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Building Your Company's Capabilities Through Global Expansion

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Building Your Company's Capabilities Through Global Expansion

To create and sustain a global competitive advantage, companies need a systematic approach to exploiting, renewing and enhancing their core capabilities.

BY DONALD LESSARD, RAFAEL LUCEA AND LUIS VIVES

THE LEADING QUESTION

How can you increase the odds of success in new international markets?

FINDINGS

- ▶Evaluate whether your company's capabilities are relevant and transferable to the new country — and whether you can appropriate value from them there.
- ▶Ask whether new capabilities gained through cross-border expansion will be complementary, transferable and value-providing to the rest of the organization.

GLOBAL COMPETITION IS becoming tougher and more complicated than ever. Over the past 30 years, sharp declines in communication and transportation costs and the reduction of trade barriers have reshaped the global economy. Major new markets continue to open. Supply chains are becoming increasingly deverticalized and geographically dispersed. In many industries, new emerging-market competitors are now challenging established multinationals. Indeed, the global competitive landscape is becoming increasingly dynamic and complex, creating both new threats and new opportunities.

Today, global strategists need to go beyond such traditional questions as which are the most attractive markets for their company, and which markets are "closest" to them in terms of institutions, level of development and culture. They must sharpen their global strategies by focusing on how to exploit, enhance and renew or even transcend their home-based sources of advantage. The question is, how? What critical questions do global strategists need to answer before committing their companies' resources to new markets?

Through our research and teaching, we have developed a framework to help strategists answer the two most crucial questions of any global strategy.

CEMEX, the Mexican cement company, developed a systematic strategy for replicating its business abroad.

COURTESY OF CEMEX

(See "About the Research.") Those two crucial questions are:

1. Will a company's current capabilities provide a competitive advantage in a target market?
2. Will that new location give the company an opportunity to enhance its capabilities?

Capabilities and Competitive Advantage

The task of the global strategist is to build a platform of capabilities culled from the resources, experiences and innovations of units operating in multiple locations; to transplant those capabilities wherever appropriate; and then to systematically upgrade and renew them — ahead of the competition.

Apple is a preeminent case of a company whose unique capabilities give it a worldwide competitive advantage, particularly with respect to its ability to build platforms from a product base that integrates functional and aesthetic design. Apple has been able to leverage and exploit its California-based design and marketing advantages successfully throughout the world. IKEA is another such case. The do-it-yourself furniture and housewares company first developed a compelling set of capabilities to design, manufacture and ship furniture at low cost and sell it in a novel way in Sweden. Later, IKEA successfully replicated this formula in many other countries.

By contrast, Telefónica, a Spanish telecommunications company that is now the world's fifth largest telecom by revenues, first developed its special advantage abroad. In 1989 and 1990, Telefónica had the opportunity to enter Chile and Argentina, countries that shared many institutional and cultural characteristics with its home country but that were undergoing more rapid market reform. Throughout the 1990s, Telefónica took what it learned in Chile and Argentina about revamping former state-owned telecoms to other Latin American countries that were privatizing their state telecoms and deregulating their telecom markets.

These examples might lead the reader to believe that creating a global advantage is an easy task. But many other instances of expensive failed experiments — some by these same winners — suggest that creating a lasting global advantage actually requires a great deal of strategic and operational finesse. Our research suggests that global winners typically create and sustain their international competitiveness through a systematic process of exploiting, renewing and enhancing their core capabilities.

ABOUT THE RESEARCH

To understand how companies develop sources of competitive advantage through their global strategy, we conducted in-depth analyses of 50 American, European, Latin American and Asian companies. We also interviewed and analyzed the public statements and other interviews of senior executives and managers in charge of global strategy in more than 20 of these companies. In addition, we reviewed the relevant strategy literature of the last 30 years, searching for articles discussing the different ways in which companies can develop sources of global competitive advantage. In this article, we cite a number of these companies, along with examples from several widely taught case studies, but regarded from a different angle than the one from which these studies are conventionally taught.

Exploit Existing Capabilities

The simplest way in which a company can gain advantage in foreign markets is by exploiting capabilities first developed at home. A number of companies have been able to successfully leverage their homegrown capabilities in foreign markets. As we noted above, IKEA successfully transferred its conception of low-cost, modular furniture with Nordic design. McDonald's took the capabilities that made the company a successful fast-food player in the United States to international markets, achieving an impressive degree of international presence and success with minimal regional adjustments.

The exploitation of capabilities can also take place through the acquisition of companies abroad:

- NH Hoteles built one of the largest business hotel chains in Europe by transferring core capabilities it developed in its home market to other European markets. In its early history, NH built a successful business hotel chain in Spain, a country where the hospitality industry had traditionally focused on "sun and holiday" hotels. NH executives realized that its capabilities as a business hotel chain could be transferred to and exploited in other countries in the same way, and during the end of the 1990s and the early 2000s, the company started to look at opportunities to transfer these capabilities to other markets.
- AXA, the largest insurance company in the world, grew an impressive network of international subsidiaries mainly through the acquisition of local players. The company won by taking its best practices and replicating them in each of those new organizations.
- CEMEX, the Mexican cement company, developed a systematic strategy for replicating its business abroad that helped propel it to a leading international position.

But not every transplant takes root. Two crucial questions every strategist must ask are how well the company's capabilities will travel and where they might best be replicated. One way to answer these questions is to use what we call the "RAT Test"; RAT stands for *relevant*, *appropriable and transferable*. The RAT Test helps identify whether a particular

market is suitable for the successful deployment of one of a company's home-market businesses.

The RAT Test comprises three questions:

1. Are the capabilities developed in the home market *relevant* to customers in the target market? In other words, would they create value for the customer?
2. If deployed in a foreign target market, would these capabilities be *appropriable*? In other words, do they allow for the capture of value? Are there sufficient barriers to imitation and innovation that prevent competitors from matching the capabilities or finding alternative solutions? Are the necessary complementors (value chain partners) all present and without undue market power?
3. Are the capabilities *transferable*? Can the company deploy its capabilities effectively in the target foreign location without sacrificing too much value creation and capture potential?

The RAT Test is as important in ruling out expanding into a particular country as it is in confirming that a proposed expansion makes sense. While there are many ways to identify what appear to be attractive markets, careful consideration of these three factors is a must, and failure to do so may result in serious blunders. Some international expansions are frustrated because the capabilities that make a company a leader in some countries are not relevant in others. IKEA, for example, made a misstep when it moved into Japan, not recognizing that the Japanese had a deep aversion to assembling their own furniture — a key element of the IKEA business model. Similarly, Telefónica found that the capabilities it had developed in Latin America in the 1990s were of little use when it tried to challenge European incumbents in their home markets.[1]

On other occasions, entering a particular country meets with failure not because the company's capabilities are not relevant to the wants and needs of its potential clients in the new country but because the company cannot appropriate the value it is generating in that market. Let us take the example of Amore Pacific, a leading South Korean beauty products company.[2] Although Japan is a large market that is geographically close to AP's home base in South Korea, the company's capabilities were not appropriable in Japan because they were too similar to those of leading Japanese beauty product companies. AP's capabilities were relevant to the Japanese market, but not different enough to enable it to develop a profitable market position.

Wal-Mart Stores' botched initial expansion into Germany, is another example of a similar failure. When Wal-Mart began opening its doors in Germany it found, among other things, that local discounters were already offering low pricing — making it impossible for the discount giant to achieve acceptable levels of profitability and ultimately forcing its exit.[3]

Even when a company's home-market capabilities are relevant to another market, value can be elusive. For example, Gamesa Corpóracion Tecnológica, a leading Spanish wind-power producer, found that although its design and manufacturing capabilities were relevant in the United States, they were not readily transferable there because the U.S. lacked the supplier base of small and medium-sized specialist companies that underpinned Gamesa's success in Spain. By contrast, Gamesa's challenges in China were not so much related to the transferability of capabilities as to their appropriability. Gamesa found that its products met the requirements of the Chinese market, but it could not develop a profitable operation there because local companies could imitate its designs quite rapidly.[4]

The RAT Test focuses on how to avoid such missteps and successfully exploit a company's existing capabilities in a new context. For a company to do so, its capabilities have to be relevant to customers in the foreign market, providing products and services that they value. In addition, the fruit of this effort must be appropriable by the company, a factor that largely depends on the strength and uniqueness of the company's capabilities vis-à-vis those of incumbents in the host country. The RAT Test reminds us that transferring relevant knowledge and capabilities across countries is rarely easy. Often, capabilities derive from experience or knowledge that is hard to codify, or they are tightly integrated with the capabilities of the company's suppliers or complementors.

Create New Capabilities

Companies also expand internationally to gain access to strategic assets or to develop new capabilities. In these cases, it is critical for strategists to determine whether the new additions will actually

result in an *overall* enhancement of the company's capabilities and its global competitive position. Developing new capabilities is on some occasions achieved through a single, deliberate action, such as the acquisition of a foreign company known to have mastered a particular technology, but at other times it derives simply from coping successfully with the challenges presented by another country's competitive and institutional environment.

In either case, we contend that the key concerns of the strategist are to determine whether the new capabilities complement the company's existing set of capabilities, whether these new capabilities can actually generate additional value for the company, and whether it is possible to transfer them from the specific context in which they were developed (the foreign country) to the rest of the organization.

One method that internationalizing companies have traditionally employed to improve their capabilities is to set up shop in well-known "lead markets" or in technology hotspots. Shimano, a sporting gear manufacturer based in Sakai, Japan, offers an interesting example of such a strategy. Early in its internationalization during the period after World War II, Shimano "tapped" the United States for a then-new technology — cold forging — that significantly increased the company's manufacturing capabilities. Later, in the early 1970s, Shimano set up marketing and technical operations in Europe to learn from the world's most sophisticated road bicycle consumers and competitors. In the mid-1980s, it repeated the operation on the West Coast of the United States to meet the requirements of mountain-biking pioneers.[5] In all three instances, Shimano gained either technical or market knowledge that complemented its already deep capabilities in the design and manufacture of bicycle components — new knowledge that Shimano was able to exploit not only in the specific markets in which the knowledge originated but also globally.

New assets and capabilities can also be gained through joint ventures and acquisitions. Lenovo Group's acquisition of IBM's PC division in 2005 allowed the Chinese electronics company to access a new set of capabilities and recombine them to improve its advantage in international markets.[6] In its early days, AXA learned how to keep its eyes open to opportunities, developing a methodology for quick integration and identification of best practices in the companies it acquired. More recently, the Tata Group, based in Mumbai, India, has also looked for complementary capabilities, such as when it acquired Land Rover and Jaguar in the United Kingdom or purchased Spanish bus maker Hispano Carrocera.[7] Indeed, acquiring complementary capabilities is a key goal for Tata in its acquisitions strategy. As Praveen Kadle, executive director of finance and corporate affairs, has said, "We acquire a company only if it gives us a new technology, new markets, new products, new customer bases or a new product development capability."[8]

In order to evaluate the potential for enhancing the current sources of advantage through the assets and new capabilities developed in foreign markets, global strategists can use what we call the "CAT Test." The CAT Test, which explores whether new capabilities will be *complementary*, *appropriable and transferable*, helps the strategist understand the potential of the new assets and capabilities to enhance existing advantages.

The CAT Test is comprised of three questions:

1. Are the new assets and capabilities that the company will develop/acquire in the new market *complementary* to the existing capabilities that constitute the base of the company's competitive advantage?
2. Are they *appropriable*? Can the company appropriate enough of the value of these new capabilities, or will other companies extract the value of the capabilities/resources that they supply?
3. Are they *transferable*? Can the company effectively bring them back from the source location and integrate them into its capability set without sacrificing their value?

As in the case of the RAT Test, the CAT Test is as important in what it excludes as in what it includes. While it is quite likely that some foreign countries will provide the conditions for upgrading a company's capabilities, only some of these options will pass the CAT Test. CEMEX, for example, bet on capturing complementary capabilities from Rinker Group's production and distribution of cement products when it acquired the Australian company in 2007, but by and large these were not transferable because of the big structural and cultural gap between the two companies.

A Virtuous Cycle

Taken together, RAT and CAT represent a cycle of capability exploitation and enhancement. (See "The RAT-CAT Cycle.") For most companies, the process of internationalization starts when they begin exploring which of their capabilities have the potential to be relevant, appropriable and transferable in other markets. As a company starts to operate in new foreign markets, it typically finds that some aspects of its existing products, services or business model need to be adapted to the local context in order to maximize the company's competitiveness in the new market. Interestingly, while its home-developed capabilities allowed the company to enter and survive in the foreign market, its subsequent efforts frequently require the development of new host-country-specific capabilities. As corporate managers become aware of these new capabilities, they should consider to what extent those new capabilities can be incorporated into the company's global capabilities and be relevant, appropriable and transferable to other countries. The result is a continuous cycle of exploration, exploitation, adaptation and enhancement.

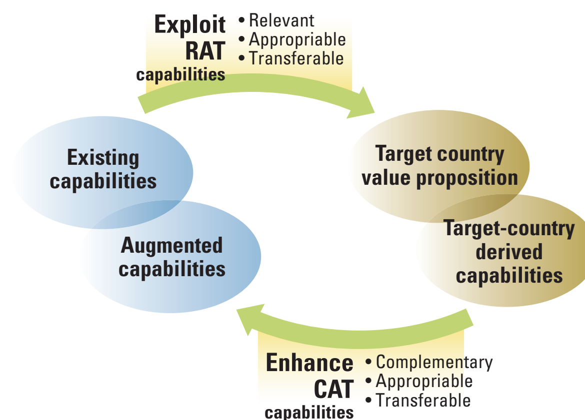
Wal-Mart provides an interesting example of this virtuous cycle. Although we earlier cited Wal-Mart as a company whose home-market capabilities did not pass the RAT Test in Germany, other markets subsequently provided Wal-Mart with CAT-ready opportunities, which it is now using to renew its business model in the United States. In 2010, for example, Wal-Mart announced it would introduce a small-store format, called Wal-Mart Express, aimed at rural and urban areas without nearby grocery stores. The decision to introduce this new format to the United States came about because of the success of Wal-Mart's small stores in Brazil, Mexico and Argentina. As stated by Bill Simon, chief executive of Wal-Mart's U.S. business, "Our group in Mexico and Latin America operates small formats very well and very profitably, and we are going to beg, borrow, steal and learn from them as quickly as we can."[9]

Accor, a hotel operator based in France, offers another example of how to create dynamic renewal through new capabilities acquired in foreign markets. Based on the success of its French hotel chain Novotel, Accor started by exploring new markets in which the set of capabilities had developed in France could be relevant, incorporating new hotels and hotel chains through acquisitions. However, in this process, the company also learned how to identify new assets and capabilities that could enhance the company's existing set of capabilities and integrate them back into the group's core practices — setting off a new exploration-exploitation cycle. This allowed Accor to diversify and enter new market segments, ranging from budget hotels, such as ibis or hotelF1, to luxury hotels, such as Sofitel or Mercure, even as the group continued to grow internationally. All these successful acquisitions have given the company both size and expertise: Accor is now one of the leading hotel chains in the world, with a presence in more than 100 countries.

CEMEX's many successes in the 1990s were due in part to a similar dynamic. Every time CEMEX acquired a new company, it rapidly transferred its technical and managerial expertise to the newly incorporated operations. However, it also established a highly formalized and rigorous process — the post-merger integration (PMI) process — geared to analyzing and evaluating what had constituted the standard practices of the newly acquired company. The PMI's ultimate goal was to identify best practices — new capabilities — that might be exploited throughout the CEMEX world. The result of this double-looped process enabled CEMEX to

THE RAT-CAT CYCLE

A company can enhance its capabilities by exploiting those that are relevant, appropriable and transferable (RAT) in another target country. Then, after the company augments its capabilities by competing in the new market, it can enhance its overall capabilities by identifying those newly acquired capabilities that are complementary, appropriable and transferable (CAT) to all or part of the rest of the organization.



pioneer the use of cheaper alternative fuels, reduce its cost of capital and even improve its capacity utilization by pooling demand regionally. Perhaps the latest successful iteration of this cycle was exemplified with CEMEX's acquisition of RMC, based in Egham, United Kingdom, in 2005. After acquiring RMC, CEMEX not only improved the efficiency of the new operations by infusing them with its long-tried-and-tested procedures, but also gained critical knowledge from RMC on a variety of fronts, including new expertise on how to operate in more environmentally regulated countries such as Germany and how to improve its concrete operations around the world.[10]

A comparison of CEMEX's successful acquisition of RMC with its largely disastrous acquisition of Rinker in 2007 underscores the importance of focusing on capabilities. While not denying that the timing of the two acquisitions had a great deal to do with their respective outcomes, it is apparent that CEMEX possessed many capabilities that were relevant for the upgrading of RMC's operations around the world, while CEMEX gained new capabilities that were complementary, appropriable and easily transferable. With Rinker, however, a more diverse and already operationally efficient firm, CEMEX's RAT capabilities were not so obvious. The ability of CEMEX to benefit from the complementary capabilities associated with Rinker did not materialize, given that the two companies had very different organizational structures and cultures.

As a company goes through successive turns of the RAT-CAT cycle, it gains greater leverage from an increasingly rich and diverse capability set. This leverage includes the benefits of overall scale, agglomeration (scale in key locations) and arbitrage across locations.[11] As this journey unfolds,

GLOBAL STRATEGY FROM A CAPABILITIES PERSPECTIVE

The global strategist's task is to build a platform of capabilities culled from the resources, experiences and innovations of units operating in multiple locations; transplant those capabilities wherever appropriate; and then systematically upgrade and renew them — ahead of the competition.

STAGE	EXPLOIT	ENHANCE	RENEW
Strategic objective	Leverage existing capabilities in new markets.	Develop complementary capabilities that can increase the power of existing capabilities.	Create a virtuous cycle that allows the company to renew its capabilities — and through them gain a stronger competitive advantage.
Boundary conditions	Existing capabilities should be relevant, appropriable and transferable to the new market.	Newfound capabilities should be complementary to the existing set and be appropriable and transferable.	New capabilities should have the potential to shake up the status quo and set off a new round of upgrading of capabilities.
Best for	Companies that are internationalizing by entering new markets	Companies that have entered a number of markets but are still building their overall competitive advantage	Companies that are at an advanced stage of global strategy development
Organizational architecture	Led from the company headquarters	Increasing importance of subsidiaries and stronger relationship between headquarters and subsidiaries	Distributed network
Nature and direction of the relationship between headquarters and subsidiaries	From the center to the subsidiaries	Subsidiaries gain in importance. They need to understand the existing sources of advantage to succeed locally and work with headquarters to integrate newfound capabilities into a global core capability.	Bidirectional
Sustainability	Short-term	Medium-term	Long-term
Test	RAT Test	CAT Test	RAT + CAT Tests
Challenges	Identify markets where existing advantages are relevant.	Identify assets and capabilities that can complement the existing core sources of advantage.	Maintain the continuous reinvention cycle.

companies become less and less dependent on the specific homegrown capabilities that made their initial international forays possible. And, as they gain in geographic scope, they are increasingly likely to become true "metanational" enterprises, capable of "creating value by searching out and mobilizing untapped pockets of technology and market intelligence that are scattered across the globe."[12]

In addition to providing an overall guide to global strategic initiatives, the RAT and CAT Tests provide a set of common principles that can be followed by managers throughout the company to help promote a dynamic virtuous cycle of strategic expansion. Every new local initiative should be subjected to the RAT Test to insure that it can travel, and any new practices encountered and developed in any location should be assessed to see if they pass the CAT Test and thus should be incorporated into the company's overall approach. A systematic process for incorporating these improved capabilities into the company's overall core capabilities can complete the cycle.

The relative importance of the RAT and CAT Tests, and the pace at which this dynamic cycle operates, will depend on a company's maturity, its stage of internationalization and the overall state of the industry. For companies based in rapidly evolving lead markets, RAT opportunities to transfer their home-market model to other countries will likely be most relevant. However, companies in businesses characterized by a multiplicity of competitive markets or that are late entrants into highly competitive global industries should be more focused on CAT opportunities. A CAT focus is also likely to be most relevant for companies that have settled into what appears to be a fairly comfortable position and that feel the need to shake up the cozy status quo and set off a new round of upgrades. (See "Global Strategy From a Capabilities Perspective" for a description of the key features of each of these three basic strategic positions and the circumstances under which either RAT or CAT should play the larger role.)

The rising level of global competition and the acceleration of technological change mean that global expansion is no longer an optional activity. Today, virtually every sizable private enterprise must have a global strategy. No program of company expansion is risk free, but taking a well-considered, strategic approach to expansion such as we suggest can help companies ensure that their cross-border successes outnumber their failures.

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