and how, smart companies focus on creating value of several kinds, not just profits. Cummins, a strong player in both China and India, enters into 50/50 joint ventures with respected local manufacturers or large customers – factories that become product sources across Cummins's global sales network in 190 countries. Cummins is less interested in full management control than in finding good partners with the same values and long-term goals. Its objectives in joint venturing include a strong baseline engine demand from the partner; a company that can help implement Cummins's advanced technologies; a source of good management personnel; and strong local standing, including a network of proven suppliers.

Newer developed-world companies that do not have to contend with an organizational legacy are finding it easier to create and manage global value chains. One example is WiChorus, based in San Jose, California, and Hyderabad, India. The company wants to bring broadband access to the Indian countryside, which lacks landline telephone cables, by building simplified WiMax-based systems of transmitters and base stations for cell phones. It does its bleeding-edge upstream development work and sourcing of high-tech components in the United States, where the best engineers, suppliers, and intellectual property protection are; it carries out the downstream, more routine network engineering, sales, and customer support functions in India. Starting out as a binational corporation has spared WiChorus the logistical and cultural strains older multinationals can have in moving activities from old to new locations.

Of course, there is no magic solution to the problem of managing global enterprises. There will always be coordination issues and conflicts among product, global customer, and regional lines of the organization. And the more people you insert into the system to lubricate it, like the colocated product group people in the regions, the more coordination and communication issues you introduce. But the best MNCs continue to learn, like P&G has, that if they want to succeed beyond their usual segment strengths and if they want to defend against challengers climbing the value ladder, they need tighter-knit, faster-responding global management mechanisms and decision-making capabilities.

Newer multinationals from emerging markets tend to have a reverse profile. They have lower costs and are more fully adapted to the emerging market, and the products around which they build an early global presence are the same ones that won them local leadership. Their management structures are simpler, in part because the founder is usually still active and a powerful force in decision making. This is true of almost all new multinationals in China and India. Another key strength of many of these companies – TCS, Hon Hai, Pearl River Piano, and others – is their ability to manage very large workforces in one location, something most Western companies gave up on decades ago. They excel at organizing

workers into cells and designing standard work flows and feedback. Their overhead costs are low.

Their biggest vulnerability, compared with incumbent MNCs, is inexperience in coordination and conflict management across borders and a lack of depth in global customer and channel knowledge. A company making a narrow product line in China and exporting to a few big customers in the United States doesn't need to change its management structure much. But when it sets its sights higher – more products, more services, stronger global brand identity – it needs more cross-border coordination mechanisms and more learning ports in its organization. Chinese companies find this challenging because of the paucity of role models among older managers and the high turnover of managers in the current gold rush.

The turnover problem is a big one. As one executive in China puts it, "Chinese organizations learn fast but also can forget fast." Turnover is a significant problem in India as well, particularly in hot sectors like information technology. And as emerging players grow, they soon face the same problems established MNCs do: international coordination, diminishing usefulness of the center for delivering products or services, loss of product uniqueness, and the need to tap more pools of talent around the world.

But as we've seen, some aspiring MNCs are getting smart about how to move into the global marketplace, and this often means experimenting with new management mechanisms and policies. For example, as Indian software-services companies' U.S. and European operations take on bigger, more customized assignments, they encounter longer sales cycles, more complex customer requirements, and greater profit risks due to mispricing. So their control systems are tracking more project characteristics and more performance and risk measures than before. Because much of the actual work is done in India or elsewhere, far from the project manager at the client site, mechanisms to coordinate and relieve tension in this relationship are critical. One of the most distinctive of these companies, Cognizant (with most operations in India, though it's headquartered in New Jersey, closer to its clients), solves this by putting "two in a box" – that is, by measuring performance and calculating payment for both the off-site workers and on-site client managers with the same formula.

Perhaps the Chinese company most dramatically stressed by globalization is Huawei, whose estimated $11.5 billion in overseas sales is up from less than $1 billion six years ago. Suddenly the company has 12 R&D centers and more than 100 sales branches around the world. This explosive growth, combined with a shift in sales emphasis from third- to first-world telecom companies as customers, has introduced a range of new practices into Huawei's traditional top-down, military-style management. They include less centralized decision making; greater emphasis on leadership potential in selecting overseas managers; more explicit training of overseas hires about Huawei's distinctive culture, lest it be lost; and earlier identification of promising young engineers for the management track. Management shapes globalization, and thereafter, globalization shapes management.

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A relentless focus on upgrading, a willingness to engage in radical experimentation, an outward focus, and a "coopetitive" mind-set that recognizes possibilities for cooperation with MNCs while also imitating them, tapping into their expertise by hiring away key personnel and even, on occasion, attacking them – these are all enablers for the aspiring MNC.

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Competing for global leadership requires that companies learn to navigate in unfamiliar waters. For incumbents, the emerging MNCs represent the threat of displacement. For the emerging challengers, globalizing is new and risky. But the greater openness today of both developed and developing economies to foreign trade and investment means that the best opportunities for growth in sales and profits are increasingly available to companies of all origins. Further, ongoing changes in the location of market growth, the shape of global supply chains, and the emergence of new global business models suggest that the conditions are right for aggressive global players to move outside their comfort zones. Industry may have been destiny thus far, but it is unlikely to remain so.

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