Learning to compete: transforming firms in the face of radical environment change

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Over the last decade, Latin American economies and companies have witnessed substantial changes as their economies have been reformed and opened to world markets. Firms that have adapted to these changes may have useful lessons to offer to companies in other countries as they face economic transformation and expanding competition.

In Latin America, coping with the new environment was not easy. Changes were swift and felt simultaneously in different dimensions of a firm’s environment: labour market; competitors; financial markets; and government regulation. Many firms were unable to adapt. Others, however, took advantage of the openings offered by deregulation and liberalisation to become world-class players, fighting for a prime place in global markets.

The transformation process that successful firms undergo when faced with radical economic reform is complex. Managing in uncertain and fast-changing conditions is a challenge. Even so, our research in the region illustrates the main action plans carried out by managers and provides a rationale for the sequencing and timing of different plans.

The similar patterns the research found in different industries and countries lead us to believe that our findings may be regular enough to inform firms in other industries and geographical settings.

The structural reforms that took place in Latin America are representative of many emerging economies that are struggling to move towards market-driven growth. Indeed, the framework could prove valuable for any firm that enjoyed a protected environment over an extended period and is now facing increased competition due to reforms or industry deregulation.
Structural reform in Latin America

Over the last 25 years a long-lasting change in development policy has occurred in Latin America. Starting with Chile in the mid-1970s, by the second half of the 1980s most countries in the region had initiated radical economic reform to replace the old model of state-directed import-substituting industrialisation. The new development strategy had four fundamental components: macroeconomic stability; trade openness; a reduced role for government – through privatisation and deregulation; and the implementation of strategies to reduce poverty.

This approach has led to profound structural reforms in tariffs, taxes, the control of the financial system and the role of state enterprise. Although countries have adopted different reform sequences and their implementations have varied in scope and content, there seems to be agreement that for structural reforms to take hold they must follow a period of macroeconomic stability.

Reforms may be classified according to their purpose and the sequence in which they are typically implemented (see Table 1). The so-called first-generation reforms are geared towards opening an economy to foreign competition, giving market forces the leading role in allocating resources (liberating the financial and labour markets) and reducing the public sector’s role in productive activities. Second-generation reforms aim to complete the transformation of the role of the state and develop accountable government institutions that will guarantee the rule of law and support private-sector initiative and activity.

Table 1
Classification of economic reforms

<table>
<thead>
<tr>
<th>Types of economic reforms typically implemented by governments</th>
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<tr>
<td>Structural reform</td>
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<tr>
<td><strong>First generation</strong></td>
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<tr>
<td>Trade reform</td>
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<tr>
<td>Financial reform</td>
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<tr>
<td>Labour reform</td>
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<td>Privatisation</td>
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<td>Tax reform efficiency</td>
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<tr>
<td><strong>Second generation</strong></td>
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<tr>
<td>Reforms to the judicial system</td>
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<tr>
<td>Reforms to the regulatory system</td>
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<tr>
<td>Improve quality of public expenditure</td>
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There have been a number of efforts to describe and quantify the reform process in Latin America. Although methods and measurements vary among studies, most evidence shows dramatic progress in first-generation reforms for the whole region (though few countries have initiated the implementation of second-generation reforms).

A 1999 report, *Indexes of Structural Reform in Latin America*, measured the reform efforts in 17 countries across five first-generation reform areas: trade reform; domestic financial liberalisation; liberalisation of external financial transactions; privatisation; and tax reform. For each reform dimension, an index was developed to measure the efforts that governments had made to implement the reform packages and a general reform index was calculated averaging the five reform indices. The resulting indices permit an examination of the sequence, timing and intensity of reform processes across countries and areas of reform.

The aggregate numbers tell a story of dramatic reform for the whole region (see Figure 1). The reform efforts initiated in some countries during the early 1970s, came to a halt after the debt crisis of 1982 but spread throughout the region after 1985. The general reform index for the region moved from 54 per cent in 1985 to 82 per cent in 1995.

**Transformation of firms**

Drastic reform patterns such as the ones illustrated in Figure 1 have implied dramatic changes in the competitive environment for firms in the region. Consider the following specific changes:

- Chile’s monopoly in long-distance telecommunications was replaced in the early 1990s by a fragmented industry with eight fierce competitors.
- In 1991 Peru enacted a new tariff scheme that lowered tariff rates for most products from a maximum of 215 per cent to a maximum of 15 per cent.
- Firms in Argentina faced an annual interest rate of 167 per cent in 1987 and 1,518 per cent in 1990. In 1992, two years into the economic reforms, this number had shrunk to 16 per cent.
- Mexico’s foreign direct investment went from $2.8bn in 1988 to $11.5bn in 1994, representing more than four per cent of Mexican GDP.

Such drastic changes in the competitive environment represented large challenges for local firms, long used to limited internal competition and basic protection from foreign exposure. Only a handful of firms in each industry survived and prospered. How did they manage to do it?

We define a competitive transformation process as the main chain of actions that firms undertake in order to achieve increasing levels of competitiveness in their respective industries. To a certain extent, all firms are constantly involved in some sort of change in order to
be more competitive. What makes the case of structural reforms interesting is the depth and intensity of the changes involved, as they represent a radical departure from previous practices and are done in a short period.

In most cases, changes in the competitive environment prompted by economic reforms have a dramatic and direct impact on firms and their markets. For example, steel producers in Mexico saw a reduction in steel prices of 40 per cent overnight due to a drastic reduction of tariffs and non-tariff import controls.

Such radical change in the environment confronts firms with the decision to either engage in a major transformation process or exit the industry. This is depicted as a “direct impact” trigger in Figure 2 and requires an immediate reaction by the firm.

Changes in the competitive environment, however, do not always have a direct impact on the day-to-day business of a firm. When a firm competes in a sector that, because of its dynamics or strong customer preferences, tends to be dominated by local firms, price reductions in import products do not represent an immediate threat to local producers. In cases like this, changes in the environment open a new set of opportunities.

Exploiting these new opportunities requires a significant transformation of the firm, though the adjustment to exploit them can be gradual. The transformation path to exploit these new opportunities, albeit at a slower pace, tends to show the same pattern as that experienced by firms that have to react to more sudden threats.

Our analysis of the actions taken suggests the transformation process that organisations go through (see Table 2). A stage of transformation is a period of time during which a firm focuses on a particular set of related issues – the main “theme” behind the actions being undertaken. Firms that successfully cope with radical change in the environment transform themselves into more competitive organisations by organising their actions around four major stages: operational effectiveness and cultural turnaround; expansion; acquisition of new capabilities; and quest for leadership.

Table 2
Main set of initiatives during the competitive transformation process

<table>
<thead>
<tr>
<th>Stage of transformation</th>
<th>Trigger economic reform</th>
<th>Main firm-level initiatives</th>
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<tbody>
<tr>
<td>Operational effectiveness and cultural turnaround</td>
<td>Commercial reform (tariffs) Privatisation Organisational redesign</td>
<td>Focus on basic efficiency and quality Changing the mindset of the firm</td>
</tr>
<tr>
<td>Expansion</td>
<td>International financial reform Domestic financial reform</td>
<td>Boosting investment New forms of financing Quest for growth</td>
</tr>
<tr>
<td>Acquisition of new capabilities</td>
<td></td>
<td>Customer service Managing technology and innovation Managing image and brand awareness</td>
</tr>
<tr>
<td>Quest for leadership</td>
<td></td>
<td>Challenging the first world Creating a multinational structure and policies</td>
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Stage 1: operational effectiveness and cultural turnaround

After trade liberalisation, firms suddenly realise that their efficiency and quality levels are below those of world-class competitors. During this first stage, firms initiate several action plans in order to narrow this performance gap. All too often this includes major changes in the structure, size, scope and particularly the culture of the firm. This first stage is consistent with the movement towards the “productivity frontier” described by Michael Porter.

The first transformation stage was seen in all companies in our sample and it typically lasted for two to three years. In this stage firms concentrate on three broad sets of initiatives: improvements in their cost structure (a focus on efficiency); redesigning the organisation to be consistent with the new efficiency principles; and changing the mindset or culture of the firm at all levels of the organisation.

Cost-reduction programmes aim to boost efficiency and take a variety of forms. Figure 3 shows the net change in workforce during the turnaround stage (Stage 1) for some firms in the sample. In our sample the most extreme case was YPF, the state-owned Argentine oil company privatised in 1991, which reduced its workforce from 55,000 employees in 1991 to 5,500 in 1993 – a 90 per cent reduction in two years. Not all firms, however, sought productivity gains through workforce reductions. Gener – the second-largest electricity generating firm in Chile – helped by a rapid expansion of its operations, was able to increase its productivity by renewing its workforce and increasing the number of people with higher education – the percentage of its employees with a college degree moved from 28 per cent in 1988 to 36 per cent in 1994.

Firms also act on other cost drivers in order to become more efficient. Enersis – an electricity conglomerate created in 1986 with the privatisation of the energy sector in Chile and the largest operator of electric utilities in Latin America today – found that one of its main cost items was “energy losses” from illegal connections and non-paying users. Enersis focused on decreasing those losses and managed to reduce them from 22 per cent in 1986 – the year when the first firm in the conglomerate was privatised – to 12 per cent in 1990. By 1999, Enersis’ level of “energy losses” was about six per cent.

This focused efficiency-enhancing effort typically pays off handsomely. Figure 4 shows data from our survey on steel producing units. In the cases of Argentina and Mexico we see an aggressive period of productivity enhancement followed by a levelling off in productivity gains. Over a short period, plants in the sample achieved an almost threefold increase in labour productivity. Dramatic changes such as these are the norm during this phase of the transformation processes.

A second set of initiatives in this stage is aimed at redesigning the organisational structure and reporting system. This change is necessary and instrumental for
the efficiency and quality efforts, as it promotes clear accountability throughout the organisation, making it easier to visualise each unit’s contribution to the final result. Implementing this change often entails moving from a functional structure to one based on business units.

Enersis, for example, created separate strategic business units for urban distribution, rural distribution, engineering and construction, software and procurement soon after its privatisation. Once the business units and their individual contributions are clearly identified firms tend to divest non-value generating activities or units. YPF reorganised itself into three main units – upstream business, downstream business and corporate – and divested several non-value-generating units such as cinemas and restaurants.

Drastic organisational and operational changes such as these require a corresponding change in the mindset of individuals working in the firm. Our interviewees pointed out three factors as the main catalysts for such organisational change: charismatic leadership; aggressive training; and new incentive schemes.

The former CEO of YPF, Jose Estenssoro, is a good example of the importance of a charismatic leader. Estenssoro was able to convince stakeholders of the importance of becoming leaner and more competitive. His ideas and enthusiasm permeated not only his own organisation but also government circles; he was instrumental in shaping government policy towards privatisation and was, up to his death in an air accident in 1995, widely seen as a key force in the competitive transformation of his company.

Similarly, Gener’s Bruno Philippi and Enersis’ Jose Yurasceck were able to generate very high loyalty and commitment from their employees during the first phase of their organisations’ transformation. The task was often described by our interviewees as involving a vast number of hours communicating with people in different parts of the organisation in order to bridge the gap between workers and top management. Gener, for example, organised regular breakfasts for the CEO and 15 to 20 workers. The breakfasts were used to gather feedback and rally support for the changes taking place.

It is also common for firms at this stage to boost their efforts on employee and worker training. YPF designed a training programme that started with top executives and then trickled down to all levels of the organisation. At different organisational levels highly motivated individuals with good communication skills were identified as “change agents” and were asked to help in the training effort.

Motivational speeches, good training courses and charismatic leadership are not always enough, however. New incentives also have to be devised. In their simplest form, incentives attempt to tie salaries to performance. Figure 5 shows evidence from steel-producing plants of this change towards performance-based salaries. Bolder steps include allowing workers to be stockholders of the firm, as Enersis did by allowing employees and workers to own as much as 30 per cent of the company during the first stage of transformation.

The first stage of transformation constitutes the basic foundation on which further change will be pursued. It is only when a firm has achieved reasonable productivity levels and a modern structure that more ambitious change can be implemented.

Stage 2: expansion

During the second transformation stage firms tend to expand their operations significantly. This push for rapid expansion comes from two main sources. First, the important changes in Stage I put a firm in a position to expand successfully as it realises that it can now

Figure 5

Steel plants in Argentina, Brazil, Chile, Mexico
tackle the many new opportunities open for growth. Second, firms realise that growth is imperative for survival in the new competitive environment and a powerful weapon against larger rivals.

Two main avenues for growth are typically pursued: expansion into related local businesses or expansion of the same business in other countries. Examples of the former are Enersis’ entry into power-generation via the control of Endesa in Chile and Sadia’s entry into prepared foods in Brazil (Endesa, formerly state-owned, is the largest electricity generation firm in Chile; Sadia is a food-processing conglomerate and Brazil’s largest poultry exporter). Examples of the latter are Gener’s expansion into Argentina and YPF’s entry into Chile with refining and distribution operations.

These examples, as most of the expansion efforts that we documented, occurred two to five years after the initial changes to increase operational effectiveness.

A second characteristic of this stage is the start of a massive investment plan aimed at both improving technology to world-class levels and satisfying a predicted increase in demand. Soon after the competitive transformation has begun, annual investment increases dramatically. For example, Hylsamex – the number-three steel producer in Mexico – introduced emerging mini-mill technology when it came to modernise plants and boost production, spending over $400m on the project.

Concurrently, new forms of financing this growth were developed. More professionally managed firms and opening economies paved the road for pioneering foreign funds. In July 1990, CTC – the largest Chilean telecommunications company, formerly state-owned and a monopoly in fixed lines – placed $100m in the form of the first Latin American ADR (American Depository Receipts) and started a trend that would be followed by many firms in the region. Enersis unveiled its ADR operation in 1993. Hylsamex issued Eurobonds for $175m in 1993 and ADRs in 1994. As of 1999, over 85 Latin American firms had issued ADRs in the US.

Stage 3: acquisition of new capabilities
In the midst of heavy expansion and investment firms quickly learn that having competitive costs and quality is not enough to succeed in the new environment.

The scale and geographical diversity achieved in Stage 2, and the nature of the challenges posed by larger foreign competitors, requires a new set of capabilities for continued success. More sophisticated clients and competitors demand increasingly sophisticated responses and strategies. Firms develop new capabilities in order to succeed; innovation is the name of the game.

For the first time, firms in these emerging economies are faced with the fact that the period of “catching up” is over. They have already learned as much as they can from foreign competitors and now they need to develop their own competitive capabilities and the mechanisms to sustain them over time. This stage typically starts four to six years after the impact of the reforms are felt in an industry.

Learning to excel in customer service is one of the steps in this new stage and sometimes this search takes a firm to its first true innovation. For example, Siderca, a producer of seamless steel tubes in Argentina, prompted by increased competition, pioneered an integrated service in the steel tube industry that included installing the tubes in customers’ oil wells and charging only for non-defective tubes after installation (tubes represent 15 per cent of the total cost of an oil well).

Based on the successful response to this new customer service strategy, it pursued it even further and was the first company to offer its customers the option to manage their tube inventory. Pemex, the state-owned Mexican oil company, was the first customer to operate under the new integrated service, resulting in a reduction of inventory from 200,000 to 17,000 tons. The new service became a standard in Pemex’s purchasing requests for tubes and now the service is being rolled out on a global basis.

Similarly, after investing in a new mini-mill, Hylsamex started to work closely with clients to understand their processes and products and be able to offer steel products tailored to their particular needs. This new production flexibility allowed clients to fine-tune their product characteristics with very short lead times – in some instances only a few days before their order was due to be delivered. By 1998 both Hylsamex and
Siderca were already working on extranet-based systems to give clients full access to their orders throughout the process.

It is in Stage 3 that firms start to manage their technological innovation process. Better technology allows firms to move to higher value-added products and services and/or lower costs and to develop differentiating technologies. Gener and YPF created “dual ladder” promotion systems in order to nurture and foster technological talent. YPF has a technological scanning unit and has even defined roles within the organisation to deal with the introduction of new technologies. Siderca created an R&D centre in 1995 staffed with scientists and engineers with doctorates and masters from the US and Europe. It also created a firm – DST Technologies, based in Liechtenstein – whose only role is to manage the intellectual assets of the group. (Siderca is now a major industry player in this realm; it owns three of the six high-performance tube thread technologies currently available in the market.)

In general, steel plants in Latin America understood that applied R&D was necessary and aggressively increased the number of qualified personnel (see Figure 6). In the food industry, Sadia took an even bolder step in order to move to higher value-added services.

It sold its large and profitable soy meal and meat businesses and decided to make an important inroad into processed foods such as fresh pasta and prepared and frozen food, putting great emphasis on product and process improvement through R&D.

An additional capability firms have to develop at this stage is brand and image management. Following reforms, heightened competition in existing markets and the explicit development of new markets during the expansion stage make it necessary for firms to learn to manage their image. The Chilean firm Enersis learned this the hard way when it faced a negative public reaction in Peru based on nationalistic feelings and again when a fire in its Argentinean operation left Buenos Aires dark for several days.

Firms have followed different strategies in order to improve their image and visibility. Modelo and Sadia, for example, have decided to concentrate their efforts in strengthening a single brand – Corona and Sadia – respectively. Other firms such as Chile’s largest brewery, CCU, have preferred to keep different brands in different countries. Interestingly, customers are not the only audience that firms must learn to inform and attract. The new scenario makes it very important to be visible to investors, bankers and other members of the international financial community. This also requires a new expertise that firms have had to develop.

Stage 4: quest for leadership

In this last stage, firms in emerging economies increasingly act and look like world leaders in their respective industries. They begin to alter their industry’s competitive pace and take customer expectations to new levels. Alternatively, some firms may find a unique position and a competitive combination that is different – but just as powerful – as world industry leaders. In either case firms start to devise their own “multinational” structure. This is done in pursuit of efficiency and synergies, as firms soon discover that with rapid international expansion there is a tendency to start duplicating functions in areas that could be better sourced or at least better co-ordinated from a single location.

For example, as its operations in Argentina grew larger, the Chilean firm Gener increasingly moved functions across the Andes. Argentina’s Siderca now manages human resource corporate policies from its location in Italy. Several firms, including Siderca and Enersis, created a holding company to host their international divisions.
Firms that have progressed as far as this last stage often take an aggressive competitive stance to signal a genuine quest for leadership on a world-wide basis. This often involves an incursion into the markets of industry leaders, as when Cementos Mexicanos (Cemex) bought the largest cement producer in Spain and instantly became one of the main global players in its industry. A similar situation happened when Argentina’s Siderca bought the Italian group Dalmine in 1997, becoming the largest seamless steel tube maker in the world.

Other similar stories have been less visible but equally interesting. Gerdau – a fast-growing Brazilian steel producer, operating nine steel mini-mills – purchased AmeriSteel, the second-largest US steel rebar manufacturer; Argentina’s YPF purchased the energy firm Maxxus in the US; and the Chilean firm Entel – formerly a monopoly in long-distance telephony in Chile – entered the long-distance US telephone market via the creation of AmericaTel.

Firms in emerging economies have also sought strategic alliances with larger firms in Europe or the US. In an interesting case, Enersis invited Endesa of Spain to form a consortium to respond to the privatisation of the Latin America electricity sector. After a reluctant start the Spanish firm not only agreed to invest in Latin America but later fought and won a hard battle to control Enersis. Modelo agreed to sell 35 per cent of his its stock to Anheuser-Busch, in exchange for technical collaboration. Gener convinced General Electric to form a joint venture to offer maintenance services to electricity firms in South America.

**Avoiding the trap of success**

The four stages do not always happen in distinct sequence. In most cases they overlap. (See Figure 7.) What is significant, however, is that in all successful organisations there was a deliberate, systematic and well-structured transformation effort. Furthermore, our data seems to suggest that there is a particular order in which things need to be tackled. The evolution from Stage 1 to Stage 4 changes the nature and source of the firms’ improvement, from basic operational effectiveness to advanced imitation and then – for those firms that get this far – to true innovation. By implementing specific action plans at each phase, firms change their source of power and improvement; they learn to compete.

The most successful firms in emerging economies have undergone an impressive transformation in the space of a few years. However, even these highly visible and successful firms face great challenges ahead. The final stage of transformation – becoming a multinational industry leader – is, for several reasons, perhaps the most difficult one for companies to face.

First, the size and potential of firms in the final stage of transformation captures the attention of much

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Figure 7

**Phases of a firm’s competitive transformation**

<table>
<thead>
<tr>
<th>Stage of transformation</th>
<th>Main source of improvement and competitive advantage</th>
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<tbody>
<tr>
<td>I</td>
<td>Operational Effectiveness</td>
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<tr>
<td>II</td>
<td>Expansion</td>
</tr>
<tr>
<td>III</td>
<td>New capabilities</td>
</tr>
<tr>
<td>IV</td>
<td>Quest for leadership</td>
</tr>
</tbody>
</table>

| Basic catch-up | Advanced imitation | Innovation |

Years after reforms begin

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larger firms from developed economies. Successful firms in emerging economies represent an interesting alternative for expansion and, in some cases, a potential threat to larger firms if given the time to grow and become stronger. In Latin America, for example, Spanish firms have been active in buying controlling shares in successful companies such as Enersis in Chile and YPF in Argentina. Had those Spanish firms waited longer the acquisition opportunity may no longer have been available.

Given that several European and US pioneers have demonstrated the benefits of investing in emerging economies, we would expect a more active presence of the larger players of the US and Europe in the years ahead.

Second, despite important advances in the liberalisation of capital, most firms in emerging economies – particularly the small ones – are unable to obtain a competitive cost of capital. Even firms with operations in the US or Europe pay a risk premium as most of their revenue and potential growth is in higher-risk countries.

Third, on a subtler level, becoming a leading multinational firm in many ways requires abandoning ties to a particular country of origin. This requires a true willingness to “play” in the global arena and, in some cases, perhaps even the need to move the headquarters or units to a different country. Such commitment to being global may represent an important cultural obstacle for some firms.

There are sizeable challenges ahead for Latin American firms in their quest for global competitiveness. But the experience and successful trajectory of several creative and long-term oriented firms show that it is possible for companies in emerging economies to learn to compete globally and become leading firms in their respective industries.

The patterns we have identified will most likely hold true for firms in other regions that are going through a similar period of intense reform – Eastern Europe, China and India. Our framework should not only help firms themselves better to prepare for the challenges produced by an economy in reform and transition but should also provide relevant information for policy makers at government level so that they can fine-tune their reforms and policies keeping corporate perspective in mind.

**Resources**


