

Growing beyond Galapagosization

— A Strategy for Approaching Emerging Markets

Utilizing Japanese Business Expertise —

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I Further Expansion of Emerging Economies

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III Fundamental Points of a Strategy for Moving beyond Galapagosization

In the past several years, it has often been said that “Japan is just like the Galapagos Islands in that Japanese companies endeavoring to meet the demands of the Japanese market are similar to the animals living in the Galapagos Islands that followed a unique evolutionary process.” Such “Galapagosization” refers to a phenomenon in which technologies and technical standards developed by Japanese companies are overly concentrated on the Japanese market, which resulted in creating standards that are only accepted in the Japanese market, causing a major hindrance to the global deployment of such standards.

Actually, Japanese companies have not yet been able to satisfactorily expand their business activities in the emerging markets that have recently been achieving rapid growth. They are having difficulties in competing with local companies as well as other overseas companies. A questionnaire survey conducted by Nomura Research Institute (NRI) revealed that, surprisingly, Japanese companies do not yet have an adequate understanding of the actual situations of local consumers.

Under such circumstances, consumer segments that have increasing interest in Japanese products have appeared. These segments consist of households with annual incomes slightly exceeding \$10,000. Successful cases in emerging markets suggest that local consumers in these segments have a sort of yearning for Japanese products. The question that then follows is what strategy Japanese companies should adopt in approaching these rising segments of households with annual incomes of at least \$10,000.

According to our surveys of Japanese companies that are successful in emerging markets, they have not necessarily adopted a strategy of increasing sales by lowering prices. Rather, they offer the image of Japan and new lifestyles to local consumers, and set prices at an affordable level.

Based on company surveys and consumer surveys in each country, NRI reached one conclusion. To grow beyond Galapagosization, Japanese companies should target the rising segments of households with annual incomes of \$10,000 or more, and should adopt a strategy that cultivates a yearning for Japanese products by skillfully leveraging the essence of Japan.

I Further Expansion of Emerging Economies

The striking growth of emerging markets is obvious. The market share of emerging economies for major household appliances as represented by refrigerators, washing machines and so on has been increasing rapidly. According to data such as the Forecast of the World Demand for Seven Major Household Appliances published by the Japan Electrical Manufacturers' Association in 2007, emerging economies including China, India and Brazil ranked among the top ten countries in terms of demand for major household appliances (Figure 1). These remarkably growing markets remind us of Japan's period of high economic growth.

However, currently growing markets are not confined to only those for major household appliances that are the principal items desired by average households. A similar situation can also be seen for luxury products such as flat-screen TVs and automobiles that are beyond the reach of the average consumer and that represent fields in which Japanese companies are relatively strong. Emerging economies have now grown to have markets that Japanese companies cannot ignore as they present a high demand.

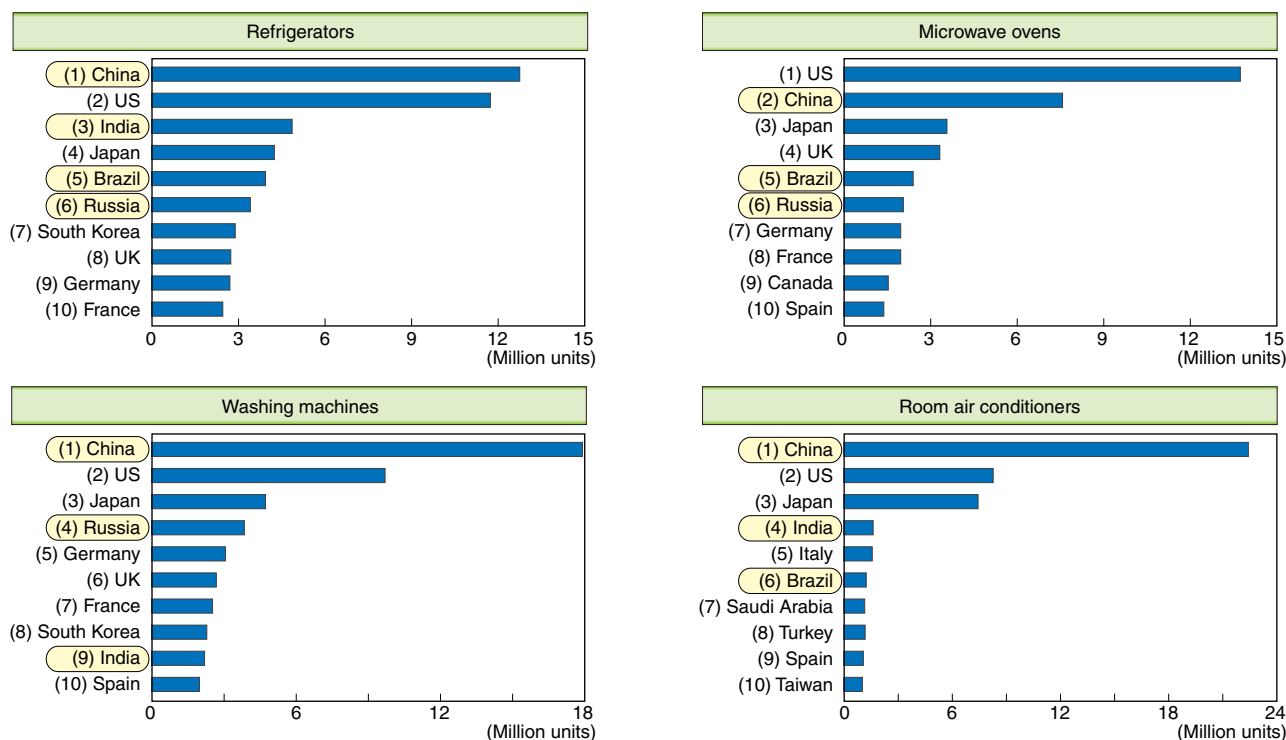
The rule of thumb is that, generally, the penetration of durable consumer goods accelerates rapidly when the household penetration rate surpasses 20 percent. Around 2007, the household penetration rates of flat-screen TVs

and passenger cars approached 20 percent in China and India. Because the household penetration rates of these durable consumer goods had been low in the past and a market that was adequate enough to generate profits could not be attained, companies participating from advanced countries and operating in these markets were assumed to have had a difficult time in generating profits. However, in the future, when the rate exceeds 20 percent, the household penetration rate is expected to rapidly increase (Figure 2). Accordingly, the next few years will be extremely important in promoting business operations in emerging markets.

This situation suggests that emerging markets are vitally important in facilitating Japan's globalization. When these emerging economies grow to present a high demand, Japanese companies must move beyond Galapagosization. Galapagosization refers to the phenomenon in which Japan's technologies, products and services have been independently developed in such a way as that they are particularly tailored to the Japanese market. These efforts have resulted in creating standards that are only accepted in the Japanese market, which constitutes a major hindrance to the global deployment of such technologies, products and services. This phenomenon was likened to the animals living in the Galapagos Islands that followed a unique evolutionary process.

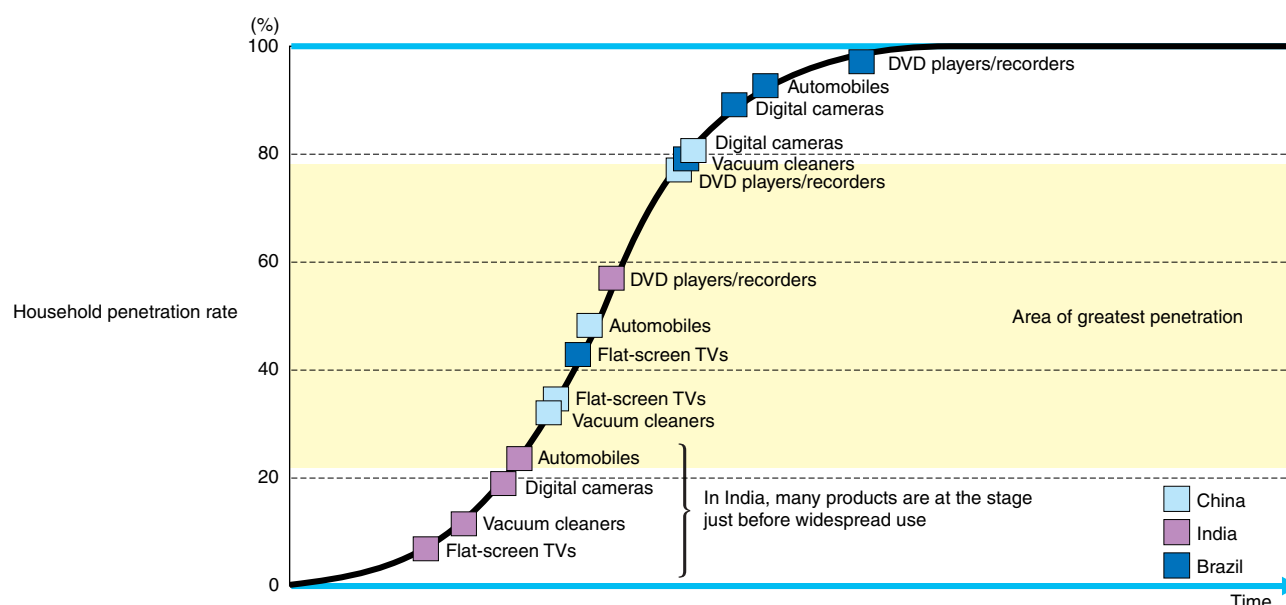
On the assumption that the accelerating growth of emerging economies would serve as a key to facilitating the globalization of Japanese companies, this paper considers the strategies Japanese companies should adopt.

Figure 1. Top Ten Countries in Terms of Demand for Major Household Appliances in 2007



Notes: BRICs that are representative emerging economies consist of Brazil, Russia, India and China.

Sources: Forecast of the World Demand for Seven Major Household Appliances published in 2007 by the Japan Electrical Manufacturers' Association in 2007; Estimates of World Demand for Air Conditioners published in 2008 by the Japan Refrigeration and Air Conditioning Industry Association.

Figure 2. Logistic Curve and Household Penetration Rates of Durable Consumer Goods in Emerging Economies

Source: Compiled based on the results of various questionnaire surveys conducted by Nomura Research Institute.

II Characteristics of Emerging Markets

1 Problems Facing Japanese Companies

Our surveys on Japanese companies operating overseas indicate that overseas sales account for more than 50 percent of the total sales in half of the companies in the following industries: precision machines, transport equipment, electrical equipment and machinery. With the exception of these industries, the global expansion of business operations by Japanese companies is otherwise extremely limited. An accelerating growth of emerging economies is about to open up major business opportunities for interested companies including Japanese companies. Nevertheless, the global expansion of business operations by Japanese companies is far from the stage of full-scale deployment and is still in its early stages.

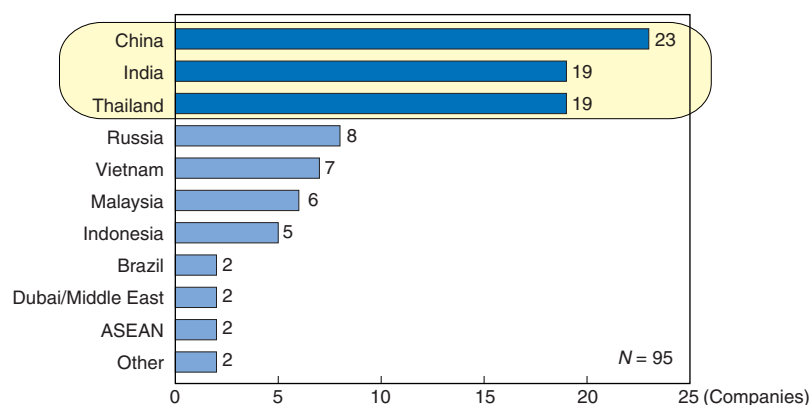
To examine the current status of business operations in emerging economies by Japanese manufacturing companies, Nomura Research Institute (NRI) conducted the Questionnaire Survey on the Present Status of Business Expansion in Emerging Markets during the period of August 18 to September 5, 2008. The target respondents were Japanese manufacturers operating in the markets of three or more countries, at least one of which is an emerging economy.

To the question of “what problems does your company face in expanding its business in top-priority emerging markets (Figure 3)?” 31.6 percent of the responding companies selected “unable to develop sales networks” and 30.3 percent selected “no clear-cut strategy on how to approach the local market” and “not price competitive in the local market” (Figure 4).

What surprised NRI about these responses was that 30.3 percent of the responding companies selected “no clear-cut strategy on how to approach the local market.” To the question of why there was an absence of such a clear-cut strategy, 20 percent of responding companies selected “inadequate understanding of local customers” and “inadequate understanding of local competitors” (Figure 5).

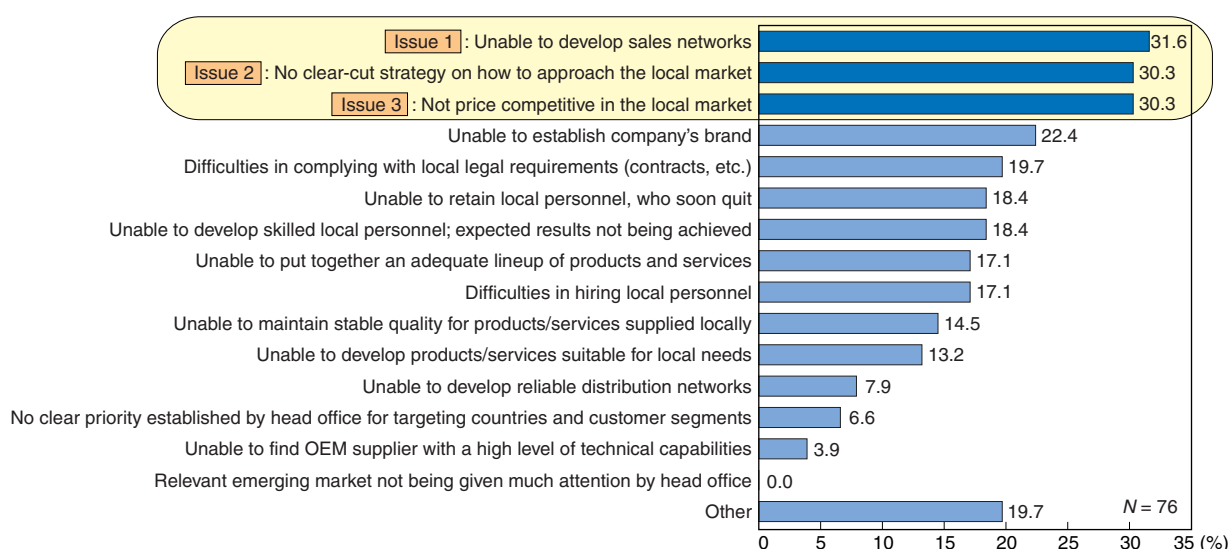
Our thinking at that time was that because Japanese companies were quick to participate in the markets of Asian countries including China, Japanese companies would have the most comprehensive understanding of local customers throughout the world. However, the results of the questionnaire survey suggest that Japanese companies have not yet reached the level of fully understanding the actual situations of consumers in emerging markets.

In expanding business operations overseas, Japanese companies tend to consider the high costs of their products as a hindrance to sales. However, logically speaking, this tendency entails a contradiction of why the appropriateness of product specifications can be discussed under circumstances where they do not have an adequate understanding of local customers. In other words, given the current status where there are no clear-cut answers as to who the target customers are in the relevant country and what the needs of such customers are, it must be nearly impossible to discuss the excess or deficiency of product specifications. Traditionally, many Japanese companies are good at carefully surveying the actual situations of consumers in the market and developing products that customers desire. Unfortunately, however, the survey findings revealed that such strengths of Japanese companies are not fully demonstrated in overseas markets. NRI considers that the development of

Figure 3. Emerging Markets Being Given Top Priority

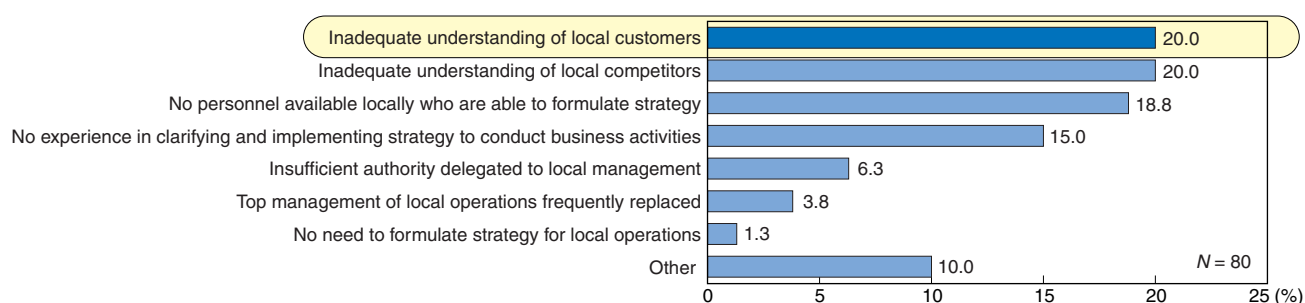
Note: ASEAN = Association of Southeast Asian Nations.

Source: Questionnaire Survey on the Present Status of Business Expansion in Emerging Markets conducted by Nomura Research Institute in August – September 2008.

Figure 4. Problems Faced in Expanding Business in Top-Priority Emerging Markets (Multiple answers)

Note: OEM = original equipment manufacturing.

Source: Questionnaire Survey on the Present Status of Business Expansion in Emerging Markets conducted by Nomura Research Institute in August – September 2008.

Figure 5. Reason(s) for Not Having Clear-Cut Strategy for Emerging Markets (Multiple answers)

Source: Questionnaire Survey on the Present Status of Business Expansion in Emerging Markets conducted by Nomura Research Institute in August – September 2008.

solutions to this problem is a key factor in successful business expansion overseas by Japanese companies.

2 Households with Annual Incomes of \$10,000 or More as Target Segments

The findings of various surveys conducted by NRI suggest that consumers in emerging markets begin to

become interested in products made by Japanese manufacturers when their annual household incomes reach \$10,000 or more. The results of the questionnaire survey mentioned above revealed that Japanese companies have a less than adequate understanding of target segments in local markets. To help clarify target segments, NRI conducted consumer surveys in three countries—Brazil, China and India. While these surveys revealed a unique

propensity to consume in each country, the general tendency found among these countries was that, as noted above, when the annual household income exceeds \$10,000, the interest that consumers have in luxury goods, such as household appliances and automobiles, which represent the strong domains of Japanese companies, increases.

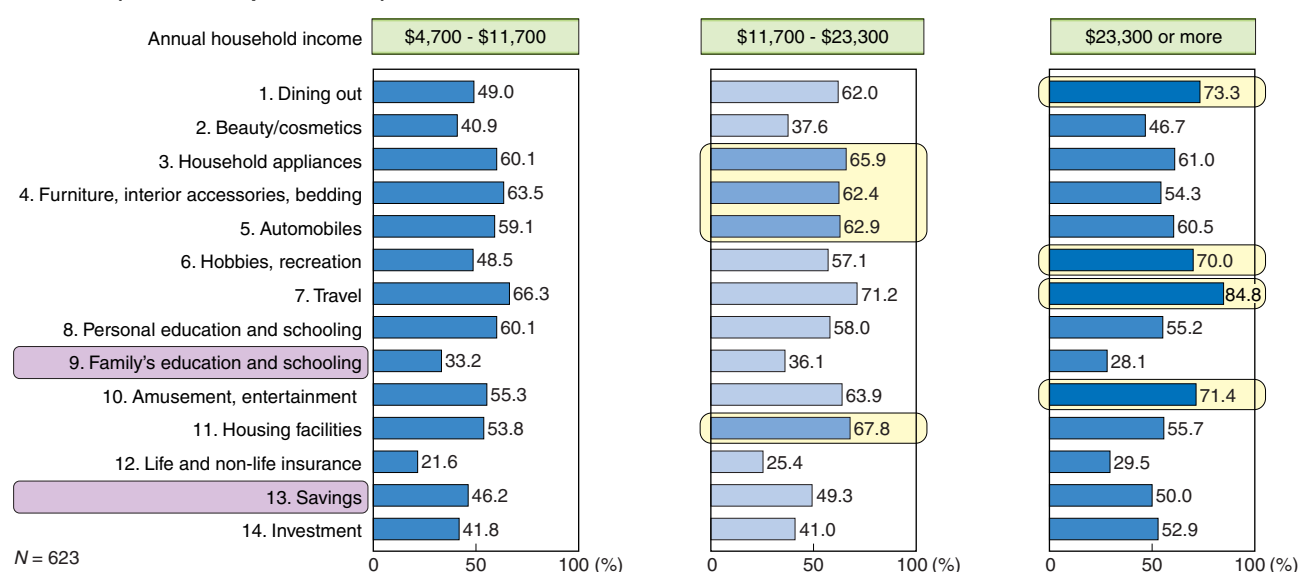
In Brazil, an active predisposition toward consumption in the amusement and leisure fields is seen among the segments of households with annual incomes of \$11,700 or more (exceeding the level of \$10,000). In contrast, the inclination to consume is low in more moderate fields such as savings and education. These

findings suggest that Brazil is a country where the proportion of income that goes into entertainment and recreation is high (Figure 6).

In comparison with Brazil, the survey revealed a conservative attitude towards consumption in China. As income increases, interest in durable consumer goods such as automobiles rapidly increases. However, as compared to Brazil, the proportion of income that goes into savings is high, which can be regarded as a general characteristic of the population of China (Figure 7).

What is noticeable in India is a thoughtful approach towards consumption. In India, as in Brazil and China, interest in durable consumer goods increases as income

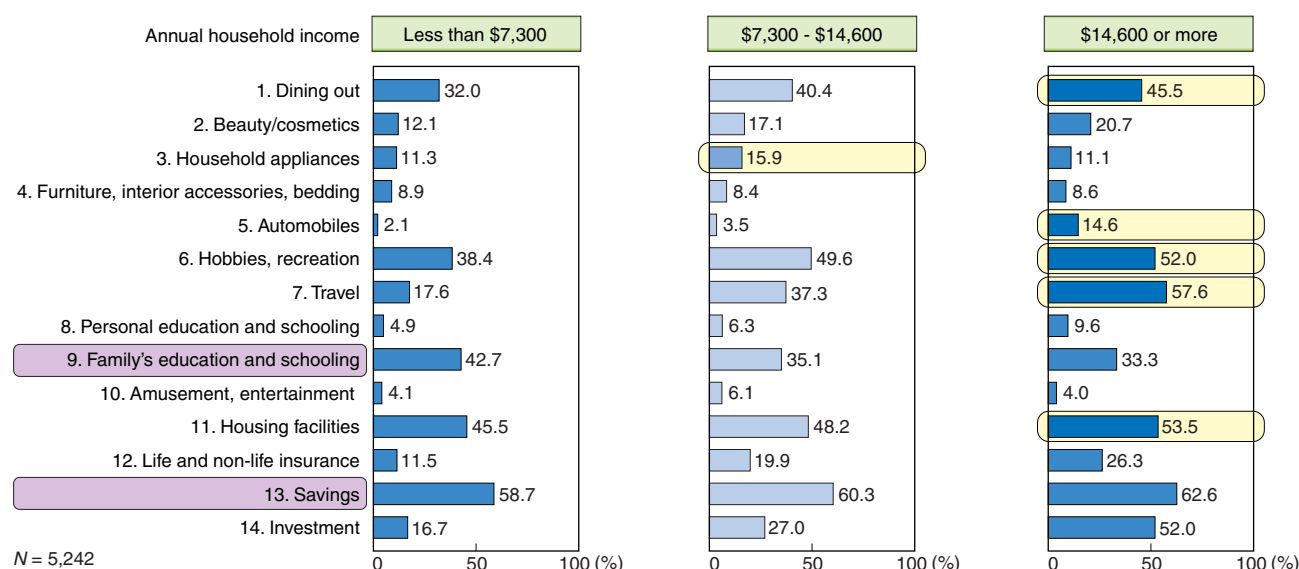
Figure 6. On Which Product(s)/Service(s) Do You Expect Your Family to Actively Spend Money over the Next Year? (Brazil; Multiple answers)



Note: 1 real = US\$0.432.

Source: Consumer Survey conducted by NRI in Brazil in 2008.

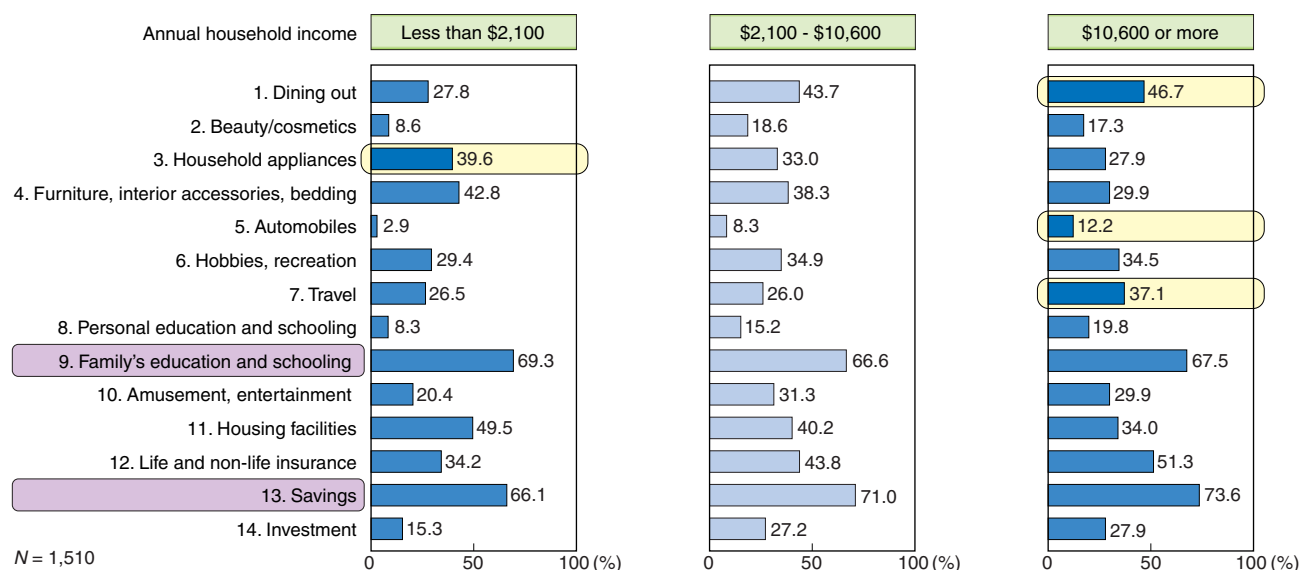
Figure 7. On Which Product(s)/Service(s) Do You Expect Your Family to Actively Spend Money over the Next Year? (China; Multiple answers)



Note: 1 yuan = US\$0.146.

Source: Consumer Survey conducted by NRI in China in 2007.

Figure 8. On Which Product(s)/Service(s) Do You Expect Your Family to Actively Spend Money over the Next Year? (India; Multiple answers)



Note: 1 rupee = US\$0.0212.

Source: Consumer Survey conducted by NRI in India in 2007.

increases. However, among all income segments, interest in the family's education and schooling and in savings is fairly high as compared to Brazil and China (Figure 8).

Although Brazil, Russia, India and China are collectively called BRICs, the characteristics of consumption differ largely from country to country. In particular, attaining success in the Indian market is expected to be considerably difficult because of the conservative, thoughtful attitude of Indian consumers toward consumption.

While the trend of increased interest in automobiles, household appliances and housing facilities is generally seen among the segments of households with annual incomes exceeding \$10,000 in each country, the details behind such increased interest must be carefully analyzed for each country.

3 More than 500 Million Households with Annual Incomes of at Least \$10,000 in Seven Emerging Economies Projected for 2020

The next point that we focused on was the pace at which the number of households with annual incomes of at least \$10,000 is increasing in emerging economies. NRI simulated annual household incomes in seven emerging economies (China, India, Brazil, Thailand, Indonesia, Malaysia and Vietnam) based on an economic development model in Asia (Figure 9 and Attached Figure at the end of this paper).

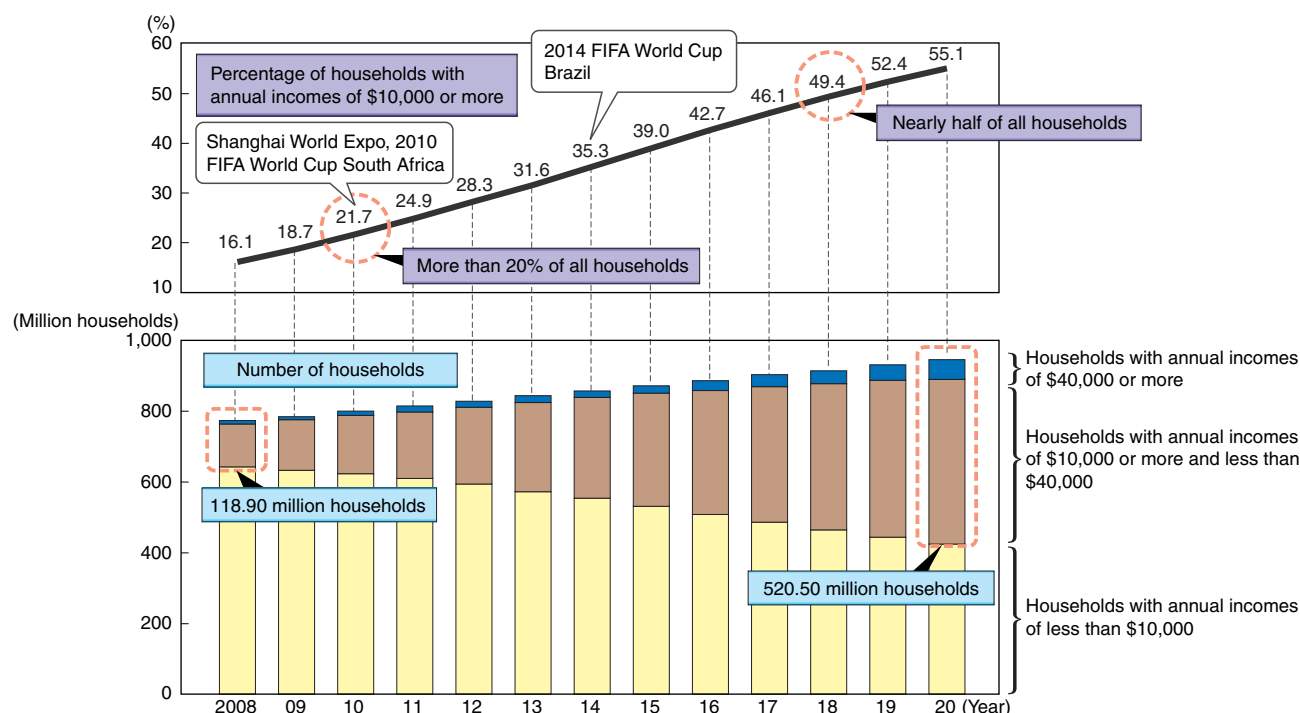
These simulations revealed that the percentage of households with annual incomes of \$10,000 or more would increase from 16.1 percent in 2008 to more than 20 percent in 2010. This means that in seven emerging

economies, interest in luxury goods will increase among 20 percent of all households, and products made by Japanese companies will become affordable in these households. In 2018, nearly 50 percent of all households in seven emerging economies will earn annual incomes of \$10,000 or more. In 2020, this percentage is projected to increase to 55.1 percent, which represents 520.50 million households. As such, the segment consisting of households with annual incomes of \$10,000 or more will expand at a rapid pace.

Because the size of this segment was not so large in the past, Japanese companies had no choice but to target the low-income segment, which constituted the majority of the population, and made strenuous efforts to produce their products at the lowest possible cost. Some companies were forced to withdraw from emerging markets because their efforts at reducing cost compromised product quality. Considering the high level of capabilities that Japanese companies have, it would have been too difficult for them to target the majority of consumers in these local markets.

However, detailed analyses of the above-mentioned simulations and other economic forecasts now indicate a rise of the segment consisting of households with annual incomes of \$10,000 or more who are expected to have an increased interest in luxury products in the future.

Conversely speaking, if Japanese companies were to succeed in selling inexpensive products to a large majority of consumers in local markets, they must know that the number of these consumers will decrease in the next several years. In sum, in light of the results of simulations, Japanese companies are now at the stage where they must review their strategies for approaching emerging markets.

Figure 9. Forecast for Annual Household Incomes in Seven Emerging Economies

Note: Seven emerging economies refer to China, India, Brazil, Thailand, Indonesia, Malaysia and Vietnam.

Source: Forecasts by NRI based on World Income Distribution 2008 – 09 published by Euromonitor International and World Development Indicators published annually by the World Bank.

4 Japanese Companies Successful in Emerging Markets by Utilizing the “Japanese Way”

This section discusses the strategy that Japanese companies should adopt to successfully approach a rising segment of households with annual incomes of \$10,000 or more; the products and services offered by Japanese companies will be within their reach.

The strategy adopted by Japanese companies that are currently successful in emerging markets generally consists of three key concepts (Figure 10). The first concept is “sell Japan’s perspectives.” More precisely, this concept means that Japan’s perspectives, culture and lifestyles are incorporated in the products.

A good example is TOTO that has the highest market share in the field of plumbing and bathroom fixtures in China. TOTO has continued its sales with focus placed on high-grade products based on the key concept of a sanitary lifestyle that is commonly accepted in Japan. As a result, the TOTO brand has now widely penetrated throughout China, and the number of Chinese consumers who want to purchase TOTO products has been doubling every year.

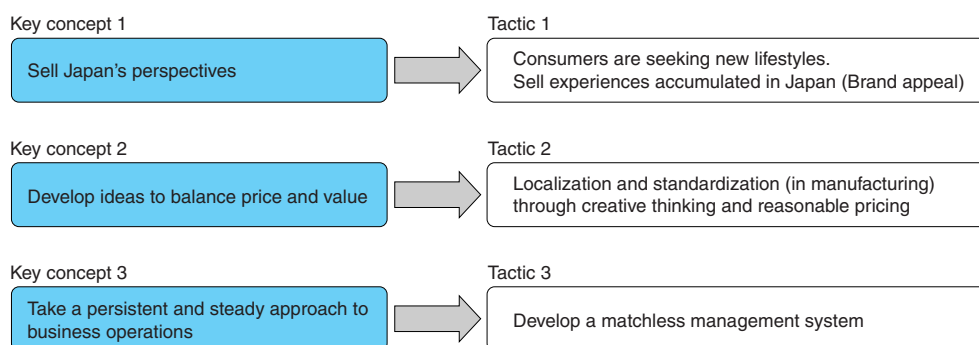
Shiseido has attained success in China with its AUPRES brand that offers the value of skin whitening to Chinese women. What was noticeable behind this success was the company’s price strategy of setting prices at a level that female office workers can somehow manage to attain. The income level of female office workers has been increasing in China. While AUPRES is not at all

inexpensive (its price corresponded to one-fifth the average monthly wage of female office workers in 1994 when this product was launched), the product has developed a yearning for skin whitening products among female office workers, successfully appealing to those whose incomes have been increasing.

The sales strategies adopted by the two companies mentioned above are characterized by the fact that the products in which Japan’s perspectives are incorporated have been marketed to Chinese consumers at prices at which they can somehow manage to attain, rather than by aimlessly reducing prices.

The second key concept is to “develop ideas to balance price and value.” The share of Panasonic’s diagonal-drum washing machines has been growing rapidly in China. Compared to those sold in Japan, dampers that serve to control noise and vibration are simplified for the washing machines sold in China. While such simplification is not possible in Japan where washing machines are installed on floors made of a variety of materials such as wood, concrete and plastic, the material of floors of the houses of consumers who can afford to purchase this type of machine in China and other emerging economies is mostly concrete. Accordingly, no specific consideration to a variety of floor materials is required. In addition, consumers in emerging economies more easily tolerate noise. In fact, they consider that the noise indicates that the machines are working well. Therefore, a high level of noise control is not as important as it is in Japan.

The simplification of dampers is a good example that research findings on differences in living environments

Figure 10. Strategies Adopted by Japanese Companies Successful in Emerging Markets

are reflected in the development of products that balance cost and necessary functions. The China Lifestyle Research Center established by Panasonic in Shanghai played a major role in this development. This center conducts research on the lifestyles of Chinese consumers to find what is required in the Chinese market. Based on deep insight acquired through research activities, the center contributes to product development that balances price and value.

There are many similar cases in which every effort is made to reduce cost and pursue greater value by conducting thorough research and surveys on what is actually needed in the local market.

The third key concept is to “take a persistent and steady approach to business operations to develop a matchless management system.” What are ultimately necessary to sell Japan’s perspectives are attentive and steady marketing efforts. Even if a company were to be successful in offering products at price levels that are within reach of consumers, it is highly likely that sooner or later competitors would adopt a similar strategy. To avoid such a situation, a strategy that competitors cannot easily imitate must be adopted.

Yakult Honsha Co., Ltd. does not rely on sales channels consisting of retailers. Instead, it deploys “Yakult Ladies” throughout the world to explain the benefits of Yakult lactobacillus beverages to each consumer in local markets. Based on this unique method of product delivery, Yakult has increased its sales performance. In Brazil, more than 6,000 Yakult Ladies sell as many as 1.3 million bottles per day. In Thailand and the Philippines as well, the Yakult brand has become widely popular among consumers. The factor seen behind this success is the attentive effort to demonstrate Japan’s management system all over the world, which is unmatched by other companies.

Toyota Motor Corporation trains all its employees throughout the world in Toyota’s fundamental management principles and philosophies, which are introduced in *The Toyota Way* written by Jeffrey Liker. While numerous companies provide their employees with technical training, Toyota instills “the Toyota Way” into its employees all over the world through the use of its Toyota Institute training center at the base of Mount Fuji.

These efforts can be considered as spreading Japan’s perspectives throughout the world.

These steady activities that Japanese companies conduct in each country have led to the achievement of a brand story of selling Japan’s perspectives as incorporated in Japanese products and services.

Based on the three key concepts mentioned above, strategies for approaching emerging markets should continue to be developed in a further well thought-out manner.

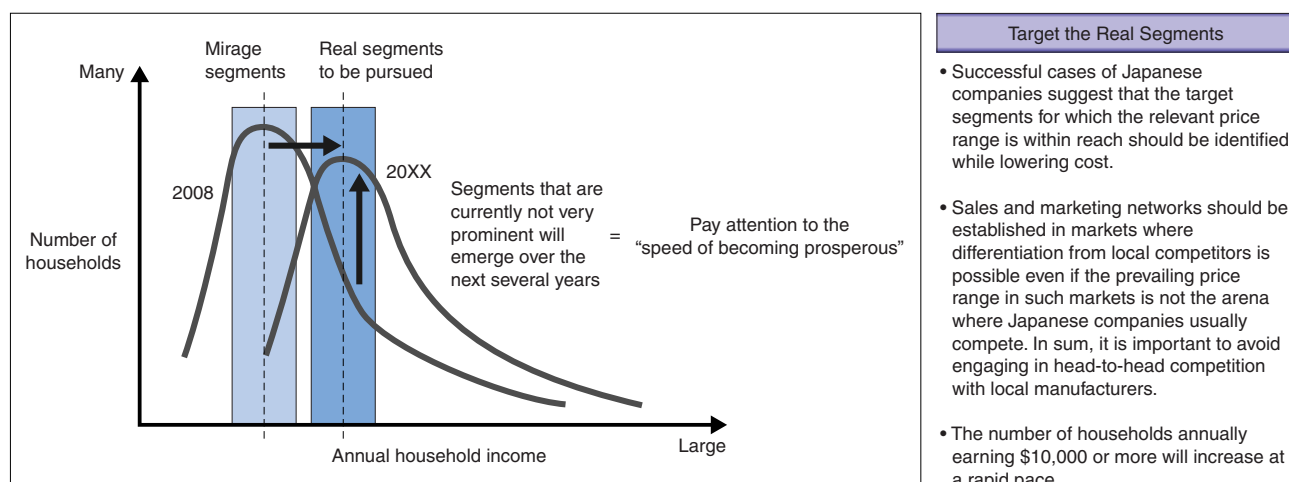
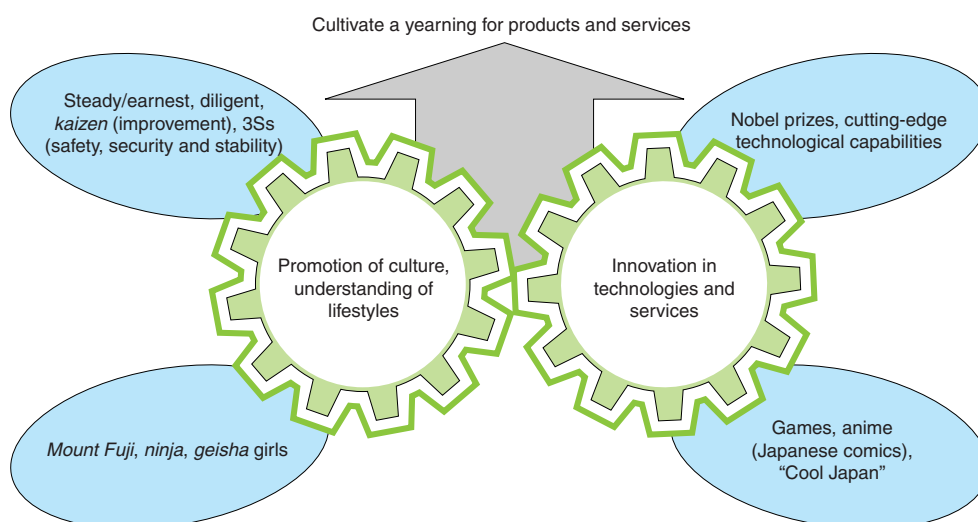
III Fundamental Points of a Strategy for Moving beyond Galapagosization

The consumer surveys and the questionnaire survey targeting companies operating in emerging markets described in Chapter II revealed that what is important in rapidly growing emerging markets is a careful analysis and a review of target segments through more detailed research on changes in consumer income.

While the pace at which the number of households with annual incomes of \$10,000 or more is increasing, it differs from country to country and is generally high. The author and colleagues call this pace the “speed of becoming prosperous.” Considering the speed of becoming prosperous, even if products particularly designed for low-income households that now constitute the majority were developed, this segment may disappear over the next several years as if it were a mirage (Figure 11).

Rather than targeting this mirage segment, it would be wiser for Japanese companies to consider the speed of becoming prosperous, estimate and analyze the emergence of segments for which they can make full use of their expertise, and deploy product lineups for these segments.

In developing such product lineups, consideration must be given to the three key concepts introduced in the successful cases described in Chapter II. In sum, attention should be paid to the fact that successful Japanese companies are selling products and services to local consumers together with the “essence” of Japan. In other words, it is

Figure 11. Ignore the Mirage Segments**Figure 12. Create New Values by Combining Japan's Technologies and Software**

advisable to encourage local consumers to desire products and services that hint of new lifestyles and Japanese perspectives, rather than simply offering low-priced products and services. A specific strategy to increase profits would be to start offering products to the high-end market, and then offer products to the segments consisting of many households that can be targeted relatively easily by setting the price range at an affordable level.

Even though consumers in local markets know that the relevant products are made by Japanese manufacturers, it is highly likely that they currently have almost no knowledge of the unique culture and image that such manufacturers offer. It would be reasonable to assume that the reaction local consumers would have for such products is only about the name of the country of manufacture, i.e., Japan. Accordingly, what is important for Japanese companies in building their brand names in local markets is to upgrade the image of "Japan" to the valuable "essence of Japan." Serious discussions about possible key words in developing this image will be increasingly needed. The author wants to reiterate that it is also important for individual employees of Japanese

companies to have a more profound understanding of "Japan" in any attempts to grow beyond Galapagosization.

NRI considers that it is desirable for Japanese companies to skillfully leverage such a "Japan" feeling to expand their future business activities overseas by overcoming the Galapagosization phenomenon that currently prevails in Japan. Of course, price competitiveness is important. Nevertheless, what is now most sorely needed is to have an adequate understanding of local markets and at the same time to know what impressions local consumers have about the Japan motif. To this end, accelerated efforts are necessary to understand Japan itself.

In fact, it is fair to assume that Japan's high technological capabilities are also supported by software based on this Japan motif. To be successful in future competition, new values must be created by combining the Japan motif (software) and the high level of Japan's technologies (Figure 12). If Japanese companies fail to achieve this goal, there will never be any opportunities for Japanese companies to be seen by consumers in emerging markets with respect and yearning.

Notes:

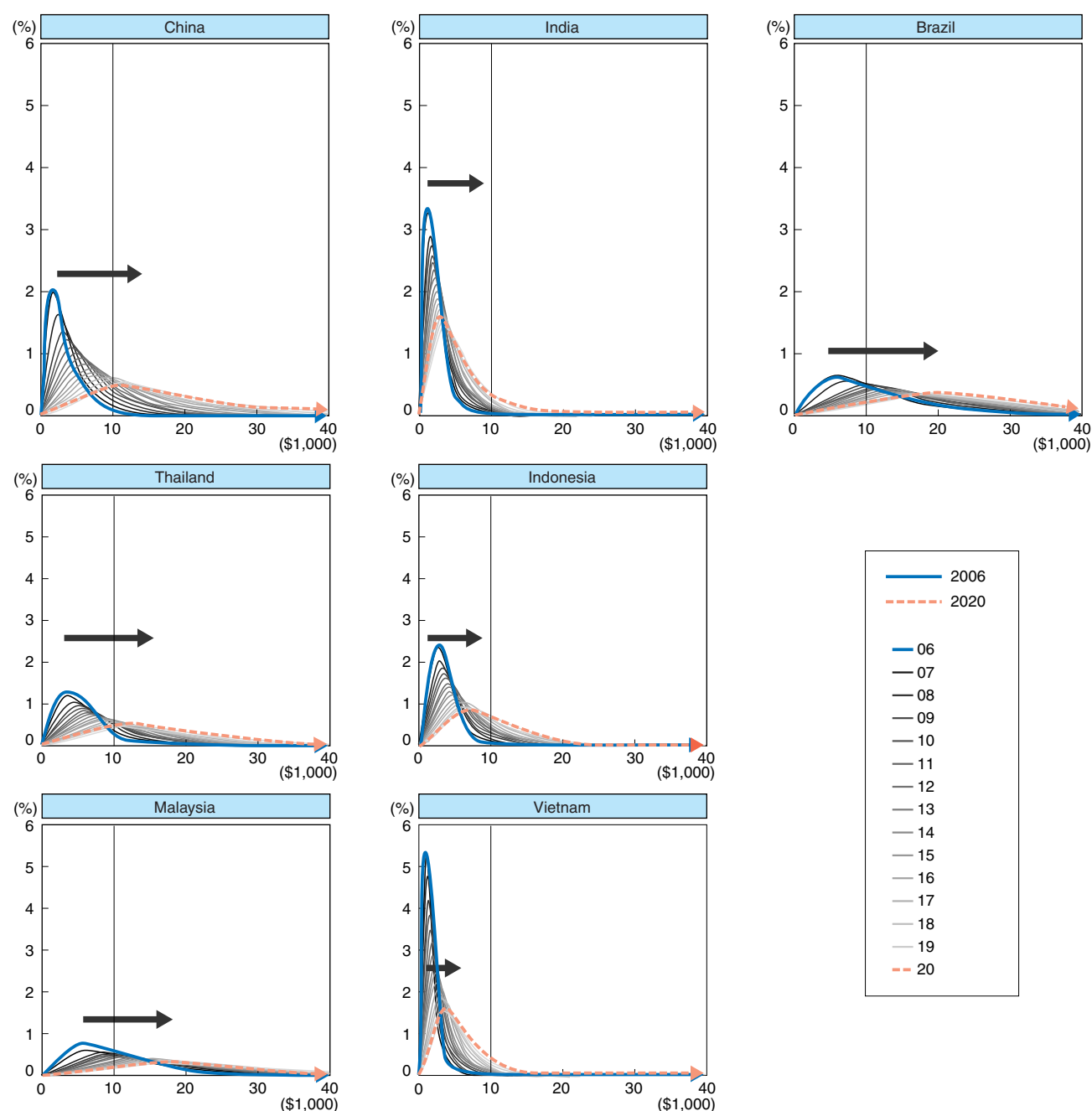
The International Development Statistics published by the World Bank were used to calculate the percentage of households with annual incomes of \$10,000 or more in seven emerging economies by converting data on disposable incomes for each household income tier (five tiers from the top 20% to the bottom 20%) into continuous curves based on logarithmic logistic distribution.

The data on actual results were used to estimate the relationships between economic growth and income in each country throughout Asia in projecting changes in income distribution as per capita GDP (gross domestic product) grows (Attached Figure). The projections made by the United

Nations were used for forecasts for population growth. The data published by IMF (International Monetary Fund) were used for the future growth of the GDP in each country; data in and after 2015 were estimated by NRI.

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Attached Figure: Relationships between Per Capita GDP and Income Distribution in Seven Emerging Economies



Source: Forecasts by NRI based on World Income Distribution 2008 – 09 published by Euromonitor International and World Development Indicators published annually by the World Bank.

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