Global growth, local roots: The shift toward emerging markets

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New markets will drive growth in demand for manufactured goods in coming decades. To meet it, companies must innovate at the local level.

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Emerging markets will power global growth over the next 20 years. By 2025, overall global consumption is forecast to reach $62 trillion, twice its 2013 level, and fully half of this increase will come from the emerging world. In 2010, the "consuming class"—people with disposable incomes of more than $10 a day—had 2.4 billion members, just over a third of the world's population. By 2025, that will rise to more than half. Taking population growth into account, there will be an extra 1.8 billion consumers, the vast majority living in emerging regions.[1]

For manufacturers, the story is even more compelling. We estimate that emerging markets will be the destination for 65 percent of the world's manufactured goods by 2025. Consumption starts with the basics, and the purchase of capital-intensive goods (such as cars, building products, and machinery) is driving the shift. By 2013, emerging markets already accounted for 59 percent of total demand for building materials, 57 percent for iron and steel, and 47 percent for machinery.

A tale of many cities

Accessing these huge, important new markets won't be straightforward, however. While more than half of the world's population will likely live in cities by 2025, the fastest growth won't take place in today's emerging-market megacities, like Mumbai or Shanghai. Instead, during the next two decades the source of about 35 percent of the growth will be the several hundred million people projected to be living in more than 400 midsize cities spread across the emerging world.[2]

1 Homi Kharas; Angus Maddison; McKinsey Global Institute Cityscope 2.0.

2 Richard Dobbs, Jaana Remes, James Manyika, Charles Roxburgh, Sven Smit, and Fabian Schaer, *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012, McKinsey.com.

Those cities will be as diverse in character as they are geographically. Take three examples. Surat, in western India, accounts for about two-fifths of the country's textile production. Foshan, China's seventh-largest city by GDP, is home to the world's largest wholesale markets for furniture and lighting products. Porto Alegre, the capital of Rio Grande do Sul, Brazil's fourth-largest state, is a major export center for agricultural products from soybeans to leather. While broadly similar in size and growth potential, these cities will probably differ widely in their patterns of consumption, much as their religious, cultural, and regulatory environments do.[3]

Certain cities in emerging markets will become as important economically as some entire countries are today. The GDP of the Chinese city of Tianjin is already the same as Stockholm's. By 2025, it will be as large as Sweden's.[4]

Get closer

The challenge for manufacturing companies isn't just to understand how demand is changing at the city rather than the country level (though research suggests that fewer than one in five executives currently makes location and resource decisions on a city basis).[5] It is also to ensure that production capabilities are developed sufficiently close to a company's most important new markets, since manufacturing is still predominately a local business. Two-thirds of global manufacturing value comes from industries that tend to locate close to sources of local demand, either to reduce transportation costs or to tailor products to local needs.[6]

Bigger manufacturing companies have the freedom to choose where and how they operate across the world. A key challenge for them in coming decades will be not just picking the right mix of production locations but also learning to operate as efficiently as possible in these highly diverse environments. To do so, we believe they will have to focus on three broad sets of skills. First, they must manage the complexity required to meet varied customer needs. Second, they need the organizational capabilities to accommodate that complexity without sacrificing productivity. Third, they must have the manufacturing agility to meet fast-changing customer demand more effectively than their competitors do. Let's look at each area in turn.

Meeting local needs

To meet the needs of consumers in emerging markets, manufacturers first have to understand those needs. To do so, there's no substitute for local insight. Companies clearly need to do their research on the ground to grasp not only the tastes and purchasing behavior of customers in key emerging markets but also the offerings of regional competitors. Moreover, customers aren't the only important stakeholders in these markets. Different regulatory regimes, political environments, input costs, and capabilities in local supply chains can all influence product designs and manufacturing decisions.

Insights must be gathered on a suitably granular level. A McKinsey study, for example, found that segmenting the Chinese market on a national or even a regional basis wasn't adequate. By analyzing consumer characteristics, demographics, government policies, and other factors, the study identified 22 distinct market clusters that can be targeted independently.[7]

3 *Urban world: Cities and the rise of the consuming class.*

4 Richard Dobbs, James Manyika, and Jonathan Woetzel, *No Ordinary Disruption*, PublicAffairs, 2015.

5 *Urban world: Cities and the rise of the consuming class.*

6 James Manyika, Jeff Sinclair, Richard Dobbs, Gernot Strube, Louis Rassey, Jan Mischke, Jaana Remes, Charles Roxburgh, Katy George, David O'Halloran, and Sreenivas Ramaswamy, *Manufacturing the future: The next era of global growth and innovation*, McKinsey Global Institute, November 2012, McKinsey.com.

7 *Manufacturing the future.*

An increasing number of companies are co-locating R&D capabilities with their emerging-market manufacturing facilities.

In emerging markets, the right combination of attributes can make or break products. Nokia achieved a dominant position in the African mobile-phone market, for example, with a simple, robust, and splash-proof handset incorporating a flashlight and a radio. And a manufacturer of consumer products was frustrated in its attempts to enter one emerging market until it conducted detailed on-the-ground research about the product it wished to sell: only then did it learn that consumers there, unlike those in every other country where it sold the product, required packaging that could be reused for other purposes after the contents were used up.[8]

Successful products require local development as well as local research. Shifting development closer to end users simplifies user testing and feedback, and also allows companies to employ designers and engineers who live and breathe the subtleties of local requirements. For these reasons, an increasing number of companies are co-locating R&D capabilities with their emerging-market manufacturing facilities. According to a McKinsey Global Survey, a majority of executives believe their R&D organizations should decentralize, with individual R&D sites operating as nodes in a global network. Thirty-eight percent say their companies plan to increase the offshoring of global R&D.[9]

Organizing for complexity

Regional manufacturing and R&D facilities need talented people. Acquiring and retaining personnel with the right technical skills is a challenge for manufacturers all over the world. But the problem is particularly acute in emerging markets, which may lack the educational infrastructure or pool of competitors to provide the right people.

Overcoming personnel shortages requires a systematic, multifaceted talent-management plan. Companies may need to bring in experienced people from elsewhere in their networks to assist in training and developing new staff. They can partner with local industry associations and academic institutions to create suitable training courses ensuring a supply of new recruits with the right basic skills. "Aviation Valley," in southeastern Poland, for example, is home to more than 100 companies that account for 90 percent of the country's aerospace sector. The nearby Rzeszów University of Technology has become a key supplier of the sector's engineers, designers, and technicians, especially staff qualified to run the advanced computer-numerical-control (CNC) machine tools widely used in the sector.[10]

8 *Manufacturing the future.*

9 *Manufacturing the future.*

10 Key National Cluster: Aviation Valley, dolinalotnicza.pl/en.

Such clusters have the advantage of increasing scale and reducing the cost of education and training facilities. But companies must ensure that their value proposition for employees is strong enough to minimize attrition to competitors.

Organizations in emerging markets must also be flexible. Products tuned to the diverse needs of local markets may, for example, use different materials and production methods, so manufacturing organizations in such a location may not look like their counterparts elsewhere. They need to be agile, too. Consumption patterns in emerging regions can be volatile and fast evolving, and companies must therefore respond quickly to keep up. That will require not only flexible manufacturing technologies (discussed below) but also flexible approaches to staffing (for example, the thoughtful use of contract and temporary labor to balance the ebbs and flows of demand).

Manufacturing agility

When companies design manufacturing systems for emerging markets, they need to balance costs, flexibility, and the ability to adopt standard methods and practices across their worldwide operations. Manufacturers in emerging markets must make the most of the additional agility inherent in their production systems: lower personnel costs will continue to let them adopt more labor-intensive methods, for example, so they can adjust the number of operators and relocate resources in response to changing demand.

Advanced design and manufacturing technologies will also play a critical role. In the design of production facilities, for example, modular approaches can reduce capital expenditures and improve flexibility, so companies can establish production quickly and then scale it up cost effectively, as demand requires. In the biopharmaceutical industry, modular manufacturing plants make it possible for new production facilities to become fully operational 12 months after the start of construction (compared with three to seven years for conventional facilities). Such plants are more energy efficient and less costly to build, as well.

The right product designs also help companies to balance standardization and scale with appropriate adaptations to local needs. Platform- or module-based approaches, like those common in the automotive industry, make it possible for companies to use standard-part product architectures in multiple markets and to add or remove features or to adapt customer-facing components to suit local markets. Platforms make companies more agile, too, so it is easier for them to alter the mix of final products according to demand.

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For manufacturers, emerging markets have become a significant source of growth. Capturing it will require companies to think and act more globally, and more locally, as well. To do so, they will need to invest in a range of areas. They must build a detailed, granular picture of varying customer requirements. They must develop truly global talent pools. And they must build agility into their technologies and processes to match rapidly evolving—and increasingly diverse—demand. The most successful organizations will manage to combine efficiencies of scale and standardization with the flexibility and insight to meet diverse customer needs.

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