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By Stuart L. Hart & Ted London

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What multinational corporations can learn from the base of the pyramid

A FEW years into the 21st century, multinational corporations (MNCs) find themselves on the horns of a dilemma. With the unprecedented performance of stocks over much of recent history as a backdrop, their shareholders now expect double-digit returns, yet the global economy limps along at an annual average rate of growth of only 2-3 percent. In addition, most large companies seem to be mired in saturated markets, so how will they be able to achieve high growth in the coming years? Meanwhile, the rapid rise of global capitalism over the past decade has been accompanied by mounting concerns over environmental degradation, labor exploitation, cultural hegemony, and loss of local autonomy, particularly among developing nations. Must corporations' quest for future growth serve only to fan the flames of the antiglobalization movement?

The best way out of this global "Catch-22" is for MNCs to focus on emerging markets, not the incremental market expansion targeted at the wealthy few, but the much larger base of the economic pyramid (BOP) – where between 4 and 5 billion people (fully two-thirds of humanity) have been bypassed or damaged by globalization. Much like the proverbial iceberg with only its tip in plain view, this huge segment of the global population – along with its massive potential market – has remained largely invisible to the corporate sector. To address this, MNCs must combine their advanced technology and global reach with a new type of deep local understanding, based on engaging local

PHOTOGRAPH BY JERRY ALEXANDER

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people. An effective combination of local and global knowledge is needed, not a replication of the Western system. This combination requires the development of a new capability – native capability. As organic agriculture pioneer Wes Jackson says, we must figure out how, once again, to become native to this place.[1]

The Wealth Trapped in the Underground Economy

For the past half-century, MNCs have chosen to focus their attention on the very tip of the world economic pyramid, where 75-100 million highly affluent "Tier 1" consumers reside[2] (see chart, p. 31). This is a cosmopolitan group, to be sure, composed of upper-income people in developed countries, especially the United States, Western Europe, and Japan, and the few rich elites from the developing world. Initial forays into so-called "emerging markets" – the former Soviet Union and its allies, along with China, India, and Latin America – focused exclusively on the 800 million or so wealthy customers, ignoring the vast majority of people considered too poor to be viable customers.

Now, with stagnation in the established markets of the world economy and rising antiglobalization sentiments, the opportunities for serving the huge base of the pyramid are becoming increasingly attractive. The good news is that concealed below the surface of the purchasing power parity numbers is an immense and fast-growing economic system that includes a thriving community of small enterprises, barter exchanges, sustainable livelihoods activities, and subsistence farming.[3] Indeed, it is estimated that well over half of the total economic activity in the developing world takes place outside the formal economy, in the so-called informal or extralegal sector.[4]

The base of the pyramid is also rich in assets, although most are unregistered, and therefore remain invisible. Indeed, Hernando de Soto, in "The Mystery of Capital," estimates that there is well over $9 *trillion* worth of unregistered assets (e.g., houses, equipment, etc.) in the rural villages and urban slums of the world.[5] Because the poor typically do not hold legal title to these assets, they remain trapped and underleveraged, protected only by the informal property systems enforced by local strongmen.

Becoming Indigenous: A Two-Way Street

In order to work at the base of the pyramid, large corporations need to learn how to become "indigenous" to the places in which they operate (see Cemex article, p. 34). Doing so will require that they first widen the corporate bandwidth by admitting voices that have, up to now, been excluded; it will also entail the development of new "native" capabilities which enable a company to develop fully contextualized solutions to real problems in ways that respect local culture and natural diversity. When combined with MNCs' ability to provide technical resources, investment, and global learning, native capability can enable companies to become truly embedded in the local context.

The base of the pyramid presents unique challenges for MNCs – it violates nearly every assumption associated with successfully serving the top of the pyramid. In fact, the biggest challenge for MNCs may have less to do with technology, intellectual property, or rule of law, even though these issues have dominated most of the work to date relating to emerging markets.[6] Instead, the fundamental challenge may be one of business model innovation – breaking free of the established mindsets, systems, and metrics that constrain the imagination of incumbent firms. Witness Nike's failed attempt to introduce its "World Shoe" in the BOP.

In an attempt to stimulate growth, Nike began to produce an athletic shoe for the booming low-income populations in China. Based upon a relatively low price point ($10-$15 per pair), the World Shoe was designed as a product that could appeal to the masses who could not afford Nike's top-of-the-line products. The World Shoe's failure in China can be traced, at least in part, to a lack of empathy and inability to reconcile disconfirming information.[7]

Nike's first mistake was to rely exclusively on its existing contract factory network to produce the product. These contract manufacturers produced Nike's high-end products and were rewarded based upon contribution margin. Because of the low price point of the World Shoe, there was a built-in disincentive for them to produce this new product. Nike also utilized its established in-country channels – primarily high-end retailers in China's large cities – to distribute the World Shoe. In fact, the World Shoe was displayed side by side with the $150 Air Max in upscale retail outlets in Beijing and Shanghai.

Rather than cajoling its existing contract manufacturers and distribution channels to produce and distribute the low-end World Shoes, Nike might have explored partnerships with counterfeiters and other local producers. Indeed, counterfeit producers possessed exactly what Nike lacked – production capacity – as well as distribution capabilities to reach precisely the low-income markets that Nike was trying to capture. Nike could have eliminated a fierce competitor and transferred its social and envi-

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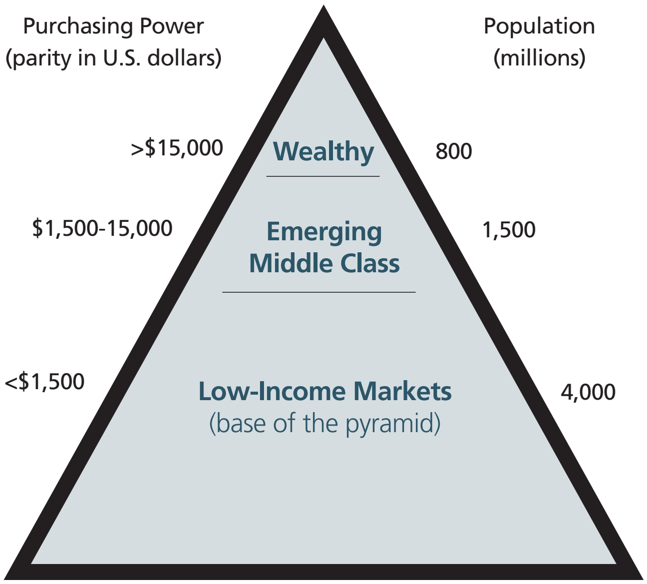
THE GLOBAL PYRAMID



SOURCE: Adapted from C.K. Prahalad and Hart, "The Fortune at the Bottom of the Pyramid," *Strategy + Business* 26: 54-67, with assistance from Ted London.

ronmental practices to the counterfeit producers – a win-win for all involved. The result might have been a business model that competes based on social capital, quality, and value for money rather than trademark and legal protection. Instead, the World Shoe project was shut down after failing to make even the modest sales targets that had been set. Producing a lower-cost shoe using the existing business system meant, paradoxically, that Nike failed to reach its target customer.

Coinvent Custom Solutions

Companies interested in developing responsive technologies and products at the base of the pyramid can learn much from fields such as rural sociology, applied anthropology, and empathy-based design. These disciplines stress the importance of codeveloping custom solutions to problems through two-way information flow. Rather than imposing preexisting solutions from above, the emphasis is on working with local partners to codesign every aspect of the product or service, including its delivery.

In our study of BOP ventures, Ted London and I discovered that successful initiatives – those that became embedded in the local community – maximized the *functionality* of the product or service in terms that were important to local users. This often meant allowing the product and business model to coevolve. As one of our respondents indicated, successful initiatives require "everybody who touches it to make money."[8] Poorly performing ventures, on the other hand, tended to view the value proposition in terms of the product itself and often completed the development process at a geographically distant location, such as the corporate R&D center, before the business model was designed.

The Indian tobacco giant ITC (formerly the Imperial Tobacco Company) was successful in marrying high-technology with traditional economic systems in its agricultural commodities business. ITC had purchased and exported Indian soy products for over a century, but the inefficiencies of the agricultural system were hindering its success. ITC exploited its knowledge of the traditional agricultural system and modern technology to increase the efficiency of the soy market in India, increasing wealth throughout the entire supply chain.

The traditional agricultural system in India was centered on *mandis* – the markets where farmers brought their produce to be auctioned. Given the obvious power asymmetries (i.e., the auctioneers had better information about commodity prices than the farmers), small farmers were often paid far less than they deserved for their produce. To facilitate better information access, ITC created a soy Web site. To address the obvious shortages – phone lines, electricity, and literate farmers – the company has provided satellite links, solar batteries, and *e-choupals*, electronic meeting places run by carefully chosen microentrepreneurs. *E-choupals* are a network of electronic meeting places in over 4,000 rural villages in India.[9]

The *e-choupals* have enabled farmers to level the playing field by gaining better access to market conditions, prices, and even other potential buyers. By eliminating the stranglehold of the *mandis*, ITC has been able to source agricultural commodities at more favorable prices, while at the same time increasing the bargaining power – and incomes – of the small farmers.[10] Thus, two of the big roadblocks faced by rural economies are mitigated by *e-choupals*: virtual aggregation provides bargaining power for even the smallest producers, and better information helps overcome uncertainty and isolation.

Once the *e-choupal* is established in a village, there is no shortage of other potential users: governments, putting their services online; consumer goods firms that are otherwise unable to reach rural villages; microcredit providers; etc. The possibilities are virtually limitless. Thus, rather than selling a defined end-product such as a consumer good, *e-choupals* instead create the *potential* for many new, perhaps unanticipated, economic activities to blossom, driven by local needs and capabilities.

ITC intends to reach 100,000 villages with its network in the next decade. The rural connectivity brought by initiatives such as *e-choupal* could literally transform the countryside in India. Ventures like this, which provide both in-reach and outreach, constitute the ultimate in creation of potential. For MNCs, therefore, identifying opportunities to create new potential constitutes another important vehicle for reaching the BOP.

Fly Under the Radar

Avoiding dependence on central institutions – national governments, corrupt regimes, and central infrastructure planning – appears to be a critical aspect of native capability. By "flying under the radar" of corruption, organizations can avoid all the problems that go along with having to deal with difficult – and changeable – central regimes. For example, both ApproTEC and World Water sought to help the rural poor gain better access to clean water. The former – which flew under the radar – is

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thriving, while the latter – which worked with central regimes – is floundering.

World Water Corporation was founded in 1984 in response to a perceived vacuum in private business activity supplying water and power in developing countries.[11] One of its notable products is the AquaSafe solar-powered water pump. This technology can pump 10 times the volume of any other solar water pump in the world – more than 2,000 gallons of water per minute from rivers and other surface water. The technology can also be used to pump groundwater up to 1,000 feet deep, to bring up clean water from wells. Given that water shortages are a major global problem, the company was confident that its powerful solar water systems would find a big market worldwide, and it went public in 1997.

By 2000, World Water Corporation had established operations in 17 developing countries, including Somalia, Pakistan, and the Philippines. Typically, the company worked through the central government to sign long-term agreements to serve as consultant and contractor for water and energy programs, with a focus on rural areas.

Unfortunately, despite World Water's best efforts, the unstable and corrupt nature of its clients' governments has put the viability of the company at serious risk. The highly visible nature of the agreements makes the scale and scope of the agreement – and the potential profit for World Water – readily apparent to a broad range of bureaucrats, government officials, and others who might benefit from either derailing the project or currying favor before it is allowed to move forward. As a result of these problems, the company's international business prospects have soured considerably, and the company's stock was only trading at about 30 cents per share in August 2004.

By contrast, ApproTEC, a Kenya-based social venture, also focused on water pumping in the Third World, but took a very different approach – both technologically and in terms of business model. ApproTEC's MoneyMaker irrigation pump is manually operated by small farmers and was codesigned with them to ensure product acceptance. At under $100, the pump was directly affordable by the end consumer, meaning that ApproTEC could launch its business on a small-scale basis and allow it to grow organically over time. It bypassed the need to deal with the central governments of Kenya and Tanzania, thereby avoiding the types of complexity and corruption that World Water exposed itself to. ApproTEC is now expanding across Africa and it estimates that the additional income generated by its water pumps equals 0.5 percent of Kenya's gross domestic product (GDP).[12]

Work With Nontraditional Partners

Companies facing challenging new environments usually need to turn to partner organizations for missing resources and expertise. Indeed, governments often require MNCs to have a local corporate partner to ensure market access in emerging economies. When entering the base of the pyramid, however, firms may need to dramatically expand the potential field of alliance partners since the large national players familiar with the ways of global capitalism seldom serve the rural poor or shantytown dwellers in their own countries.

One BOP venture in Kenya – Honey Care Africa – created a particularly interesting three-way partnership between the private sector, the development sector, and the local community. The partnership exploits the core competencies of each of the partners: the private sector's marketing prowess, the development sector's social capital and microfinance expertise, and the local community's entrepreneurial spirit. The end objective and reason for creating Honey Care was to make beekeeping accessible to poor farmers, and to create a domestic source of high-quality honey for Kenya.

Traditionally, Kenyan communities used log hives, baskets, or clay pots for beekeeping. While cheap to set up, these crude techniques produced small volumes of poor-quality honey. Honey Care thus based its business model on making advanced, yet context-appropriate beekeeping equipment available to these small farmers. They procure and sell all of the equipment required to establish a beekeeping enterprise – Langstroth hives, honey harvesting kits, and honey production machines – to a development-sector partner. In turn, this organization leverages local social capital to provide microcredit financing to small farmers for the purchase of the equipment. Honey Care does not allow its development agency partners to outright donate beekeeping equipment, as it believes that sustainable rural development cannot be achieved via "handouts."[13]

Honey Care takes many steps to ensure that all parties in the relationship are successful. First, it requires that the farmers receive extensive beekeeping training before receiving the microfinance loans. By understanding how to best utilize their new equipment, beekeepers will be more likely to have higher quantity and quality yields. Honey Care also commits to purchasing all of the honey produced by these farmers, guaranteeing them a steady income and providing Honey Care with a loyal supply of high-quality honey. Lastly, Honey Care deducts a designated percentage of their earnings and uses it to repay the farmers' loans. The guaranteed income and mandatory repayment process greatly decreases the default risk of the loans.[14] Not only does the microfinance partner benefit from this lowered risk, but the farmer is able to develop a positive credit history. Honey Care sells the honey to distributors and retailers for sale to end consumers.

By working with nontraditional partners who were embedded in the local scene, Honey Care Africa has been able to become indigenous, while leveraging its core competencies in equipment procurement and marketing. The company has achieved success by doubling the income of many poor farmers, providing high-quality honey for the Kenyan market, and creating economic, social, and environmental value for local

Of the 3.7 million recipients of Grameen Bank's "microloans" in Bangladesh (left), which require no collateral, 96 percent are women.

PHOTOGRAPH COURTESY OF GRAMEEN BANK

communities. Indeed, Honey Care is today the largest producer of high-quality honey in East Africa.[15]

Build Social, Not Legal, Contracts

In the informal sectors, relationships are primarily grounded in social – not legal – contracts, and the organizations with the most expertise in serving these populations – local government and civil society – have a strong social orientation. Successfully operating in this space requires a capability to understand and appreciate the benefits of the existing social infrastructure, not complain about its lack of Western-style institutions.

The lending model of the Grameen Bank in Bangladesh, for example, entails no legally enforceable instruments whatsoever. To succeed, it was necessary for Grameen to turn most of the established assumptions about banking (e.g., loan size, need for collateral, contractual enforcement) upside down. Grameen instead focused on making very small loans to poor women based upon a "peer lending" model where small groups of loan recipients became mutually responsible for each others' credit. Since there is no collateral, legal papers would be useless. If a borrower defaults, bank staff work with her to restructure the debt or plan an alternative repayment schedule. The entire business model is based upon social capital and trust.

By the late 1990s, Grameen was lending in excess of $250 million each year to more than 2.3 million poor customers in over 40,000 villages throughout Bangladesh. Even more amazing, it achieved a 95 percent repayment rate, the highest of any bank on the Indian subcontinent, and indeed much higher even compared to North American and European banks in the United States. The imagination of the Grameen Bank has led to a global explosion of institutional interest in microlending over the past decade, including the recent entry of financial giants such as Citigroup.

Moving Beyond the Transnational Model

For MNCs to flourish in the 21st century, it appears that they must expand their conception of the global economy to include the varied economic activities that occur outside of the formal, wage-based economy. They must embrace the informal, barter, and household economies and tailor their business models to enhance the way people currently live. In partnership with local entrepreneurs, NGOs, and local governments, MNCs can help build a system of governance *from the ground up*, rather than waiting for corrupt central governments to reform.

Native capability enables the corporation to become truly *embedded* – part of the local landscape – rather than an alien force that imposes its will from the outside. Embeddedness takes time to develop and cannot be quickly duplicated by competitors. Competitive advantage is then based upon deep understanding of and integration with the local environment. Companies earn it by creating a web of trusted connections with a diversity of organizations and building on the available social infrastructure. Rather than looking to overcome limitations in the environment – lack of central institutions, rule of law, etc. – native capability emphasizes the crafting of strategies that build on *existing* conditions and resources.

Unlike the conventional transnational model, which focuses on transferring proprietary resources from within the firm, native capability assumes that the critical knowledge for success lies beyond the firm's boundaries. MNCs, not their local partners, are the ones that must do the unlearning. Given that, competitive advantage is premised less on protecting existing proprietary technology or intellectual property, and more on developing trust and social capital. Generic principles and learnings from specific settings, however, can and must be transferred and applied in other BOP contexts – that is how the capability is fostered and spread. The time has come for MNCs to move beyond the traditional conception of transnational success. And developing native capability is one of the keys to creating a truly sustainable global enterprise. □

1 Wes Jackson, "Becoming Native to This Place" (New York: Counterpoint, 1994).
2 Portions of this section are excerpted from Prahalad and Hart, Op. cit.
3 London and Hart, Op. cit.
4 Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
5 De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.*
6 See, for example, Robert Hoskisson, Lorraine Eden, Chung-Ming Lau, and Michael Wright, "Strategy in Emerging Economies," *Academy of Management Journal* 43, no. 3 (2000): 249-267; David Arnold and John Quelch, "New Strategies in Emerging Economies," *Sloan Management Review* 40, no. 1 (1998): 7-20.
7 See Heather McDonald, Ted London, and Stuart Hart, "Expanding the Playing Field: Nike's World Shoe Project" (Washington, D.C.: World Resources Institute, 2002).
8 London and Hart, Op. cit.
9 For a full description of e-choupal, see: "Yogeth Deveshwar, the Boss of India's Biggest Tobacco Firm, is Putting Rural India Online," *The Economist*, June 5, 2004.
10 For more information on the e-choupals see C.K. Prahalad, "The Fortune at the Bottom of the Pyramid" (University of Pennsylvania: Wharton School Publishing, 2005).
11 See www.worldwater.com/company_history.htlm.
12 ApproTEC. "The Impacts." http://www.approtec.org/impacts.shtml.
13 Honey Care Africa. Frequently Asked Questions. http://www.honeycareafrica.com/aboutus/faqs.htm#Why
14 Honey Care Africa. How Honey Care Works. http://www.honeycareafrica.com/aboutus/howhoneycareworks.htm
15 See IFC-backed Kenyan SME project wins sustainable development prize, Jan. 7, 2003, http://web.worldbank.org.