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Overcoming institutional distance: Expansion to base-of-the-pyramid markets

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ABSTRACT

The paper assesses the international expansion of developed-country multinationals to base-of-the-pyramid markets to launch new-to-the-world product innovations. The case study, of Philips Lighting, uses an international-business framework on the transferability and development of capabilities during international expansion. Institutional distance limits transferability from developed-country markets to base-of-the-pyramid markets; heterogeneity limits transferability across base-of-the-pyramid markets. The case shows that only extant capabilities independent of an institutional context are transferable, thereby forcing the firm to pay more attention to locally building new capabilities for market research and distribution. The transferable capabilities are mainly procedural (such as a customer-centric vision, and experience in high-tech product development); collaboration with local partners eases the development of new capabilities. Firms can improve their base-of-the-pyramid internationalization strategy by assessing the transferability of their capabilities and by adapting their organizational structure to stimulate knowledge sharing when building new capabilities.

1. Introduction

"The approach is the same, but the way is different," a Philips employee answered when asked about the difference between targeting potential customers in developed countries and targeting the base-of-the-pyramid population, being the lower tier in the pyramidal categorization of the world population according to annual per capita income, or the 4 billion poorest people in the world (Prahalad & Hart, 2002). His answer refers to how each international expansion has similarities ("the approach is the same, …"), but that the institutional voids in less developed countries (such as weak regulatory institutions and an inadequate intermediary infrastructure for marketing and distribution, especially towards the poor in dispersed, rural communities) force a firm to rethink the on-the-ground implementation of its expansion strategy ("… but the way is different"). The difference originates from the distance between the multinational's traditional working environment—the developed countries (Rugman & Verbeke, 2004)—and the low-income markets in less developed countries. The expansion of developed-country multinationals into the distant, foreign base-of-the-pyramid markets is central in the base-of-the-pyramid proposition. How the foreignness of a developed-country multinational affects the expansion towards the base of the pyramid is the subject of this paper, analyzing the extant capabilities that facilitate a firm's first steps into the base of the pyramid and the capabilities the firm builds locally. The ultimate question is how the firm can transfer capabilities to expand to other base-of-the-pyramid markets.

The base-of-the-pyramid proposition addresses developed-country multinationals, points them at the possibilities of approaching the consumer market of the poor with newly developed products (contrary to general belief), and suggests adaptations in business models to do so profitably (Hart, 2010; Hart & Christensen, 2002; Prahalad, 2006; Simanis & Hart, 2008). These suggestions lay the foundation for the base-of-the-pyramid proposition (Karnani, 2007).

London and Hart (2004) and Hart (2010) advise companies to develop a native capability or social embeddedness: a multinational must become accustomed to the markets of the poor in less developed countries, and get to know and understand how the poor live (London & Hart, 2004). Even though international-business research has focused on business expansion in developed countries (Ellis & Zhan, 2011; London & Hart, 2004), international-business concepts are useful to analyze how multinationals can develop a base-of-the-pyramid internationalization strategy. Base-of-the-pyramid proponents emphasize the advantages of developed-country multinationals in the base-of-the-pyramid markets, but critics (e.g., Karnani, 2007) point at the disadvantages of developed-country multinationals compared to domestic firms and the disadvantages compared to small local enterprises. The literature on the base-of-the-pyramid proposition extensively discusses the motives for entering base-of-the-pyramid markets (such as the vast unmet needs) and the required adaptations to the business model (such as changing mentality and working with partners), but pays less attention to the specificities and complexities of international expansion. This paper uses international-business concepts to analyze base-of-the-

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pyramid internationalization, and subsequently explores the internationalization of developed-country multinationals towards the base of the pyramid using a real world case study of the activities of Philips Lighting.

2. International expansion to the base of the pyramid

International expansion to the base-of-the-pyramid markets requires great efforts from multinationals as they lack experience and affinity with those markets (Prahalad & Hammond, 2002). International-business literature has conventionally called a foreign multinational disadvantaged compared to a domestic firm because of the multinational's "unfamiliarity with and lack of roots in a local environment" (Zaheer, 1995, p. 343). Zaheer (1995) labeled the disadvantage a liability of foreignness. Sethi and Judge (2009), however, point out that a multinational can also experience advantages from being foreign and being a multinational.

Verbeke's (2009, pp. 136–137) conceptual framework explains how a firm, while expanding internationally, can leverage extant capabilities to new markets as long as the capabilities are not bound to the initial location; how a firm may have to build new capabilities in a new host market; and how distance with the host market affects the leveraging and building of capabilities. Applied to the base of the pyramid, Verbeke's framework helps to analyze the advantages and disadvantages for developed-country multinationals expanding to base-of-the-pyramid markets. The framework will serve as the conceptual backbone of this paper.

2.1. Distance to the base of the pyramid

A larger distance decreases the transferability of capabilities across countries, and forces a multinational to put more effort into getting to know the new environment to develop new capabilities (Verbeke, 2009, p. 137). Distance transcends the conventional geographical distance to include distance in terms of culture, administrative or legislative heritage, and economic development (Ghemawat, 2001). Khanna, Palepu, and Sinha (2005) and Webb, Kistruck, Ireland, and Ketchen (2010) emphasize the institutional distance between developed and less developed countries. Institutional distance refers to the differences in terms of "product, capital, and labor markets; […] regulatory system; and […] mechanisms for enforcing contracts" (Khanna & Palepu, 1997, p. 41). A multinational's foreignness to a host country manifests itself in a lack of knowledge on the local market and a lack of local contacts (Sethi & Judge, 2009). In developed countries, firms rely on intermediaries, and the presence of strong institutions allows firms to focus on core activities (Khanna & Palepu, 1997). The generally weak institutions in less developed countries force firms to take on a wider range of activities, including market research and distribution (Khanna & Palepu, 1997; Khanna et al., 2005).

2.2. Leveraging extant capabilities

Seelos and Mair (2006, p. 2) point out that "resources and capabilities that companies have developed in mature markets may be of low or uncertain value in the context of poor countries." In the presence of institutional voids such as at the base of the pyramid a multinational can no longer rely on all skills developed in the home-country's institutional context (Anderson & Markides, 2007; Khanna et al., 2005; Verbeke, 2009, p. 136; Webb et al., 2010). The capabilities that a multinational can leverage to the base-of-the-pyramid markets would therefore be independent of an institutional context. According to Hart (2010, pp. 19, 104) these capabilities are managerial, financial, and technological resources, and the ability to learn.

2.3. Building new capabilities

The base-of-the-pyramid literature pays more attention to building new capabilities than to leveraging extant capabilities (Chesbrough, Ahern, Finn, & Guerraz, 2006; Prahalad & Hart, 2002): building local capabilities takes a firm more effort than conventionally presumed (Tallman & Fladmore-Lindquist, 2002).

The base-of-the-pyramid literature emphasizes the importance of social embeddedness to overcome the liability of foreignness. Hart (2010) advises invention together with the poor to get a deep understanding of how the local community works (based on two-way communication between the firm and the community; Hart & Sharma, 2004), resulting into products that fit the local way of living.

A multinational may learn about the cultures and lifestyles of the poor on its own. To deeply understand the local community before developing a product, the multinational can, for example, let employees live in a community among the poor for a while (Hart, 2010, p.231; Simanis & Hart, 2008).

A multinational can also learn about the poor by tapping into complementary resources of other organizations (Verbeke, 2009, p. 34, 50). A multinational can gather local knowledge from, get access to, and gain credibility with the poor through local partners (London & Hart, 2004; Seelos & Mair, 2006; Webb et al., 2010). London and Hart (2004) advise firms to collaborate with non-traditional partners, such as local governments, non-governmental organizations, and local community groups. Especially non-governmental organizations would be valuable partners to bridge institutional distance and build base-of-the-pyramid business models (Chesbrough et al., 2006; Webb et al., 2010). Small local entrepreneurs could build the last mile of the distribution chain (Vachani & Smith, 2008). Working with non-traditional partners requires great effort and time due to differences in location, mission, and organizational culture (Arora & Romijn, 2009; Webb et al., 2010).

2.4. Base-of-the-pyramid transferability

The multinational's global reach would be its main asset to expand to a market of 4 billion people (Prahalad & Hart, 2002). Few studies have, however, paid attention to the expansion of base-of-the-pyramid projects (Arora & Romijn, 2009), where a multinational leverages capabilities across base-of-the-pyramid markets. The firm can use the knowledge gained and competencies developed in one base-of-the-pyramid market continuously for a deeper understanding of that first base-of-the-pyramid market, and later apply them in succeeding base-of-the-pyramid markets. Cultural and institutional distance between base-of-the-pyramid markets, however, limits base-of-the-pyramid transferability as firms, for example, have to adapt products and search different partners (Arora & Romijn, 2009; Webb et al., 2010). The firm may even be able to transfer some new capabilities to more developed markets (Hart & Christensen, 2002).

2.5. An enabling organizational structure

Internal organizational barriers can hamper the success of base-of-the-pyramid projects (see Hart, 2010, pp. 176, 273–274; Olsen & Boxenbaum, 2009). Barriers for setting up and implementing base-of-the-pyramid projects revolve around the difficulties in changing mindsets, evaluation methods, and routines (Olsen & Boxenbaum, 2009). Having a win-win mindset is important: a belief that projects can create mutual value, benefiting both the poor and the firm (London, 2007; London, Anupindi, & Sheth, 2010; Olsen & Boxenbaum, 2009). As base-of-the-pyramid projects often have longer expected payback periods and higher perceived risk, Hart and Milstein (2003) and Prahalad and Hammond (2002) advise multinationals to separate the funding pool for base-of-the-pyramid projects from the pool for other