

9

Export, intermediate and hierarchical entry modes

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Case study

- 9.1 Lysholm Linie Aquavit

Learning objectives

After studying this chapter you should be able to do the following:

- Distinguish between indirect, direct and cooperative export modes.
- Describe and understand the five main entry modes of indirect and direct exporting.
- Discuss how manufacturers can influence intermediaries to be effective marketing partners.
- Describe and understand the main intermediate entry modes.
- Explain the different stages in joint-venture formation.
- Explore the reasons for the 'divorce' of the two parents in a joint-venture constellation.
- Explore different ways of managing a joint venture/strategic alliance.
- Describe and understand the main hierarchical modes.
- Compare and contrast the two investment alternatives: acquisition versus greenfield.
- Explain the different determinants that influence the decision to withdraw investments from a foreign market.

9.1 Introduction

Export modes (section 9.2) are the most common modes for initial entry into international markets. With export entry modes a firm's products are manufactured in the domestic market or third countries and then transferred either directly or indirectly to the host market.

Exporting can be organized in a variety of ways, depending on characteristics of the host market and the number and types of available intermediaries.

Intermediate modes (section 9.3) are distinguished from export modes because they are primarily vehicles for the transfer of knowledge and skills, although they may also create export opportunities. They are distinguished from the hierarchical entry modes in that there is no full ownership (by the parent firm) involved, but ownership and control can be shared between the parent firm and a local partner. This is the case with the (equity) joint venture.

Hierarchical modes

The firm owns and controls the foreign entry mode/organization.

The final group of entry modes is the **hierarchical modes** (section 9.4), where the firm completely owns and controls the foreign entry mode. Here it is a question of where control in the firm lies. The degree of control that head office can exert on the subsidiary will depend on how many and which value chain functions can be transferred to the market. This again depends on the allocation of responsibility and competence between head office and the subsidiary, and how the firm wants to develop this at an international level.

9.2 Export modes

In establishing export channels a firm has to decide which functions will be the responsibility of external agents and which will be handled by the firm itself. While export channels may take many different forms, for the purposes of simplicity three major types may be identified: indirect, direct and cooperative export marketing groups.

- 1 *Indirect export.* This is when the manufacturing firm does not take direct care of exporting activities. Instead another domestic company, such as an export house or trading company, performs these activities, often without the manufacturing firm's involvement in the foreign sales of its products.
- 2 *Direct export.* This usually occurs when the producing firm takes care of exporting activities and is in direct contact with the first intermediary in the foreign target market. The firm is typically involved in handling documentation, physical delivery and pricing policies, with the product being sold to agents and distributors.
- 3 *Cooperative export.* This involves collaborative agreements with other firms (export marketing groups) concerning the performance of exporting functions.

In Figure 9.1 the different export modes are illustrated in a value chain.

Partner mindshare

No matter which of the three export modes the manufacturer uses in a market, it is important to think about what level of 'mindshare', that the manufacturer 'occupies' in the mind of the export-partner. **Partner mindshare** is a measurement of the strength of a relationship in terms of trust, commitment and cooperation. There is a strong and proven correlation between mindshare levels and how willing an export intermediary is to place one company-brand in front of another, or how likely the intermediary is to defect. Mindshare also expresses itself very clearly in sales performance. Intermediaries who have high mindshare will, typically, sell more than those with low mindshare.

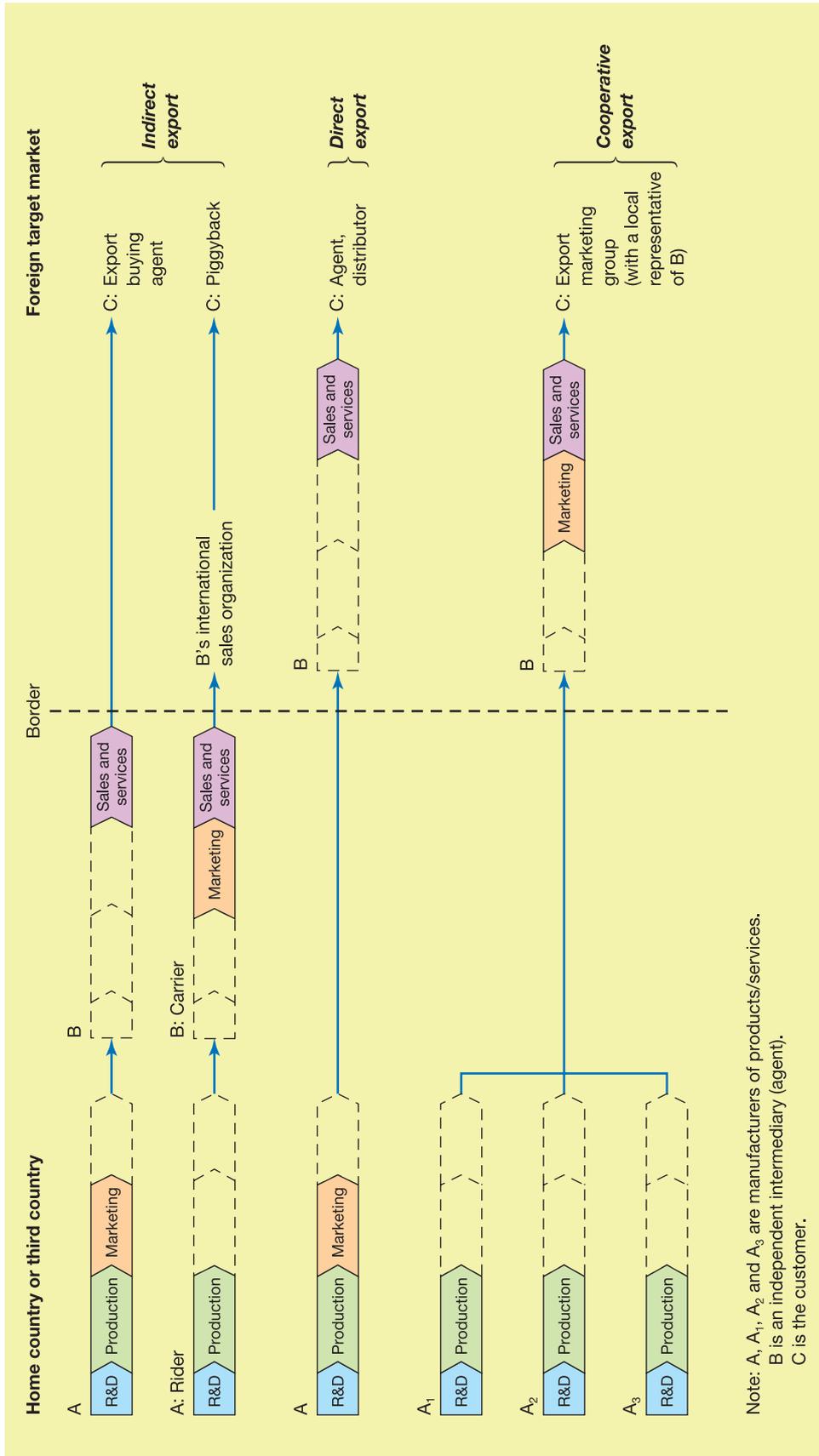
Mindshare can be broken down into three drivers (Gibbs, 2005)

- 1 commitment and trust;
- 2 collaboration;
- 3 mutuality of interest and common purpose.

Partner mindshare

The level of mindshare that the manufacturer's product occupies in the mind of the export partner (e.g. agent or distributor).

Figure 9.1 Export modes



Good mindshare is going to depend upon scoring well across the board. For example, there are manufacturers, who are good communicators, but are not trusted.

As well as these three mindshare drivers there is a fourth group we need to measure – product, brand and profit. This fourth measures the perceived attractiveness of the supplier's product offering to the intermediary. The manufacturer can think of this as a hygiene driver. Broadly speaking, the performance of the manufacturer needs to be as good as the competition for him to garner the full benefit from strong mindshare.

Many manufacturers with excellent products and strong brands which offer good profits, struggle precisely because they are seen by the export partner as arrogant, untrustworthy and unhelpful. In other words, they have low mindshare at the export partner.

Each of the three drivers can be broken down further. For instance, collaboration is based partly on a measure of how good the manufacturer is at cooperating on sales. Another constituent of collaboration measures its ability to cooperate on marketing. Other constituents measure whether it is perceived as communicating relevant information in a timely way, how much real joint planning takes place and how valuable the export intermediary finds this process.

Mindshare is severely damaged when suppliers refuse to share resources with partners. Partners may feel excluded – not part of the family. If the intermediary has no long-term stake in manufacturer, and has more mindshare with a competitor, then one could choose to simply wind down activities with that intermediary. Alternatively, the manufacturer can fight back by integrating its products and campaigns into the intermediary's business plan and going out of its way to show commitment to the intermediaries. At Oracle they are doing that by saying: 'Our approach is to give marketing materials to our partners. Give them the things they would get if they were internal employees' (Hotopf, 2005).

Manufacturers need to understand the partners' business models, goals, their value to the manufacturer and what it would cost to replace them. But the manufacturer also needs to look at the long-term value of the relationship (life time value = year-on-year value multiplied by the number of years that the manufacturer typically does business with export intermediaries). This can be used to justify investments in the relationship.

Indirect export modes

Indirect export occurs when the exporting manufacturer uses independent organizations *located in the producer's country*. In indirect exporting the sale is like a domestic sale. In fact the firm is not really engaging in global marketing, because its products are carried abroad by others. Such an approach to exporting is most likely to be appropriate for a firm with limited international expansion objectives. If international sales are viewed primarily as a means of disposing of surplus production, or as a marginal, use of **indirect export modes** may be appropriate. This method may also be adopted by a firm with minimal resources to devote to international expansion, which wants to enter international markets gradually, testing out markets before committing major resources and effort to developing an export organization.

It is important for a firm to recognize, however, that the use of agents or export management companies carries a number of risks. In the first place the firm has little or no control over the way the product or service is marketed in other countries. Products may be sold through inappropriate channels, with poor servicing or sales support and inadequate promotion, or be under- or overpriced. This can damage the reputation or image of the product or service in foreign markets. Limited effort may be devoted to developing the market, resulting in lost potential opportunities.

Particularly significant for the firm interested in gradually edging into international markets is that, with indirect exporting, the firm establishes little or no contact with

Indirect export modes

Manufacturer uses independent export organizations located in its own country (or third country).

markets abroad. Consequently the firm has limited information about foreign market potential, and obtains little input to develop a plan for international expansion. The firm will have no means to identify potential sales agents or distributors for its products.

While exporting has the advantage of the least cost and risk of any entry method, it allows the firm little control over how, when, where and by whom the products are sold. In some cases the domestic company may even be unaware that its products are being exported.

Moreover, an SME that is already experienced in traditional exporting may have resources that are too limited to open up a great number of export markets by itself. Thus, through indirect export modes the SME is able to utilize the resources of other experienced exporters and to expand its business to many countries.

There are five main entry modes of indirect exporting:

- 1 export buying agent;
- 2 broker;
- 3 export management company/export house;
- 4 trading company;
- 5 piggyback (shown as a special case of indirect exporting in Figure 9.1).

1 Export buying agent (export commission house)

Some firms or individuals do not realize that their products or services have potential export value until they are approached by a buyer from a foreign organization, which might make the initial approach, purchase the product at the factory gate and take on the task of exporting, marketing and distributing the product in one or more overseas markets.

The **export buying agent** is a representative of foreign buyers who resides in the exporter's home country. As such, this type of agent is essentially the overseas customer's hired purchasing agent in the exporter's domestic market, operating on the basis of orders received from these buyers. Since the export buying agent acts in the interests of the buyer, it is the buyer that pays a commission. The exporting manufacturer is not directly involved in determining the terms of purchase; these are worked out between the export buying agent and the overseas buyer.

The export commission house essentially becomes a domestic buyer. It scans the market for the particular merchandise it has been requested to buy. It sends out specifications to manufacturers inviting bids. Other conditions being equal, the lowest bidder gets the order and there is no sentimentality, friendship or sales talk involved.

From the exporter's point of view, selling to export commission houses represents an easy way to export. Prompt payment is usually guaranteed in the exporter's home country, and the problems of physical movement of the goods are generally taken completely out of its hands. There is very little credit risk and the exporter has only to fulfil the order, according to specifications. A major problem is that the exporter has little direct control over the global marketing of products.

Small firms find that this is the easiest method of obtaining foreign sales but, being totally dependent on the purchaser, they are unlikely to be aware of a change in consumer behaviour and competitor activity, or of the purchasing firm's intention to terminate the arrangement. If a company is intent upon seeking longer-term liability for its export business it must adopt a more proactive approach, which will inevitably involve obtaining a greater understanding of the markets in which its products are sold.

2 Broker

Another type of agent based in the home country is the export/import broker. The chief function of a broker is to bring a buyer and a seller together. Thus the broker is a

Export buying agent

A representative of foreign buyers who is located in the exporter's home country. The agent offers services to the foreign buyers: such as identifying potential sellers and negotiating prices.

specialist in performing the contractual function, and does not actually handle the products sold or bought. For its services the broker is paid a commission (about 5 per cent) by the principal. The broker commonly specializes in particular products or classes of product. Being a commodity specialist there is a tendency for the broker to concentrate on just one or two products. Because the broker deals primarily in basic commodities, for many potential export marketers this type of agent does not represent a practical alternative channel of distribution. The distinguishing characteristic of export brokers is that they may act as the agent for either the seller or the buyer.

3 Export management company/export house

Export houses or export management companies (EMCs) are specialist companies set up to act as the 'export department' for a range of companies. As such the EMC conducts business in the name of each manufacturer it represents. All correspondence with buyers and contracts are negotiated in the name of the manufacturer, and all quotations and orders are subject to confirmation by the manufacturer.

By carrying a large range EMCs can spread their selling and administration costs over more products and companies, as well as reducing transport costs because of the economies involved in making large shipments of goods from a number of companies.

EMCs deal with the necessary documentation, and their knowledge of local purchasing practices and government regulations is particularly useful in markets that might prove difficult to penetrate. The use of EMCs, therefore, allows individual companies to gain far wider exposure of their products in foreign markets at much lower overall costs than they could achieve on their own, but there are a number of disadvantages, too:

- The export house may specialize by geographical area, product or customer type (retail, industrial or institutional), and this may not coincide with the supplier's objectives. So the selection of markets may be made on the basis of what is best for the EMC rather than for the manufacturer.
- As EMCs are paid by commission they might be tempted to concentrate upon products with immediate sales potential, rather than those that might require greater customer education and sustained marketing effort to achieve success in the longer term.
- EMCs may be tempted to carry too many product ranges and as a result the manufacturer's products may not be given the necessary attention from sales people.
- EMCs may carry competitive products that they may promote to the disadvantage of a particular firm.

Manufacturers should therefore take care in selecting a suitable EMC and be prepared to devote resources to managing the relationship and monitoring its performance.

As sales increase the manufacturer may feel that it could benefit from increased involvement in international markets, by exporting itself. However, the transition may not be very easy. First, the firm is likely to have become very dependent on the export house and, unless steps have been taken to build contacts with foreign customers and to build up the firm's knowledge of its markets, moving away from using an EMC could prove difficult. Second, the firm could find it difficult to withdraw from its contractual commitments to the export house. Third, the EMC may be able to substitute products from an alternative manufacturer and so use its existing customer contacts as a basis for competing against the original manufacturer.

4 Trading company

Trading companies are part of the historical legacy from colonial days and, although different in nature now, they are still important trading forces in Africa and the Far

East. Although international trading companies have been active throughout the world, it is in Japan that the trading company concept has been applied most effectively. There are thousands of trading companies in Japan involved in exporting and importing, and the largest firms (varying in number from nine to 17 depending upon source of estimate) are referred to as general trading companies or *Soge Shosha*. This group of companies, which includes C. Itoh, Mitsui & Company and Mitsubishi Shoji Kaisha, handle 50 per cent of Japan's exports and 67 per cent of its imports. While the smaller trading companies usually limit their activities to foreign trade, the larger general trading companies are also heavily involved in domestic distribution and other activities.

Trading companies play a central role in such diverse areas as shipping, warehousing, finance, technology transfer, planning resource development, construction and regional development (e.g. turnkey projects), insurance, consulting, real estate and deal making in general (including facilitating investment and joint ventures). In fact it is the range of financial services offered that is a major factor distinguishing general trading companies from others. These services include the guaranteeing of loans, the financing of both accounts receivable and payable, the issuing of promissory notes, major foreign exchange transactions, equity investment and even direct loans.

Another aspect of their operations is to manage counter-trade activities (barter), in which sales into one market are paid for by taking other products from that market in exchange. The essential role of the trading company is to find a buyer quickly for the products that have been taken in exchange. Sometimes this can be a very resource-demanding process.

Counter trade is still a very widespread trading form in Eastern Europe and developing countries because of their lack of 'hard' currency. One of the motivations for western firms to go into counter trade is the low-cost sources of production and raw materials for use in the firm's own production (Okoroafo, 1994).

Piggyback

An abbreviation of 'Pick-a-Back': i.e. choosing a back to ride on. It is about the rider's use of the carrier's international distribution organization.

5 Piggyback

In piggybacking the export-inexperienced SME, the 'rider', deals with a larger company (the 'carrier') which already operates in certain foreign markets and is willing to act on behalf of the rider that wishes to export to those markets. This enables the carrier to utilize fully its established export facilities (sales subsidiaries) and foreign distribution. The carrier is either paid by commission and so acts as an agent or, alternatively, buys the product outright and so acts as an independent distributor. Piggyback marketing is typically used for products from unrelated companies that are non-competitive (but related) and complementary (allied).

Sometimes the carrier will insist that the rider's products are somewhat similar to its own, in view of the need to deal with technical queries and after-sales service 'in the field'. Branding and promotional policies are variable in piggybacking. In some instances the carrier may buy the products, put its own brand on them, and market them as its own products (private labels). More commonly the carrier retains the brand name of the producer and the two work out promotional arrangements between them. The choice of branding and promotional strategy is a function of the importance of brand to the product and of the degree to which the brand is well established.

Piggybacking has the following advantages/disadvantages for the carrier and the rider.

Carrier

Advantages: A firm that has a gap in its product line or excess capacity in its export operation has two options. One is to develop internally the products necessary to round out its line and fill up its exporting capacity. The other option is to acquire the necessary products outside by piggybacking (or acquisition). Piggybacking may be

attractive because the firm can get the product quickly (someone already has it). It is also a low-cost way to get the product because the carrier firm does not have to invest in R&D, production facilities or market testing for the new product. It can just pick up the product from another firm. In this way the firm can broaden its product range without having to develop and manufacture extra products.

Disadvantages: Piggybacking can be extremely attractive for the carrier, but some concerns exist about quality control and warranty. Will the rider maintain the quality of the products sold by another firm? This depends in part on whose brand name is on the product. If the rider's name is on the product the quality incentive might be stronger. A second concern is continuity of supply. If the carrier develops a substantial market abroad, will the rider firm develop its production capacity, if necessary? Each of these items should be a subject in the agreement between the two parties. If the piggybacking arrangement works out well there is another potential advantage for the carrier. It might find that the rider is a good acquisition candidate or joint-venture partner for a stronger relationship.

Rider

Advantages: Riders can export conveniently without having to establish their own distribution systems. They can observe carefully how the carrier handles the goods and hence learn from the carrier's experience – perhaps to the point of eventually being able to take over its own export transactions.

Disadvantages: For the smaller company this type of agreement means giving up control over the marketing of its products – something that many firms dislike doing, at least in the long run. Lack of commitment on the part of the carrier and the loss of lucrative sales opportunities in regions not covered by the carrier are further disadvantages.

In summary, piggyback marketing provides an easy, low-risk way for a company to begin export marketing operations. It is especially well suited to manufacturers that either are too small to go directly into exports or do not want to invest heavily in foreign marketing.

Direct export modes

Direct exporting occurs when a manufacturer or exporter sells directly to an importer or buyer located in a foreign market area. In our discussion of indirect exporting we examined ways of reaching foreign markets without working very hard. Indeed, in the indirect approaches, foreign sales are handled in the same way as domestic sales: the producer does the global marketing only by proxy (that is, through the firm that carries its products overseas). However, both the global marketing know-how and the sales achieved by these indirect approaches are limited.

As exporters grow more confident they may decide to undertake their own exporting task. This will involve building up overseas contacts, undertaking marketing research, handling documentation and transportation, and designing marketing mix strategies.

Direct export modes include export through foreign-based agents and distributors (independent intermediaries).

The terms 'distributor' and 'agent' are often used synonymously. This is unfortunate because there are distinct differences: distributors, unlike agents, take title to the goods, finance the inventories and bear the risk of their operations, whereas agents do not. Distributors are paid according to the difference between the buying and selling prices rather than by commission (agents). Distributors are often appointed when after-sales service is required, as they are more likely than agents to possess the necessary resources.

Direct export modes
Manufacturer sells directly to an importer, agent or distributor located in the foreign target market.

Distributors

Distributors (importers)

Independent company that stocks the manufacturer's product. It will have substantial freedom to choose own customers and price. It profits from the difference between its selling price and its buying price from the manufacturer.

Exporting firms may work through **distributors (importers)**, which are the exclusive representatives of the company and are generally the sole importers of the company's product in their markets. As independent merchants, distributors buy on their own accounts and have substantial freedom to choose their own customers and to set the conditions of sale. For each country exporters deal with one distributor, take one credit risk, and ship to one destination. In many cases distributors own and operate wholesale and retail establishments, warehouses and repair and service facilities. Once distributors have negotiated with their exporters on price, service, distribution and so on their efforts focus on working their own suboperations and dealers.

The distributor category is broad and includes more variations, but distributors usually seek exclusive rights for a specific sales territory and generally represent the manufacturer in all aspects of sales and servicing in that area. The exclusivity is in return for the substantial capital investment that may be required on the part of the distributor in handling and selling products.

Agents

Agents

Independent company that sells on to customers on behalf of the manufacturer (exporter). Usually it will not see or stock the product. It profits from a commission (typically 5–10 per cent) paid by the manufacturer on a pre-agreed basis.

Agents may be exclusive, where the agent has exclusive rights to specified sales territories; semi-exclusive, where the agent handles the exporter's goods along with other non-competing goods from other companies; or non-exclusive, where the agent handles a variety of goods, including some that may compete with the exporter's products.

An agent represents an exporting company and sells to wholesalers and retailers in the importing country. The exporter ships the merchandise directly to the customers, and all arrangements on financing, credit, promotion, etc., are made between the exporter and the buyers. Exclusive agents are widely used for entering international markets. They cover rare geographic areas and have subagents assisting them. Agents and subagents share commissions (paid by the exporter) on a pre-agreed basis. Some agents furnish financial and market information, and a few also guarantee the payment of customers' accounts. The commissions that agents receive vary substantially, depending upon services performed, the market's size and importance, and competition among exporters and agents.

The advantages of both agents and distributors are that they are familiar with the local market, customs and conventions, have existing business contacts and employ foreign nationals. They have a direct incentive to sell through either commission or profit margin, but since their remuneration is tied to sales they may be reluctant to devote much time and effort towards developing a market for a new product. Also, the amount of market feedback may be limited as the agent or distributor may see itself as a purchasing agent for its customers rather than as a selling agent for the exporter. If the agent or distributor is performing well and develops the market it risks being replaced by a subsidiary of the principal. Therefore a long-term strategy is needed whereby it might be useful to include the agent in any new entry mode decision (e.g. advent of a subsidiary) to avoid the disincentive of being replaced.

Choice of an intermediary

The selection of a suitable intermediary can be a problematic process. But the following sources may help a firm to find such an intermediary:

- asking potential customers to suggest a suitable agent;
- obtaining recommendations from institutions such as trade associations, chambers of commerce and government trade departments;
- using commercial agencies;

- poaching a competitor’s agent;
- advertising in suitable trade papers.

In selecting a particular intermediary the exporter needs to examine each candidate firm’s knowledge of the product and local markets, experience and expertise, required margins, credit ratings, customer care facilities and ability to promote the exporter’s products in an effective and attractive manner.

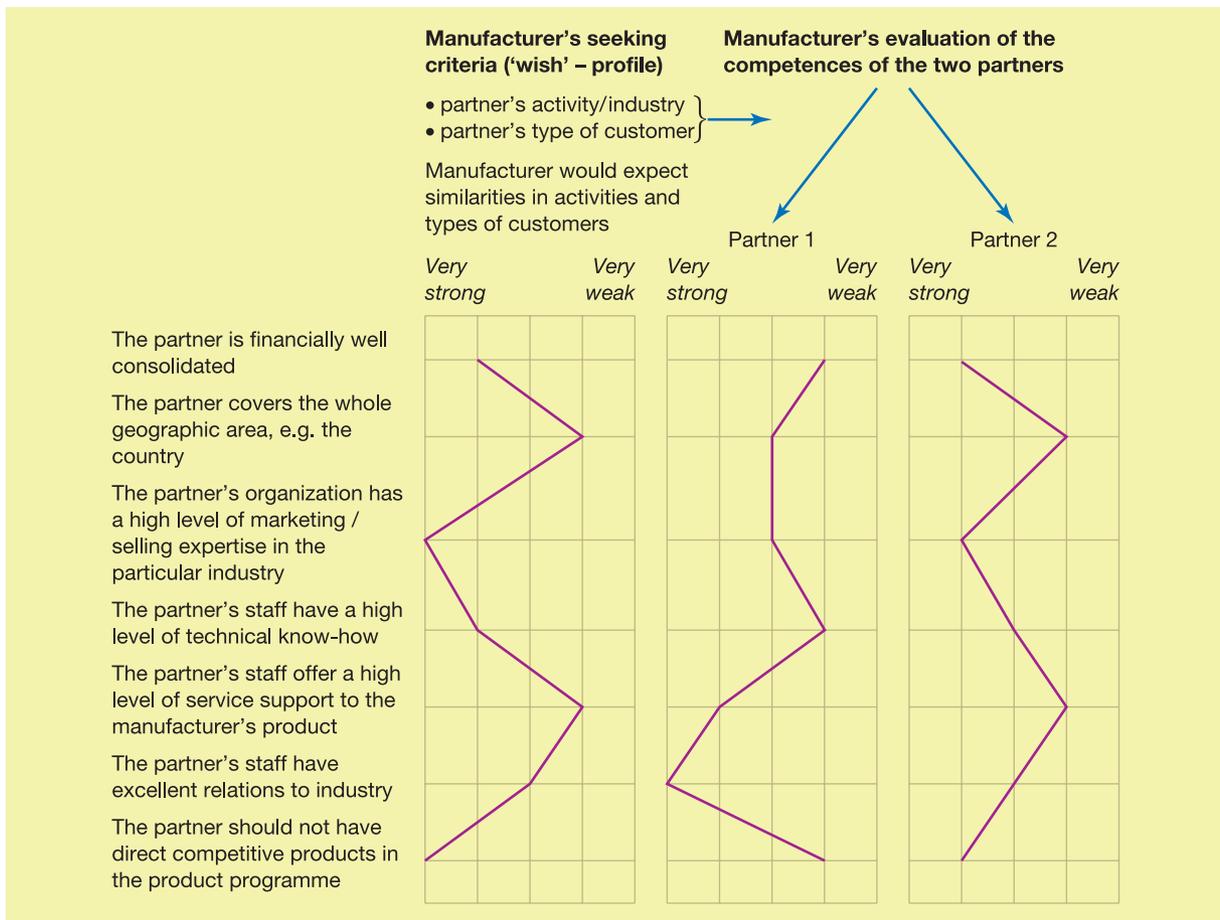
Figure 9.2 shows the matchmaking of a manufacturer and its ‘wish’-profile, and two potential intermediaries and their performance profiles in a particular market.

If Partners 1 and 2 were the only potential candidates for the manufacturer, Partner 2 would probably be chosen because of the better match of profiles between what the manufacturer wants on the market (‘wish’-profile) and the performance profile of Partner 2.

The criteria listed in Figure 9.2 would probably not be the only criteria in a selection process. Some other specific desirable characteristics of an intermediary (to be included in the decision-making process) are listed below (Root, 1998):

- size of firm;
- physical facilities;
- willingness to carry inventories;
- knowledge/use of promotion;
- reputation with suppliers, customers and banks;

Figure 9.2 An example of matchmaking between a manufacturer and two potential distribution partners



- record of sales performance;
- cost of operations;
- overall experience;
- knowledge of English or other relevant languages;
- knowledge of business methods in manufacturer's country.

When an intermediary is selected by the exporting manufacturer it is important that a contract is negotiated and developed between the parties. The foreign representative agreement is the fundamental basis of the relationship between the exporter and the intermediary. Therefore the contract should clearly cover all relevant aspects and define the conditions upon which the relationship rests. Rights and obligations should be mutually defined and the spirit of the agreement must be one of mutual interest.

For most exporters the three most important aspects of their agreement with foreign representatives are sole or exclusive rights, competitive lines and termination of the agreement. The issue of agreeing territories is becoming increasingly important, as in many markets distributors are becoming fewer in number, larger in size and sometimes more specialized in their activity. The trend to regionalization is leading distributors increasingly to extend their territories through organic growth, mergers and acquisitions, making it more difficult for firms to appoint different distributors in individual neighboring markets.

In general there are some principles that apply to the law of agency in all nations:

- An agent cannot take delivery of the principal's goods at an agreed price and resell them for a higher amount without the principal's knowledge and permission.
- Agents must maintain strict confidentiality regarding their principal's affairs and must pass on all relevant information.
- The principal is liable for damages to third parties for wrongs committed by an agent 'in the course of his or her authority' (e.g. if the agent fraudulently misrepresents the principal's firm).

During the contract period the support and motivation of intermediaries is important. Usually this means financial rewards for volume sold, but there can also be other means:

- significant local advertising and brand awareness development by the supplying firm;
- participation in local exhibitions and trade fairs, perhaps in cooperation with the local intermediary;
- regular field visits and telephone calls to the agent or distributor;
- regular meetings of agents and distributors arranged and paid for by the supplying company in the latter's country;
- competitions with cash prizes, free holidays, etc., for intermediaries with the highest sales;
- provision of technical training to intermediaries;
- suggestion schemes to gather feedback from agents and distributors;
- circulation of briefings about the supplying firm's current activities, changes in personnel, new product developments, marketing plans, etc.

Evaluating international distribution partners

Even if the firm has been very careful in selecting intermediaries a need can arise to extricate oneself quickly from a relationship that appears to be going nowhere.

In the process of evaluating international distribution partners Figure 9.3 can be used:

Figure 9.3 International partner matrix

Country (market) attractiveness	High	7. Get new partner or switch mode	8. Grow partner	9. Consider integration
	Medium	4. Get new partner	5. Grow partner ----- Maintain	6. Maintain position
	Low	1. Consider exit	2. Maintain position	3. Consider rewarding or alternative mode
		Low	Medium	High
		Partner performance		

According to Figure 9.3 the two most important criteria for evaluating international distributor partners are:

- 1 the performance of the distributor partner;
- 2 the general attractiveness of the market where the partner operates.

Performance can be evaluated by using criteria like achieved turnover and market share, profits generated for the manufacturer, established network to potential customers, etc. The country (market) attractiveness can be evaluated by using criteria like the ones discussed in Chapter 7 (Table 7.2 and Figure 7.5), for example, market size and market growth.

If the partner performance is low combined with a low attractiveness of the country (Cell 1), then the company should consider an exit from that country, especially if the low attractiveness seems to be a long-term phenomenon.

If the partner performance is high, but the country attractiveness is low (Cell 3), then the company could consider better rewarding of the partner or a shift to another entry mode (e.g. a joint venture). In this way the company can prevent dissatisfaction on the partner's side by rewarding it with a bigger part of the created profit pool in such a difficult market (low attractiveness).

If the partner is doing badly on a very attractive market (Cell 7), the partner should be switched with another (and better) one or the company should switch to another mode (e.g. own sales subsidiary) with better control opportunity.

If the market is very attractive and the partner is doing a good job (Cell 9), then the company could consider forward integration, by turning the existing entry mode (distributor) into a subsidiary and promoting the distributor as the new CEO of the subsidiary, provided he or she has got the necessary competences for such a position and is endowed with sufficient management talent.

The other cells of Figure 9.3 are mainly concerned with maintaining current position or 'growing' the existing partner. This can be done by offering training in the company's product/service solutions at HQ, or visiting the partner in the local market in order to show it that you are committed to its selling efforts in that local market.

Termination of contracts with distribution partners

Cancellation clauses in distribution partner agreements usually involve rights under local legislation and it is best that a contract is scrutinized by a local lawyer before signature, rather than after a relationship has ended and a compensation case is being fought in the courts.

Termination laws differ from country to country, but the European Union situation has been largely reconciled by a Directive regarding agents that has been effective in all EU member states since 1994. Under the Directive, an agent whose agreement is terminated is entitled to the following:

- full payment for any deal resulting from its work (even if concluded after the end of the agency);
- a lump sum of up to one year's past average commission;
- compensation (where appropriate) for damages to the agent's commercial reputation caused by unwarranted termination.

Outside western Europe some countries regard agents as basically employees of client organizations, while others see agents as self-contained and independent businesses. It is essential to ascertain the legal position of agency agreements in each country in which a firm is considering doing business. For example, laws in Saudi Arabia are extremely strong in protecting agents.

Cooperative export modes/export marketing groups

Export marketing groups are frequently found among SMEs attempting to enter export markets for the first time. Many such firms do not achieve sufficient scale economies in manufacturing and marketing because of the size of the local market or the inadequacy of the management and marketing resources available. These characteristics are typical of traditional, mature, highly fragmented industries such as furniture and clothing. Frequently the same characteristics are to be found among small, recently established high-technology firms.

Figure 9.1 shows an export marketing group with manufacturers A_1 , A_2 and A_3 , each having separate upstream functions but cooperating on the downstream functions through a common, foreign-based agent.

One of the most important motives for SMEs to join with others is the opportunity of effectively marketing a complementary product programme to larger buyers. The following example is from the furniture industry.

Manufacturers A_1 , A_2 and A_3 have their core competences in the upstream functions of the following complementary product lines:

- A_1 Living room furniture
- A_2 Dining room furniture
- A_3 Bedroom furniture.

Together they form a broader product concept that could be more attractive to a buyer in a furniture retail chain, especially if the total product concept targets a certain lifestyle of the end customers.

The cooperation between the manufacturers can be tight or loose. In a loose cooperation the separate firms in a group sell their own brands through the same agent, whereas a tight cooperation often results in the creation of a new export association. Such an association can act as the exporting arm of all member companies, presenting a united front to world markets and gaining significant economies of scale. Its major functions are the following:

- exporting in the name of the association;
- consolidating freight, negotiating rates and chartering ships;
- performing market research;
- appointing selling agents abroad;
- obtaining credit information and collecting debts;

- setting prices for export;
- allowing uniform contracts and terms of sale;
- allowing cooperative bids and sales negotiation.

Firms in an association can research foreign markets more effectively together, and obtain better representation in them. By establishing one organization to replace several sellers they may realize more stable prices, and selling costs can be reduced. Through consolidating shipments and avoiding duplicated effort firms realize transportation savings, and a group can achieve standardization of product grading and create a stronger brand name, just as the California fruit growers did with Sunkist products.

Considering all the advantages for an SME in joining an export marketing group, it is surprising that so few groups are actually running. One of the reasons for this could be that the firms have conflicting views as to what the group should do. In many SMEs there are strong feelings of independence inspired by their founders and entrepreneurs, which may be contrary, for example, to the common goal setting of export marketing groups. One of the major tasks of the export group is to balance the interests of the different stakeholders in the group.

9.3 Intermediate modes

Intermediate entry modes include a variety of arrangements, such as licensing, franchising, management contracts, turnkey contracts, joint ventures and technical know-how or coproduction arrangements. In Figure 9.4 the most relevant intermediate modes are shown in the usual value chain perspective.

Generally speaking, contractual arrangements take place when firms possessing some sort of competitive advantage are unable to exploit this advantage because of resource constraints, for instance, but are able to transfer the advantage to another party. The arrangements often entail long-term relationships between partner firms and are typically designed to transfer intermediate goods such as knowledge and/or skills between firms in different countries.

Contract manufacturing

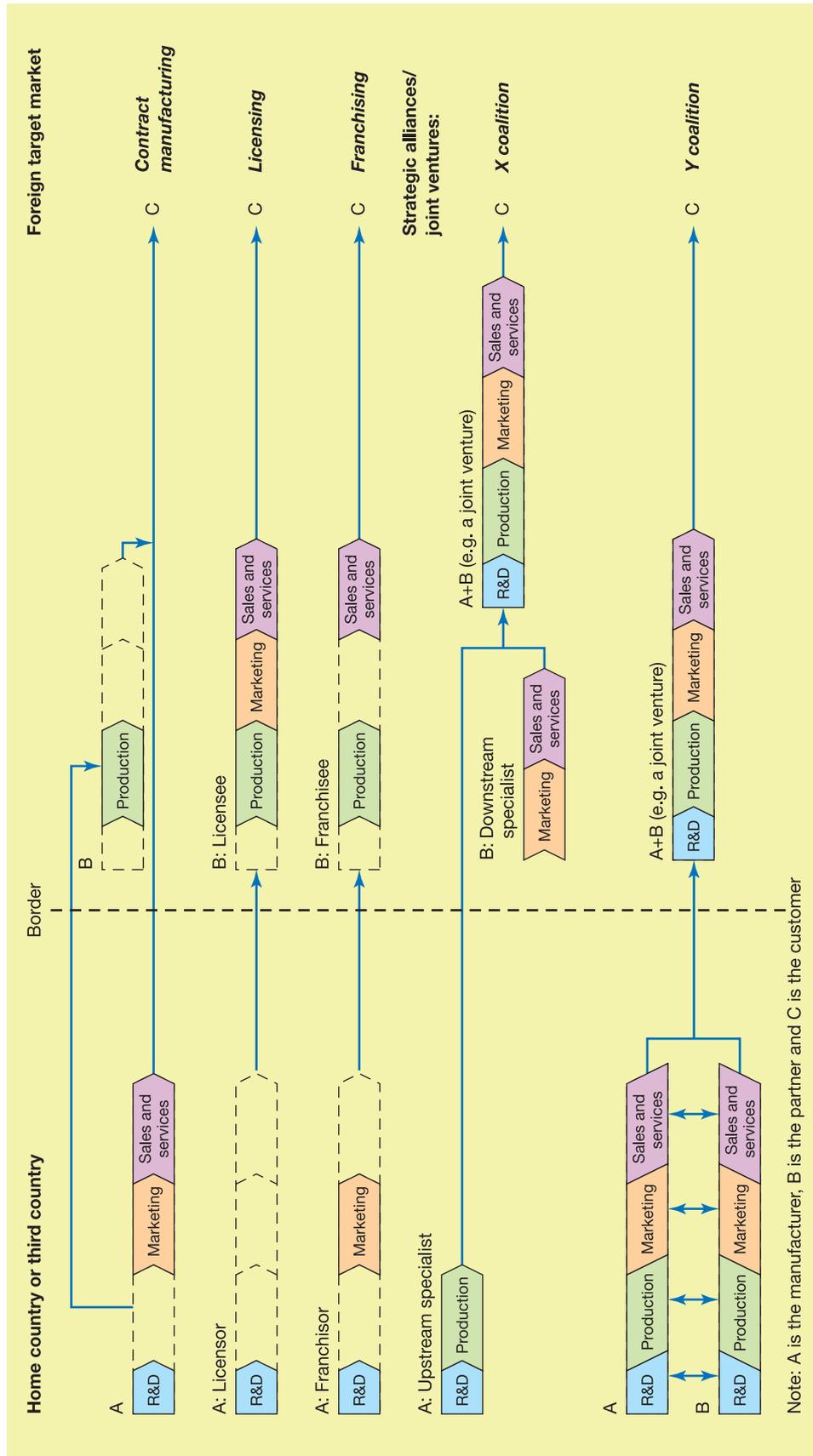
Several factors may encourage the firm to produce in foreign markets:

- Desirability of being close to foreign customers. Local production allows better interaction with local customer needs concerning product design, delivery and service.
- Foreign production costs (e.g. labour) are low.
- Transportation costs may render heavy or bulky products non-competitive.
- Tariffs or quotas can prevent entry of an exporter's products.
- In some countries there is government preference for national suppliers.

Contract manufacturing
Manufacturing is outsourced to an external partner, specialized in production and production technology.

Contract manufacturing enables the firm to have foreign sourcing (production) without making a final commitment. Management may lack resources or be unwilling to invest equity to establish and complete manufacturing and selling operations. Yet contract manufacturing keeps the way open for implementing a long-term foreign development policy when the time is right. These considerations are perhaps most important to the company with limited resources. Contract manufacturing enables the firm to develop and control R&D, marketing, distribution, sales and servicing of its

Figure 9.4 Intermediate modes



products in international markets, while handing over responsibility for production to a local firm (see Figure 9.4).

Payment by the contractor to the contracted party is generally on a per unit basis, and quality and specification requirements are extremely important. The product can be sold by the contractor in the country of manufacture, its home country, or some other foreign market.

This form of business organization is quite common in particular industries. For example, Benetton and IKEA rely heavily on a contractual network of small overseas manufacturers.

Contract manufacturing also offers substantial flexibility. Depending on the duration of the contract, if the firm is dissatisfied with product quality or reliability of delivery it can shift to another manufacturer. In addition, if management decides to exit the market it does not have to sustain possible losses from divesting production facilities. On the other hand, it is necessary to control product quality to meet company standards. The firm may encounter problems with delivery, product warranties or fulfilling additional orders. The manufacturer may also not be as cost efficient as the contracting firm, or may reach production capacity, or may attempt to exploit the agreement.

Thus, while contract manufacturing offers a number of advantages, especially to a firm whose strength lies in marketing and distribution, care needs to be exercised in negotiating the contract. Where the firm loses direct control over the manufacturing function mechanisms need to be developed to ensure that the contract manufacturer meets the firm's quality and delivery standards.

Licensing

Licensing

The licensor gives a right to the licensee against payment, e.g. a right to manufacture a certain product based on a patent against some agreed royalty.

Licensing is another way in which the firm can establish local production in foreign markets without capital investment. It differs from contract manufacturing in that it is usually for a longer term and involves much greater responsibilities for the national firm, because more value chain functions have been transferred to the licensee by the licensor (see Figure 9.4).

A licensing agreement

A licensing agreement is an arrangement wherein the licensor gives something of value to the licensee in exchange for certain performance and payments from the licensee. The licensor may give the licensee the right to use one or more of the following things:

- a patent covering a product or process;
- manufacturing know-how not subject to a patent;
- technical advice and assistance, occasionally including the supply of components, materials or plant essential to the manufacturing process;
- marketing advice and assistance;
- the use of a trade mark/trade name.

In the case of trade mark licensing the licensor should try not to undermine a product by overlicensing it. For example, Pierre Cardin diluted the value of his name by allowing some 800 products to use the name under license. Overlicensing can increase income in the short run, but in the long run it may mean killing the goose that laid the golden egg.

In some situations the licensor may continue to sell essential components or services to the licensee as part of the agreement. This may be extended so that the total agreement may also be one of cross-licensing, wherein there is a mutual exchange of knowledge and/or patents. In cross-licensing there might not be a cash payment involved.

Licensing can be considered a two-way street because a license also allows the original licensor to gain access to the licensee's technology and product. This is important because the licensee may be able to build on the information supplied by the licensor. Some licensors are very interested in grantbacks and will even lower the royalty rate in return for product improvements and potentially profitable new products. Where a product or service is involved the licensee is responsible for production and marketing in a defined market area. This responsibility is followed by all the profits and risks associated with the venture. In exchange the licensee pays the licensor royalties or fees, which are the licensor's main source of income from its licensing operations and that usually involve some combination of the following elements:

- A lump sum not related to output. This can include a sum paid at the beginning of an agreement for the initial transfer of special machinery, parts, blueprints, knowledge and so on.
- A minimum royalty – a guarantee that at least some annual income will be received by the licensor.
- A running royalty – normally expressed as a percentage of normal selling price or as a fixed sum of money for units of output.

Other methods of payment include conversions of royalties into equity, management and technical fees, and complex systems of counter purchase, typically found in licensing arrangements with eastern European countries.

If the foreign market carries high political risk then it would be wise for the licensor to seek high initial payments and perhaps compress the timescale of the agreement. Alternatively, if the market is relatively free of risk and the licensee is well placed to develop a strong market share, then payment terms will be somewhat relaxed and probably influenced by other licensors competing for the agreement.

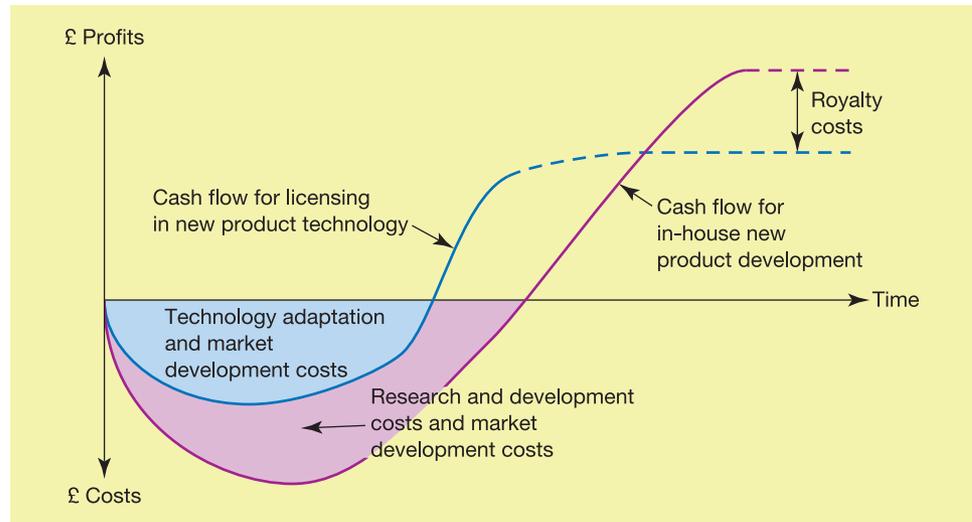
The licensing agreement or contract should always be formalized in a written document. The details of the contract will probably be the subject of detailed negotiation and hard bargaining between the parties, and there can be no such thing as a standard contract.

In the following we see licensing from the viewpoint of a *licensor* (licensing out) and a *licensee* (licensing in). This section is written primarily from the licensor's viewpoint, but licensing in may be an important element in smaller firms' growth strategies, and therefore some consideration is given to this issue too.

Licensing out

Generally there is a wide range of strategic reasons for using licensing. The most important motives for licensing out are as follows:

- The licensor firm will remain technologically superior in its product development. It wants to concentrate on its core competences (product development activities) and then outsource production and downstream activities to other firms.
- The licensor is too small to have financial, managerial or marketing expertise for overseas investment (own subsidiaries).
- The product is at the end of its product life cycle in the advanced countries because of obsolescent technology or model change. A stretching of the total product life cycle is possible through licensing agreements in less developed countries.
- Even if direct royalty income is not high margins on key components to the licensee (produced by the licensor) can be quite handsome.
- If government regulations restrict foreign direct investment or if political risks are high licensing may be the only realistic entry mode.
- There may be constraints on imports into the licensee country (tariff or non-tariff barriers).

Figure 9.5 Life cycle benefits of licensing

Sources: Lowe and Crawford, 1984; Bradley, 1995, p. 388.

Licensing in

Empirical evidence shows (Young *et al.*, 1989, p. 143) that many licensing agreements actually stem from approaches by licensees. This would suggest that the licensee is at an immediate disadvantage in negotiations and general relations with the licensor. In other cases licensing in is used as the easy option, with the license being renewed regularly and the licensee becoming heavily dependent on the technology supplier (the licensor).

As Figure 9.5 shows, licensing in can improve the net cash flow position of the licensee, but mean lower profits in the longer term. Because technology licensing allows the firms to have products on the market sooner than otherwise, the firm benefits from an earlier positive cash flow. In addition, licensing means lower development costs. The immediate benefits of quick access to new technology, lower development costs and a relatively early cash flow are attractive benefits of licensing.

Table 9.3 (see the Summary) summarizes the advantages and disadvantages of licensing for the licensor.

Franchising

Franchising

The franchisor gives a right to the franchisee against payment, e.g. a right to use a total business concept/system, including use of trade marks (brands), against some agreed royalty.

The term **franchising** is derived from the French, meaning 'to be free from servitude'. Franchise activity was almost unknown in Europe until the beginning of the 1970s. The concept was popularized in the United States, where over one-third of retail sales are derived from franchising, in comparison with about 11 per cent in Europe (Young *et al.*, 1989, p. 111).

A number of factors have contributed to the rapid growth rate of franchising. First, the general worldwide decline of traditional manufacturing industry and its replacement by service-sector activities has encouraged franchising. It is especially well suited to service and people-intensive economic activities, particularly where these require a large number of geographically dispersed outlets serving local markets. Second, the growth in popularity of self-employment is a contributory factor to the growth of franchising. Government policies in many countries have improved the whole climate for small businesses as a means of stimulating employment.

A good example of the value of franchising is the Swedish furniture manufacturer IKEA, which franchises its ideas throughout the western world, especially in Europe and North America. In terms of retail surface area and the number of visitors to retail stores, this company has experienced very significant growth through franchising in recent years.

Franchising is a marketing-oriented method of selling a business service, often to small independent investors who have working capital but little or no prior business experience. However, it is something of an umbrella term that is used to mean anything from the right to use a name to the total business concept. Thus there are two major types of franchising:

- 1 Product and trade name franchising. This is very similar to trade mark licensing. Typically it is a distribution system in which suppliers make contracts with dealers to buy or sell products or product lines. Dealers use the trade name, trade mark and product line. Examples of this type of franchising are soft drink bottlers such as Coca-Cola and Pepsi.
- 2 Business format 'package' franchising.

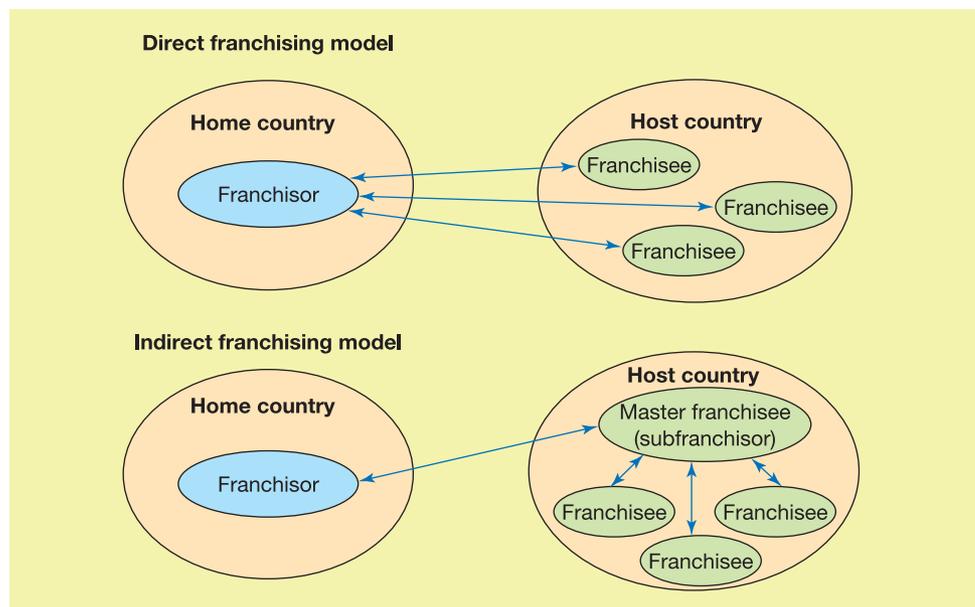
The latter is the focus of this section.

International business format franchising is a market entry mode that involves a relationship between the entrant (the franchisor) and a host country entity, in which the former transfers, under contract, a business package (or format) that it has developed and owns, to the latter. This host country entity can be either a franchisee or a master franchisee (subfranchisor). The franchise system can be set up as a direct or indirect system (see Figure 9.6).

In the direct system the franchisor is controlling and coordinating the activities of the franchisees directly. In the indirect system a master franchisee (subfranchisor) is appointed to establish and service its own subsystem of franchisees within its territory.

The advantages of the direct system include access to local resources and knowledge, more adaptation and the possibility of developing a successful master franchisee (subfranchisor) as a tool for selling the concept to other prospective franchisees within the

Figure 9.6 Direct and indirect franchising models



Source: Based on Welsh *et al.* (2006)

country. The indirect system has disadvantages, including monitoring issues because of loss of control. There have been examples of a master franchisee holding the sub-franchisees hostage to compete against the franchisor. Ultimately, the success of the indirect system will be determined by the capabilities and commitment of the master franchisee (Welsh *et al.*, 2006).

The package transferred by the franchisor contains most elements necessary for the local entity to establish a business and run it profitably in the host country in a prescribed manner, regulated and controlled by the franchisor. The package can contain the following items:

- trade marks/trade names;
- copyright;
- designs;
- patents;
- trade secrets;
- business know-how;
- geographic exclusivity;
- design of the store;
- market research for the area;
- location selection.

In addition to this package the franchisor also typically provides local entities with managerial assistance in setting up and running local operations. All locally-owned franchisees, can also receive subsupplies from the franchisor or the master franchisees (subfranchisor) and benefit from centrally coordinated advertising. In return for this business package the franchisor receives from the franchisee or subfranchisor an initial fee up front and/or continuing franchise fees, based typically on a percentage of annual turnover as a mark-up on goods supplied directly by the franchisor.

There is still a lively debate about the differences between licensing and franchising, but if we define franchising in the broader 'business format' (as here), we see the differences presented in Table 9.1.

Types of business format franchise include business and personal services, convenience stores, car repairs and fast food. US fast-food franchises are some of the best-known global franchise businesses, and include McDonald's, Burger King and Pizza Hut.

The fast-food business is taken as an example of franchising in the value chain approach of Figure 9.4. The production (e.g. assembly of burgers) and sales and service functions are transferred to the local outlets (e.g. McDonald's restaurants), whereas the central R&D and marketing functions are still controlled by the franchisor (e.g. McDonald's head office in the United States). The franchisor will develop the general marketing plan (with the general advertising messages), which will be adapted to local conditions and cultures.

As indicated earlier, business format franchising is an ongoing relationship that includes not only a product or a service but also a business concept. The business concept usually includes a strategic plan for growth and marketing, instruction on the operation of the business, elaboration of standards and quality control, continuing guidance for the franchisee, and some means of control of the franchisee by the franchisor. Franchisors provide a wide variety of assistance for franchisees, but not all franchisors provide the same level of support. Some examples of assistance and support provided by franchisors are in the areas of finance, site selection, lease negotiation, cooperative advertising, training and assistance with store opening. The extent of ongoing support to franchisees also varies among franchisors. Support areas include central data processing, central purchasing, field training, field operation evaluation,

Table 9.1 How licensing and franchising differ

Licensing	Franchising
The term 'royalties' is normally used.	'Management fees' is regarded as the appropriate term.
Products, or even a single product, are the common element.	Covers the total business, including know-how, intellectual rights, goodwill, trade marks and business contacts. (Franchising is all-encompassing, whereas licensing concerns just one part of the business.)
Licences are usually taken by well-established businesses.	Tends to be a start-up situation, certainly as regards the franchisee.
Terms of 16–20 years are common, particularly where they relate to technical know-how, copyright and trade marks. The terms are similar for patents.	The franchise agreement is normally for 5 years, sometimes extending to 11 years. Franchises are frequently renewable.
Licenses tend to be self-selecting. They are often established businesses and can demonstrate that they are in a strong position to operate the licence in question. A licensee can often pass its licence on to an associate or sometimes unconnected company with little or no reference back to the original licensor.	The franchisee is very definitely selected by the franchisor, and its eventual replacement is controlled by the franchisor.
Usually concerns specific existing products with very little benefit from ongoing research being passed on by the licensor to its licensee.	The franchisor is expected to pass on to its franchisees the benefits of its ongoing research programme as part of the agreement.
There is no goodwill attached to the licence as it is totally retained by the licensor.	Although the franchisor does retain the main goodwill, the franchisee picks up an element of localized goodwill.
Licenses enjoy a substantial measure of free negotiation. As bargaining tools they can use their trade muscle and their established position in the marketplace.	There is a standard fee structure and any variation within an individual franchise system would cause confusion and mayhem.

Sources: Based on Perkins (1987), pp. 22, 157 and Young *et al.* (1989), p. 148.

newsletters, regional and national meetings, a hotline for advice and franchisor–franchisee advisory councils. The availability of these services is often a critical factor in the decision to purchase a franchise, and may be crucial to the long-term success of marginal locations or marginally prepared owners.

International expansion of franchising

Franchisors, as other businesses, must consider the relevant success factors in making the decision to expand their franchising system globally. The objective is to search for an environment that promotes cooperation and reduces conflict. Given the long-term nature of a franchise agreement country stability is an important factor.

Where should the international expansion start? The franchising development often begins as a response to a perceived local opportunity, perhaps as an adaptation of a franchising concept already operating in another foreign market. In this case the market focus is clearly local to begin with. In addition, the local market provides a better environment for testing and developing the franchising format. Feedback from the marketplace and franchisees can be obtained more readily because of the ease of communication. Adjustments can be made more quickly because of the close local contact.

A whole variety of minor changes in the format may be necessary as a result of early experience in areas such as training, franchisee choice, site selection, organization of suppliers, promotion and outlet decoration. The early stages of franchise development represent a critical learning process for the franchisor, not just about how to adapt the total package to the market requirements but also regarding the nature of the franchising method itself. Ultimately, with a proven package and a better understanding of its operation, the franchisor is in a better position to attack foreign markets, and is more confident about doing so with a background of domestic success.

Developing and managing franchisor–franchisee relationships

Franchising provides a unique organizational relationship in which the franchisor and franchisee each bring important qualities to the business. The franchise system combines the advantages of economy of scale offered by the franchisor with the local knowledge and entrepreneurial talents of the franchisee. Their joint contribution may result in success. The franchisor depends on franchisees for fast growth, an infusion of capital from the franchise purchase fee, and an income stream from the royalty fee paid by franchisees each year. Franchisors also benefit from franchisee goodwill in the community and, increasingly, from franchisee suggestions for innovation. The most important factor, however, is the franchisee's motivation to operate a successful independent business. The franchisee depends on the franchisor for the strength of the trade mark, technical advice, support services, marketing resources and national advertising that provides instant customer recognition.

There are two additional key success factors, which rest on the interdependence of the franchisee and the franchisor:

- 1 integrity of the whole business system;
- 2 capacity for renewal of the business system.

1 Integrity of the business system

The business will be a success in a viable market to the extent that the franchisor provides a well-developed, proven business concept to the franchisee and the franchisee is motivated to follow the system as it is designed, thereby preserving the integrity of the system. Standardization is the cornerstone of franchising: customers expect the same product or service at every location. Deviations from the franchising business concept by individual franchisees adversely affect the franchisor's reputation. The need for the integrity of the system requires that the franchisor exerts control over key operations at the franchise sites (Doherty and Alexander, 2006).

2 Capacity for renewal of the business system

Although most franchisors conduct research and development within the parent company, the highest proportion of innovation originates from franchisees in the field. Franchisees are most familiar with customers' preferences. They sense new trends and the opportunity to introduce a new product and service. The issue is getting the franchisee to share new ideas with the parent company. Not all franchisees are willing to share ideas with the franchisor, for a number of reasons. The most common is failure of the franchisor to keep in close contact with the franchisees; the most troubling is a lack of trust in the franchisor. The franchisor needs to promote a climate of trust and cooperation for mutual benefit.

Handling possible conflicts: Conflict is inherent in the franchisor–franchisee relationship, since all aspects that are good for the franchisor may not be good for the franchisee. One of the most basic conflicts is failure of either the franchisor or the franchisee to live up to the terms of the legal agreement.

Disagreement over objectives may be the result of poor communication on the part of the franchisor, or failure on the part of the franchisee to understand the franchisor's objectives. Both franchisor and franchisee agree on the need for profits in the business, not only to provide a living but to stay competitive. However, the two parties may disagree on the means of achieving profits. The number of conflicts between franchisors and franchisees may be reduced by establishing extensive monitoring of the franchisee (e.g. computer-based accounting, purchasing and inventory systems). Another way of reducing the number of conflicts is to view franchisors and franchisees as partners in running a business; both objectives and operating procedures have to be in harmony. This view requires a strong common culture with shared values established by the use of intensive communication between franchisor and franchisees in different countries (e.g. cross-national/regional meetings, cross-national/regional advisory councils).

Joint ventures/strategic alliances

Joint venture (JV)

An equity partnership typically between two partners. It involves two 'parents' creating the 'child' (the 'joint venture' acting in the market).

A **joint venture (JV)** or a strategic alliance is a partnership between two or more parties. In international joint ventures these parties will be based in different countries, and this obviously complicates the management of such an arrangement.

A number of reasons are given for setting up joint ventures, including the following:

- Complementary technology or management skills provided by the partners can lead to new opportunities in existing sectors (e.g. multimedia, in which information processing, communications and the media are merging).
- Many firms find that partners in the host country can increase the speed of market entry.
- Many less developed countries, such as China and South Korea, try to restrict foreign ownership.
- Global operations in R&D and production are prohibitively expensive, but are necessary to achieve competitive advantage.

The formal difference between a joint venture and a strategic alliance is that a strategic alliance is typically a non-equity cooperation, meaning that the partners do not commit equity into or invest in the alliance. The joint venture can be either a contractual non-equity joint venture or an equity joint venture.

In a contractual joint venture no joint enterprise with a separate personality is formed. Two or more companies form a partnership to share the cost of investment, the risks and the long-term profits. An equity joint venture involves the creation of a new company in which foreign and local investors share ownership and control. Thus, according to these definitions, strategic alliances and non-equity joint ventures are more or less the same (Figure 9.7).

The question of whether to use an equity or a non-equity joint venture is a matter of how to formalize the cooperation. Much more interesting is to consider the roles that partners are supposed to play in the collaboration.

In Figure 9.8 two different types of coalition are shown in the value chain perspective. These are based on the possible collaboration pattern along the value chain. In Figure 9.8 we see two partners, A and B, each having its own value chain. Three different types of value chain partnership, appear:

- 1 *Upstream-based collaboration.* A and B collaborate on R&D and/or production.
- 2 *Downstream-based collaboration.* A and B collaborate on marketing, distribution, sales and/or service.
- 3 *Upstream/downstream-based collaboration.* A and B have different but complementary competences at each end of the value chain.

Figure 9.7 Joint ventures and strategic alliance

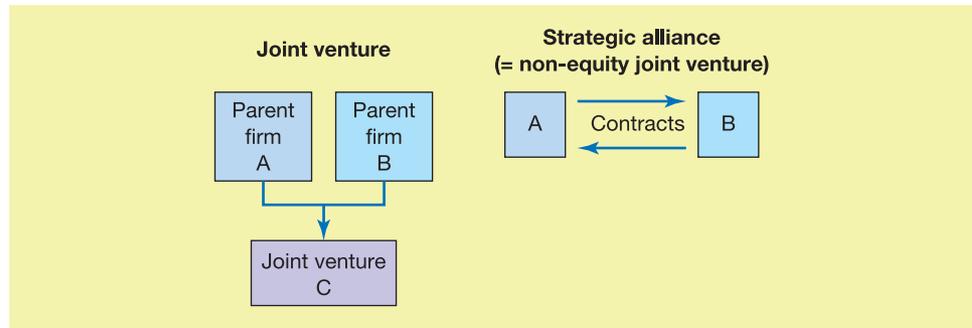
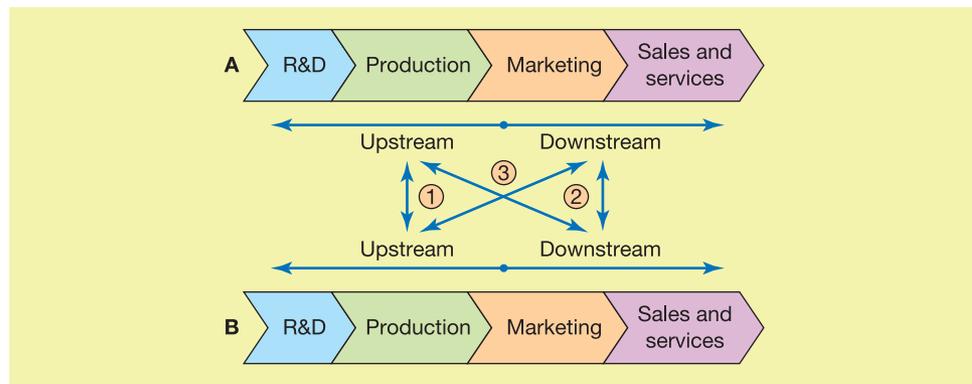


Figure 9.8 Collaboration possibilities for partners A and B in the value chain



Source: Adapted from Lorange and Roos, 1995, p. 16.

Y coalition

Each partner in the alliance/JV contributes with complementary product lines or services. Each partner takes care of all value chain activities within their product line.

X coalition

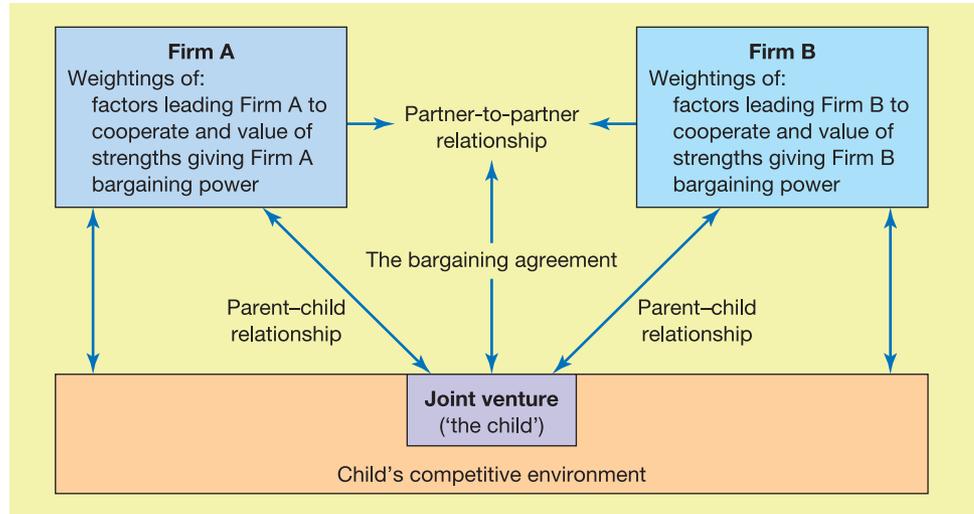
The partners in the value chain divide the value chain activities between them, e.g. the manufacturer (exporter) specializes in up-stream activities, whereas the local partner takes care of the down-stream activities.

Types 1 and 2 represent the so-called **Y coalition** and type 3 represents the so-called **X coalition** (Porter and Fuller, 1986, pp. 336–337):

- **Y coalitions.** Partners share the actual performance of one or more value chain activities: for example, joint production of models or components enables the attainment of scale economies that can provide lower production costs per unit. Another example is a joint marketing agreement where complementary product lines of two firms are sold together through existing or new distribution channels, and thus broaden the market coverage of both firms.
- **X coalitions.** Partners divide the value chain activities between themselves: for example, one partner develops and manufactures a product while letting the other partner market it. Forming X coalitions involves identifying the value chain activities where the firm is well positioned and has its core competences. Take the case where A has its core competences in upstream functions but is weak in downstream functions. A wants to enter a foreign market but lacks local market knowledge and does not know how to get access to foreign distribution channels for its products. Therefore A seeks and finds a partner, B, which has its core competences in the downstream functions but is weak in the upstream functions. In this way A and B can form a coalition where B can help A with distribution and selling in a foreign market, and A can help B with R&D or production.

In summary, X coalitions imply that the partners have asymmetric competences in the value chain activities: where one is strong the other is weak and vice versa. In Y coalitions, on the other hand, partners tend to be more similar in the strengths and weaknesses of their value chain activities.

Figure 9.9 Partner-to-partner relationships creating a joint venture



Source: K.R. Harrigan (2003) *Joint Ventures, Alliances and Corporate Strategy*, Pub. Beard Books.

Managing the joint venture

In recent years we have seen an increasing number of cross-border joint ventures. An alliance or joint venture is able to sustain its structure and remain an efficient mechanism for interfirm transactions as long as partners' economic interests exceed potential costs in managing the alliance. But it is dangerous to ignore the fact that the average lifespan for alliances is only about seven years, and nearly 80 per cent of joint ventures ultimately end in a sale by one of the partners (Wahyuni *et al.*, 2007).

Harrigan's model (Figure 9.9) can be used as a framework for explaining this high 'divorce rate'. As Figure 9.10 shows, the final agreement is determined by the relative bargaining power of both prospective partners.

Changes in bargaining power

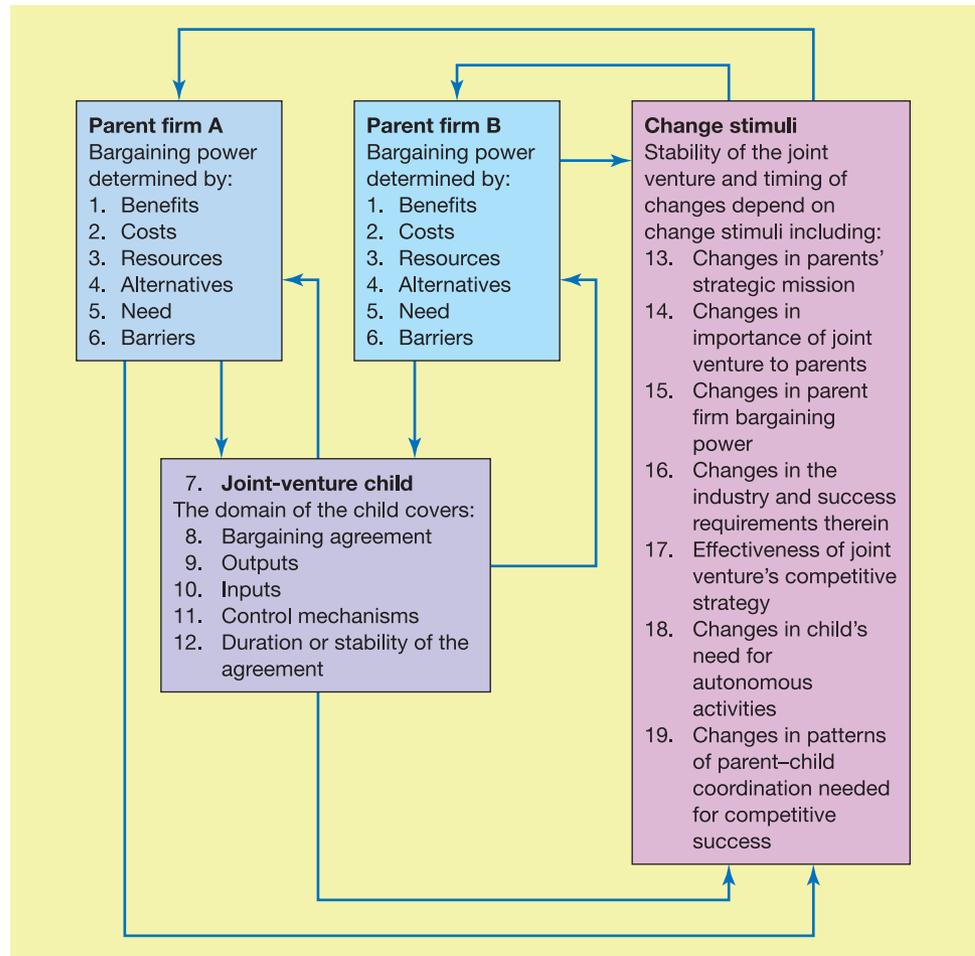
According to Bleeke and Ernst (1994), the key to understanding the 'divorce' of the two parents is changes in their respective bargaining power. Let us assume that we have established a joint venture with the task of penetrating markets with a new product. In the initial stages of the relationship the product and technology provider generally has the most power. But unless those products and technologies are proprietary and unique power usually shifts to the party that controls distribution channels and thus customers.

The bargaining power is also strongly affected by the balance of learning and teaching. A company that is good at learning can access and internalize its partner's capabilities more easily, and is likely to become less dependent on its partner as the alliance evolves. Before entering a joint venture some companies see it as an intermediate stage before acquiring the other partner. By entering a joint venture the prospective buyer of the partner is in a better position to assess the true value of such intangible assets as brands, distribution networks, people and systems. This experience reduces the risk that the buyer will make an uninformed decision and buy an expensive 'lemon' (Nanda and Williamson, 1995).

Other change stimuli and potential conflicts

Diverging goals: As the joint venture progresses the goals of the two partners may diverge. For example, unacceptable positions can develop in the local market when the

Figure 9.10 Model of joint-venture activity



Source: K.R. Harrigan (2003) *Joint Ventures, Alliances and Corporate Strategy*, Pub. Beard Books.

self-interest of one partner conflicts with the interest of the joint venture as a whole, as in the pricing of a single-source input or raw material.

Diverging goals typically arise in the local market entry joint ventures. These joint ventures are created when multinational enterprises (MNEs) take local partners to enter foreign markets. The MNE is usually interested in maximizing its global income, that is, the net income of all of its affiliates, and this means that it is quite willing to run losses on some affiliates if this leads to higher net income for the whole network. The local partner, however, wants to maximize the profits of the specific affiliate of which it is part owner. Conflicts then flare up whenever the two goals are incompatible, as global income maximization is not necessarily compatible with the maximization of the separate profits of each affiliate. For example, conflicts may arise concerning the role given to the joint venture within the MNE network (and particularly on its allocation of export markets). This was the case when General Motors (GM) set up with Daewoo to manufacture subcompact cars for the Korean market and for export to the United States under GM's Pontiac badge. Since GM's Opel subsidiary was selling similar subcompacts in Europe, GM limited the joint venture's export to its US Pontiac subsidiary. Dissatisfied with Pontiac's performance, Daewoo decided to export to Eastern Europe in competition with Opel, a move that contributed to the dissolution of the joint venture (Hennert and Zeng, 2005).

Double management: A potential problem is the matter of control. By definition, a joint venture must deal with double management. If a partner has less than 50 per cent ownership that partner must in effect let the majority partner make decisions. If the board of directors has a 50–50 split it is difficult for the board to make a decision quickly if at all.

Repatriation of profits: Conflicts can also arise with regard to issues such as repatriation of profits, where the local partner desires to reinvest them in the joint venture while the other partner wishes to repatriate them or invest them in other operations.

Mixing different cultures: An organization's culture is the set of values, beliefs and conventions that influence the behaviour and goals of its employees. This is often quite different from the culture of the host country and the partner organization. Thus, developing a shared culture is central to the success of the alliance.

Partnering is inherently very people oriented. To the extent that the cultures of the partners are different, making the alliance work may prove difficult. Cultural differences often result in an 'us versus them' situation. Cultural norms should be consistent with management's vision of the alliance's ideal culture. This may entail creating norms as well as nurturing those that already exist. The key to developing a culture is to acknowledge its existence and to manage it carefully. Bringing two organizations together and letting nature take its course is a recipe for failure. Language differences are also an obvious hurdle for an international alliance.

Ignoring the local culture will almost certainly destroy the chances of it accepting the alliance's product or service. Careful study of the culture prior to embarking on the venture is vital. Again, extensive use of local managers is usually preferred.

Shared equity

Shared equity may also involve an unequal sharing of the burden. Occasionally, international companies with 50–50 joint ventures believe that they are giving more than 50 per cent of the technology, management skill and other factors that contribute to the success of the operation, but are receiving only half the profits. Of course, the national partner contributes local knowledge and other intangibles that may be underestimated. Nevertheless, some international companies believe that the local partner gets too much of a 'free ride'.

Developing trust in joint ventures: Developing trust takes time. The first times that companies work together their chances of succeeding are very slight. But once they find ways to work together all sorts of opportunities appear. Working together on relatively small projects initially helps develop trust and determine compatibility while minimizing economic risk. Each partner has a chance to gauge the skills and contributions of the other, and further investment can then be considered. Of course, winning together in the marketplace on a project of any scale is a great way to build trust and overcome differences. It usually serves as a precursor to more ambitious joint efforts.

Providing an exit strategy: As indicated earlier, there is a significant probability that a newly formed joint venture will fail, even if the previously mentioned key principles are followed. The anticipated market may not develop, one of the partner's capabilities may have been overestimated, the corporate strategy of one of the partners may have changed, or the partners may simply be incompatible. Whatever the reason for the failure, the parties should prepare for such an outcome by addressing the issue in the partnership contract. The contract should provide for the liquidation or distribution of partnership assets, including any technology developed by the alliance.

Other intermediate entry modes

Management contracting emphasizes the growing importance of services and management know-how. The typical case of management contracting is where one firm

(contractor) supplies management know-how to another company that provides the capital and takes care of the operating value chain functions in the foreign country. Normally the contracts undertaken are concerned with management operating/control systems and training local staff to take over when the contracts are completed. It is usually not the intention of the contractor to continue operating after the contract expires. Normally it is the philosophy to operate, transfer know-how to the local staff and then depart. This will usually give a strong competitive position to pick up other management contracts in the area.

Management contracts typically arise in situations where one company seeks the management know-how of another company with established experience in the field. The lack of management capability is most evident for developing countries. Normally the financial compensation to the contractor for the management services provided is a management fee, which may be fixed irrespective of the financial performance or may be a percentage of the profit (Luostarinen and Welch, 1990). The advantages and disadvantages of management contracting are listed in Table 9.3 (see the Summary).

9.4 Hierarchical modes

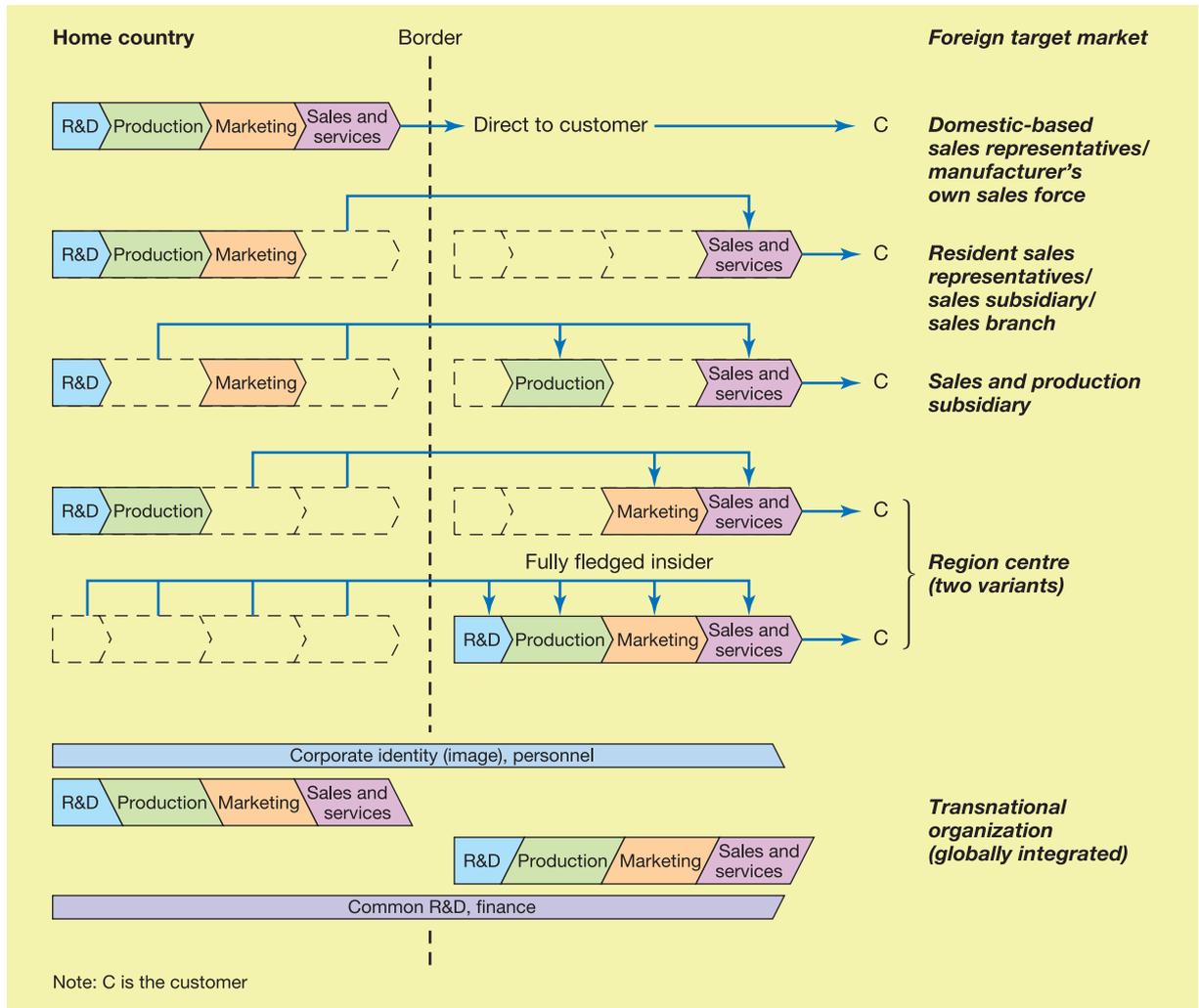
An organization that is not wholly-owned (i.e. 100 per cent) will here be viewed as an export mode or an intermediate mode. The following example, though, may suggest some of the problems involved in this sharp division: a majority-owned (e.g. 75 per cent) joint venture is, according to definition, an intermediate mode, but in practice a firm with 75 per cent will generally have nearly full control, similar to a hierarchical mode.

If a producer wants greater influence and control over local marketing than export modes can give it is natural to consider creating own companies in the foreign markets. However, this shift involves an investment, except in the case of the firm having its own sales force, which is considered an operating cost (see Figure 9.11).

As a firm goes through Figure 9.11 it chooses to decentralize more and more of its activities to the main foreign markets. In other words, it transfers the responsibility of performing the value chain functions to the local management in the different countries. While moving through Figure 9.11 the firm also goes from one internationalization stage to another (Perlmutter, 1969):

- *Ethnocentric orientation*, represented by the domestic-based sales representatives. This orientation represents an extension of the marketing methods used in the home country to foreign markets.
- *Polycentric orientation*, represented by country subsidiaries. This orientation is based on the assumption that markets/countries around the world are so different that the only way to succeed internationally is to manage each country as a separate market with its own subsidiary and adapted marketing mix.
- *Regiocentric orientation*, represented by a region of the world (section 9.5).
- *Geocentric orientation*, represented by the transnational organization. This orientation is based on the assumption that the markets around the world consist of similarities and differences and that it is possible to create a transnational strategy which takes advantage of the similarities between the markets by using synergy effects to leverage learning on a worldwide basis.

Figure 9.11 Hierarchical modes in a value chain perspective



The following description and discussion concerning hierarchical modes takes Figure 9.11 as its starting point.

Domestic-based sales representatives

Domestic-based sales representative

The sales representative resides in the home country of the manufacturer and travels abroad to perform the sales function.

A **domestic-based sales representative** is one who resides in one country, often the home country of the employer, and travels abroad to perform the sales function. As the sales representative is a company employee better control of sales activities can be achieved than with independent intermediaries. Whereas a company has no control over the attention that an agent or distributor gives to its products or the amount of market feedback provided, it can insist that various activities be performed by its sales representatives.

The use of company employees also shows a commitment to the customer that the use of agents or distributors may lack. Consequently they are often used in industrial markets, where there are only a few large customers that require close contact with suppliers, and where the size of orders justifies the expense of foreign travel. This method of market entry is also found when selling to government buyers and retail chains, for similar reasons.

Resident sales representatives/foreign sales branch/foreign sales subsidiary

In all these cases the actual performance of the sales function is transferred to the foreign market. These three options all display a greater customer commitment than using domestic-based sales representatives. In making the decision whether to use travelling domestic-based representatives or resident sales representatives in any particular foreign market a firm should consider the following:

- *Order making or order taking.* If the firm finds that the type of sales job it needs done in a foreign market tends towards order taking it will probably choose a travelling domestic-based sales representative, and vice versa.
- *The nature of the product.* If the product is technical and complex in nature and a lot of servicing/supply of parts is required the travelling salesperson is not an efficient entry method. A more permanent foreign base is needed.

Sometimes firms find it relevant to establish a formal branch office, to which a resident salesperson is assigned. A **foreign branch** is an extension and a legal part of the firm. A foreign branch also often employs nationals of the country in which it is located as salespeople. If foreign market sales develop in a positive direction the firm (at a certain point) may consider establishing a wholly-owned sales subsidiary. A foreign **subsidiary** is a local company owned and operated by a foreign company under the laws of the host country.

The sales subsidiary provides complete control of the sales function. The firm will often keep a central marketing function at its home base, but sometimes a local marketing function can be included in the sales subsidiary. When the sales function is organized as a sales subsidiary (or when sales activities are performed) all foreign orders are channelled through the subsidiary, which then sells to foreign buyers at normal wholesale or retail prices. The foreign sales subsidiary purchases the products to be sold from the parent company at a price. This, of course, creates the problem of intra-company transfer pricing. In Chapter 16 this problem will be discussed in further detail.

One of the major reasons for choosing sales subsidiaries is the possibility of transferring greater autonomy and responsibility to these subunits, being close to the customer. However, another reason for establishing sales subsidiaries may be the tax advantage. This is particularly important for companies headquartered in high-tax countries. With proper planning companies can establish subsidiaries in countries having low business income taxes and gain an advantage by not paying taxes in their home country on the foreign-generated income until such income is actually repatriated to them. Of course the precise tax advantages that are possible with such subsidiaries depend upon the tax laws in the home country compared to the host country.

One of the most interesting things to determine for a firm doing business in a foreign market is when to switch from an agent to having its own sales subsidiary and own sales force (Ross *et al.*, 2005). Figure 9.12 shows the total sales and marketing costs associated with using two different entry modes:

- *Agent:* This curve is based on a contract where the agent gets a minimum annual commission independent of annual sales. The agent will get the same percentage in commission independent of how much they will generate in annual sales.
- *Sales subsidiary:* This curve is based on the assumption that the sales force in the sales subsidiary will have a fixed salary per annum (independent of the annual sales), but will be paid an extra bonus if they fulfil certain sales objectives.

Under these circumstances there will be a certain break-even point from where it is more advantageous (from a financial standpoint) to switch from an agent to own sales

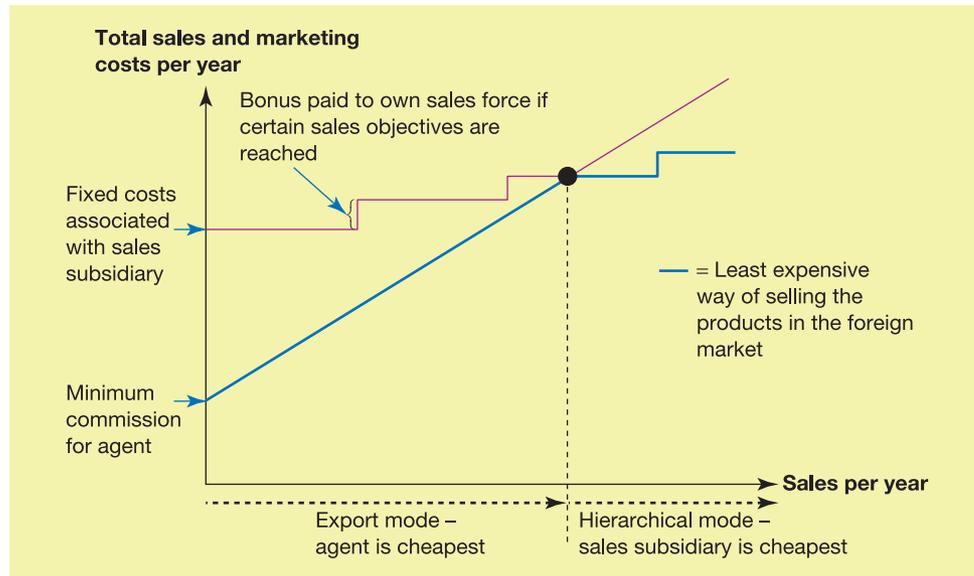
Foreign branch

An extension of and a legal part of the manufacturer (often called a sales office). Taxation of profits takes place in the manufacturer's country.

Subsidiary

A local company owned and operated by a foreign company under the laws and taxation of the host country.

Figure 9.12 Break-even shifting from agent to sales subsidiary



subsidiary. Of course other issues, like control, flexibility and level of investment must be considered before making such a switch.

Sales and production subsidiary

Particularly in developing countries sales subsidiaries may be perceived as taking money out of the country and contributing nothing of value to the host country in which they are based. In those countries a sales subsidiary will generally not be in existence long before there are local demands for a manufacturing or production base.

Generally, if the company believes that its products have long-term market potential in a politically relatively stable country, then only full ownership of sales and production will provide the level of control necessary to meet fully the firm's strategic objectives. However, this entry mode requires great investment in terms of management time, commitment and money. There are considerable risks, too, as subsequent withdrawal from the market can be extremely costly – not simply in terms of financial outlay but also in terms of reputation in the international and domestic market, particularly with customers and staff.

Japanese companies have used this strategy to build a powerful presence in international markets over a long period of time. Their patience has been rewarded with high market shares and substantial profits, but this has not been achieved overnight. They have sometimes spent more than five years gaining an understanding of markets, customers and competition, as well as selecting locations for manufacturing, before making a significant move.

The main reasons for establishing some kind of local production are as follows:

- *To defend existing business.* Japanese car imports to Europe were subject to restrictions, and as their sales increased so they became more vulnerable. With the development of the single European market Nissan and Toyota set up operations in the United Kingdom.
- *To gain new business.* Local production demonstrates strong commitment and is the best way to persuade customers to change suppliers, particularly in the industrial markets where service and reliability are often the main factors when making purchasing decisions.

- *To save costs.* By locating production facilities overseas costs can be saved in a variety of areas such as labour, raw materials and transport.
- *To avoid government restrictions* that might be in force to restrict imports of certain goods.

Assembly operations

An assembly operation is a variation of the production subsidiary. Here a foreign production plant might be set up simply to assemble components manufactured in the domestic market or elsewhere. The firm may try to retain key component manufacture in the domestic plant, allowing development, production skills and investment to be concentrated, and maintaining the benefit from economies of scale. Some parts or components may be produced in various countries (multisourcing) in order to gain each country’s comparative advantage. Capital-intensive parts may be produced in advanced nations, and labour-intensive assemblies may be produced in a less developed country, where labour is abundant and labour costs are low. This strategy is common among manufacturers of consumer electronics. When a product becomes mature and faces intense price competition it may be necessary to shift all of the labour-intensive operations to LDCs. This is the principle behind the international product life cycle (IPLC).

Region centres (regional headquarters)

Until now choice of foreign entry mode has mainly been discussed in relation to one particular country. If we suspend this condition, we consider option 3 in Figure 9.13, where ‘geographically focused start-up’ is an attempt to serve the specialized needs of a particular region of the world. It is very difficult for competitors to imitate a successful coordination of value chain activities in a particular region, as it involves tacit knowledge and is socially complex.

The world is increasingly being regionalized through the formation of such groupings as the European Union, the North American Free Trade Area (NAFTA) and the Association of South-East Asian Nations (ASEAN).

In Figure 9.11 two examples of **region centres** are shown. The first variant shows that the downstream functions have been transferred to the region. In the second variant even greater commitment is shown to the region because here all the value chain activities are moved to the region, whereby the firm has become a fully fledged insider

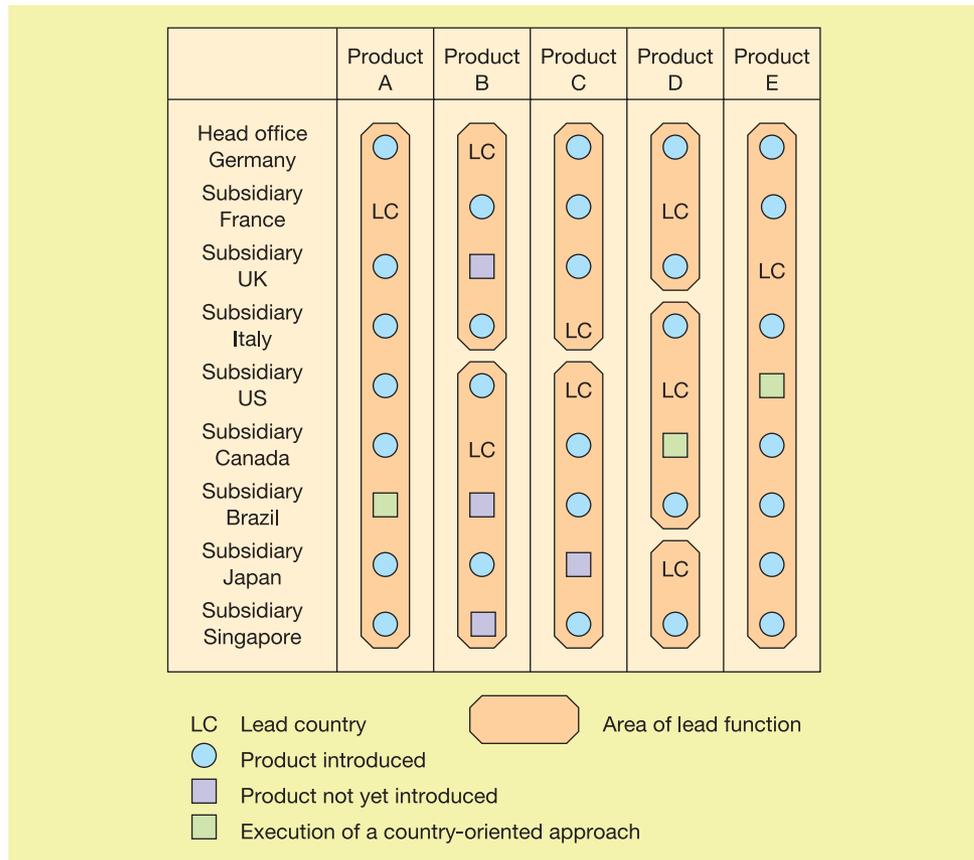
Region centres
The regional HQ (‘lead country’) will usually play the role of coordinating and stimulating sales in the whole region.

Figure 9.13 Types of international new venture

		Number of countries involved	
		Few	Many
Coordination of value chain activities	Few activities coordinated across countries (primarily logistics)	Export/import start-up ①	Multinational trader ②
	Many activities coordinated across countries	Geographically focused start-up ③	Global start-up ④

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Figure 9.14 The lead country concept



Source: Raffée and Kreutzer, 1989. Published with permission of Emerald Publishing Ltd.; www.emeraldinsight.com.

in the region. At this stage the firm has all the necessary functions in the region to compete effectively against local and regional competitors. At the same time, the firm can respond to regional customer needs. This situation is also illustrated in the lower part of Figure 9.13, where many activities are coordinated across countries.

Formation of region centres implies creation of a regional headquarters or appointment of a 'lead country', which will usually play the role of coordinator and stimulator with reference to a single homogeneous product group (see Figure 9.14).

The coordination role consists of ensuring three things:

- 1 Country and business strategies are mutually coherent.
- 2 One subsidiary does not harm another.
- 3 Adequate synergies are fully identified and exploited across business and countries.

The stimulator role consists of two functions:

- 1 facilitating the translation of 'global' products into local country strategies;
- 2 supporting local subsidiaries in their development (Lasserre, 1996).

Figure 9.14 (an example of a multinational company having its head office in Germany) shows that different countries/subsidiaries can have a leading function for different product groups. In the diagram there is a world market such that for products A and E only one country/subsidiary has the coordination function on a global basis (France and the United Kingdom, respectively). For product D there are three regions with a lead country in each region.

The choice of a lead country is influenced by several factors:

- the marketing competences of the foreign subsidiaries;
- the quality of human resources in the countries represented;
- the strategic importance of the countries represented;
- location of production;
- legal restrictions of host countries.

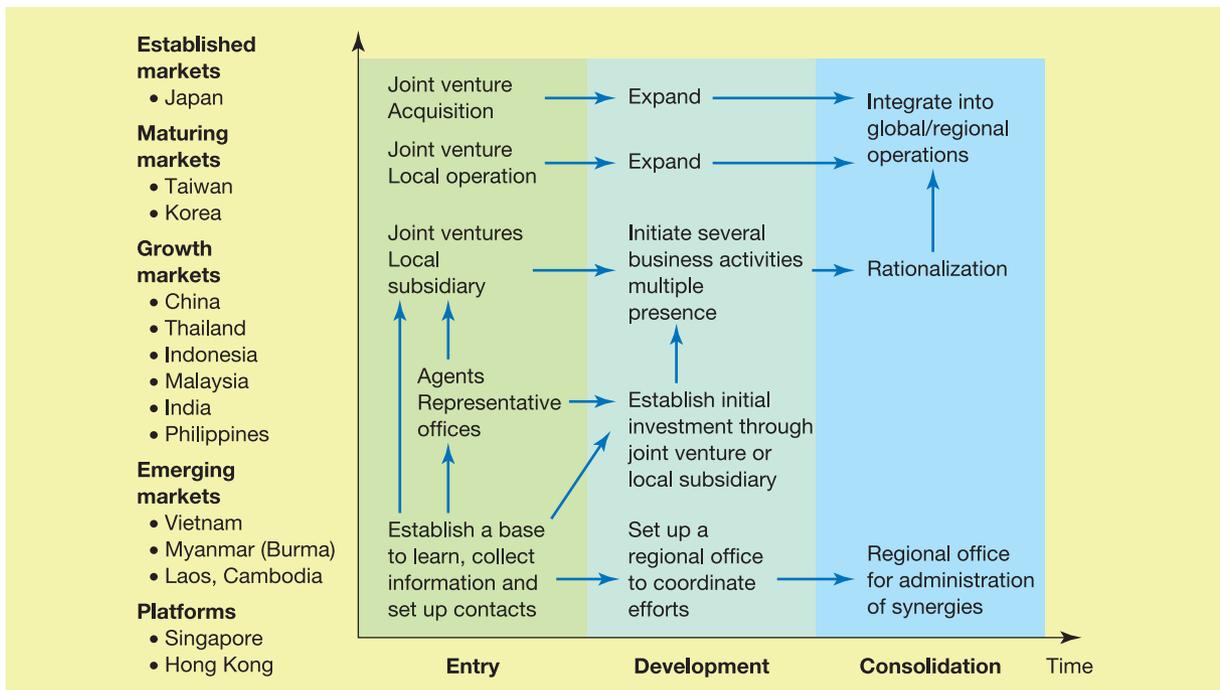
The country with the best ‘leading’ competences should be chosen for the job as lead country.

Figure 9.15 shows how a firm can develop the region centre concept in the Asia-Pacific area. The countries in the Asia-Pacific area are so different that you have to proceed in a sequential way. The example is based on a country-by-country approach together with developing a regional view (Lasserre, 1995).

One can distinguish four types of country in Asia, which are represented in Figure 9.15:

- 1 The *platform countries*, such as Singapore or Hong Kong, which can be used in the starting phase as bases for gathering intelligence and initiating first contacts that can later become the centre of regional coordination. For instance, medium-sized companies with no prior experience in the region could establish their presence by setting up a ‘listening post’ in these countries.
- 2 The *emerging countries*, such as Vietnam today and Myanmar (Burma) and Cambodia in the near future. The task in these countries is to establish an initial presence through a local distributor and build the necessary relationships in order to prepare for the establishment of a local operation, either directly or through a joint venture.

Figure 9.15 Developing the region centre concept in Asia-Pacific



Source: Reprinted from *Long Range Planning*, Vol. 29, No. 1, Lasserre, P. (1996) 'Regional headquarters: the spearhead for Asian Pacific markets', p. 21, Copyright 1996, with permission from Elsevier.

- 3 The *growth countries*, such as China and the ASEAN countries, where it is becoming urgent to establish a significant presence in order to capitalize on the opportunities generated by rapid economic development.
- 4 The *maturing* and *established countries*, such as Korea and Taiwan, which already have significant economic infrastructures and well-established local and international competitors. In the entry phase the task here is to find a way to acquire, through massive investment, the necessary operational capability to catch competitors up.

The particular entry and pathway to development will depend upon the company's prior experience and capabilities, and on the particular strategic attractiveness of an industrial sector in a country.

Gradually the firm will start to look at all the countries in one region, because some activities, notably strategic, intelligence, financial, engineering, R&D, training and specialized services, can reap the benefits of economies of scale only by servicing the whole region.

Transnational organization

In this final stage of internationalization companies attempt to coordinate and integrate operations across national boundaries so as to achieve potential synergies on a global scale. Management views the world as a series of interrelated markets. At this stage the employees tend to identify more strongly with their company than with the country in which they operate.

Common R&D and frequent geographical exchange of human resources across borders are among the characteristics of a **transnational organization**. Its overall goal will be to achieve global competitiveness through recognizing cross-border market similarities and differences, and linking the capabilities of the organization across national boundaries. One of the relatively few international companies that have reached this stage is Unilever – see also section 7.5.

In summary, managing a transnational organization requires the sensitivity to understand the following:

- when a global brand makes sense or when local requirements should take precedence;
- when to transfer innovation and expertise from one market to another;
- when a local idea has global potential;
- when to bring international teams together fast to focus on key opportunities.

Establishing wholly-owned subsidiaries – acquisition or greenfield

All the hierarchical modes presented in this chapter (except domestic-based sales representatives) involve investment in foreign-based facilities. In deciding to establish wholly-owned operations in a country a firm can either acquire an existing company or build its own operations from scratch (greenfield investment).

Acquisition

Acquisition enables rapid entry and often provides access to distribution channels, an existing customer base and, in some cases, established brand names or corporate reputations. In some cases, too, existing management remains, providing a bridge to entry into the market and allowing the firm to acquire experience in dealing with the local market environment. This may be particularly advantageous for a firm with limited international management expertise, or little familiarity with the local market.

Transnational organization

Integration and coordination of operations (R&D, production, marketing, and sales and services) across national boundaries in order to achieve synergies on a global scale.

In saturated markets the industry is highly competitive or there are substantial entry barriers, and therefore there is little room for a new entrant. In these circumstances acquisitions may be the only feasible way of establishing a base in the host country.

Acquisitions take many forms. According to Root (1987) acquisition may be horizontal (the product lines and markets of the acquired and acquiring firms are similar), vertical (the acquired firm becomes supplier or customer of the acquiring firm), concentric (the acquired firm has the same market but different technology, or the same technology but different markets) or conglomerate (the acquired firm is in a different industry from that of the acquiring firm). No matter what form the acquisition takes, coordination and styles of management between the foreign investor and the local management team may cause problems.

Greenfield investment

The difficulties encountered with acquisitions may lead firms to prefer to establish operations from the ground up, especially where production logistics is a key industry success factor, and where no appropriate acquisition targets are available or they are too costly.

The ability to integrate operations across countries, and to determine the direction of future international expansion, is often a key motivation to establish wholly-owned operations, even though it takes longer to build plants than to acquire them. Further motives for green field investment can also include incentives offered by the host country.

Furthermore, if the firm builds a new plant, it can not only incorporate the latest technology and equipment, but also avoid the problems of trying to change the traditional practices of an established concern. A new facility means a fresh start and an opportunity for the international company to shape the local firm into its own image and requirements.

Location/Relocation of HQ

The starting point is to consider the traditional checklist of HQ site selection criteria (Baaij *et al.* 2005):

- corporate tax advantages;
- investment incentives;
- investment climate;
- company law (internal restriction – the owners' wishes have to be followed);
- operational costs;
- quality, availability and costs of the workforce;
- quality of living (major hotels and restaurants, proximity of quality housing, cultural life and recreation, quality of schools, cultural diversity, safety, crime and health factors, personal taxes, cost of living, etc.);
- level of infrastructure (in particular transportation, communication and IT)
- level of high-level business services (e.g. accounting, legal and management consulting);
- sufficient representative office space;
- the presence of other major corporations.

The main benefit of using this checklist is not to find suitable sites, but to eliminate unsuitable ones. Once these factors have been assessed, more strategic criteria for the right HQ location can be considered.

There are three strategic motives that can affect the HQ location decision:

- 1 mergers and acquisitions;
- 2 internationalization of leadership and ownership;
- 3 strategic renewal.

1 Mergers and acquisitions

When companies of equal size merge, they need to find a neutral location for the headquarters of the merged corporation. In 1987, ASEA from Västerås in Sweden and BBC Brown Boveri of Baden, Switzerland merged to create ABB Asea Brown Boveri. The new headquarters were not situated in either original location, but in Zurich.

2 Internationalization of leadership and ownership

In the case of acquisitions, the obvious solution is the most effective – the new headquarters is that of the acquirer, and the acquired corporation relocates (e.g. DaimlerChrysler). The second motive – internationalization of leadership and ownership – makes corporations less sensitive to national sentiments or ties to a specific country. Foreign board executives and shareholders will be less attached to the traditional home country, and less likely to resist a cross-border relocation of the headquarters.

3 Strategic renewal

The final reason for relocating headquarters is strategic renewal. This was a key reason for Philips Electronics' relocation to Amsterdam after 106 years of emotional ties to Eindhoven, the town where Philips was founded. Relocation can be a mechanism of change as it symbolises a fresh start and a break with the past.

Foreign divestment: withdrawing from a foreign market

While a vast theoretical and empirical literature has examined the determinants of entering into foreign direct investments, considerably less attention has been given to the decision to exit from a foreign market.

Most of the studies undertaken show a considerable 'loss' of foreign subsidiaries over time:

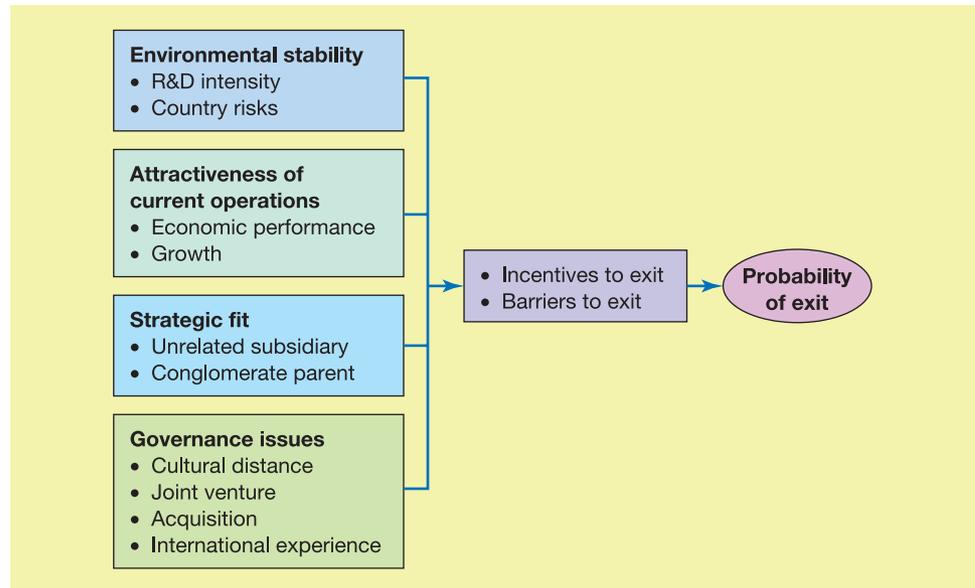
- Between 1967 and 1975 the 180 largest US-based multinationals added some 4,700 subsidiaries to their networks, but more than 2,400 affiliates were divested during the same period (Boddewyn, 1979).
- Out of 225 FDIs undertaken by large Dutch multinationals in the period 1966–88, only just over half were still in existence in 1988 (Barkema *et al.*, 1996).

Closing down a foreign subsidiary or selling it off to another firm is a strategic decision, and the consequence may be a change of foreign entry mode (e.g. from a local sales and production subsidiary to an export mode or a joint venture), or a complete withdrawal from a host country.

The most obvious incentive to exit is profits that are too low, which in turn may be due to high costs, permanent decreases in local market demand or the entry into the industry of more efficient competitors. Besides being voluntary, the divestment may also be a result of expropriation or nationalization in the foreign country.

In order to investigate further the question of why foreign divestments take place it is necessary to look at the specific factors that may influence incentives and barriers to exit, and thereby the probability of exiting from a foreign subsidiary. Benito (1996) classifies the specific factors into four main groups (Figure 9.16).

Figure 9.16 Divestment of foreign operation: a framework



Source: Benito, 1997, pp. 309–34.

Environmental stability

This is a question of the predictability of the environment – competitively and politically – in which the foreign subsidiary operates:

- *R&D intensity*. Perceived barriers to exit are likely to increase due to large market-specific investments made in R&D and the marketing of the products.
- *Country risks*. These risks are typically outside the firm's scope of control. Political risks may often lead to forced divestment, with the result that expropriation takes place.

Attractiveness of current operations

- *Economic performance*. Unsatisfactory economic performance (i.e. inability to produce a net contribution to overall profits) is the most obvious reason why particular subsidiaries are sold off or shut down. On the other hand, if the subsidiary is a good economic performer, the owners may see an opportunity to obtain a good price for the unit while it is performing well.
- *Growth*. Economic growth in the host country would normally make FDI even more attractive, thereby increasing the barriers to exit from such a country. However, the attractiveness of the location would make such operations more likely targets for takeovers by other investors.

Strategic fit

Unrelated expansion (i.e. diversification) increases the governance cost of the business, and economies of scale and scope are also rarely achieved by unrelated subsidiaries. Hence these factors increase the incentives to exit.

The same arguments apply to a conglomerate parent.

Governance issues

- *Cultural distance.* Closeness between home country and host countries results in easier monitoring and coordination of production and marketing activities in the various locations. Thus culturally close countries increase the barriers to exit and vice versa.
- *Joint venture and acquisition.* A joint venture with a local partner can certainly reduce barriers to the penetration of a foreign market by giving rapid access to knowledge about the local market. On the other hand, whenever a joint venture is set up with a foreign partner, both different national and corporate cultures may have an impact on its success. Joint ventures and acquisitions are put in a difficult situation in the often critical initial phases of the integration process. Thus a lack of commitment in the parent company or companies may increase the incentive to exit.
- *Experience.* Firms learn from experience how to operate in the foreign environment, and how to search for solutions to problems that emerge. As experience is accumulated it becomes easier to avoid many of the problems involved in running foreign subsidiaries and to find workable solutions if problems should arise. This also includes the unpleasant decision to close down a subsidiary.

9.5 Summary

The advantages and disadvantages of the three main types of market entry modes are summarized in Tables 9.2 to 9.4.

Table 9.2 Advantages and disadvantages of the different export modes for the manufacturer

Export mode	Advantages	Disadvantages
<i>Indirect exporting</i> (e.g. export buying agent, broker or export management company)	Limited commitment and investment required. High degree of market diversification is possible as the firm utilizes the internationalization of an experienced exporter. Minimal risk (market and political). No export experience required.	No control over marketing mix elements other than the product. An additional domestic member in the distribution chain may add costs, leaving smaller profit to the producer. Lack of contact with the market (no market knowledge acquired). Limited product experience (based on commercial selling).
<i>Direct exporting</i> (e.g. distributor or agent)	Access to local market experience and contacts with potential customers. Shorter distribution chain (compared to indirect exporting). Market knowledge acquired. More control over marketing mix (especially with agents). Local selling support and services available.	Little control over market price because of tariffs and lack of distribution control (especially with distributors). Some investment in sales organization required (contact from home base with distributors or agents). Cultural differences, providing communication problems and information filtering (transaction costs occur). Possible trade restrictions.
<i>Export marketing groups</i>	Shared costs and risks of internationalization. Provide a complete product line or system sales to the customer.	Risk of unbalanced relationships (different objectives). Participating firms are reluctant to give up their complete independence.

Table 9.3 Advantages and disadvantages of the different intermediate modes

Intermediate entry mode	Advantages	Disadvantages
Contract manufacturing (seen from the contractor's viewpoint)	<p>Permits low-risk market entry.</p> <p>No local investment (cash, time and executive talent) with no risk of nationalization or expropriation.</p> <p>Retention of control over R&D, marketing and sales/after-sales service.</p> <p>Avoids currency risks and financing problems.</p> <p>A locally made image, which may assist in sales, especially to government or official bodies.</p> <p>Entry into markets otherwise protected by tariffs or other barriers.</p> <p>Possible cost advantage if local costs (primarily labour costs) are lower.</p> <p>Avoids intra-corporate transfer-pricing problems that can arise with a subsidiary.</p>	<p>Transfer of production know-how is difficult.</p> <p>Contract manufacture is only possible when a satisfactory and reliable manufacturer can be found – not always an easy task.</p> <p>Extensive technical training will often have to be given to the local manufacturer's staff.</p> <p>As a result, at the end of the contract, the subcontractor could become a formidable competitor.</p> <p>Control over manufacturing quality is difficult to achieve despite the ultimate sanction of refusal to accept substandard goods.</p> <p>Possible supply limitation if the production is taking place in developing countries.</p>
Licensing (seen from the licensor's viewpoint)	<p>Increases the income on products already developed as a result of expensive research.</p> <p>Permits entry into markets that are otherwise closed on account of high rates of duty, import quotas and so on.</p> <p>A viable option where manufacture is near the customer's base.</p> <p>Requires little capital investment and should provide a higher rate of return on capital employed.</p> <p>There may be valuable spin-off if the licensor can sell other products or components to the licensee. If these parts are for products being manufactured locally or machinery, there may also be some tariff concessions on their import.</p> <p>The licensor is not exposed to the danger of nationalization or expropriation of assets.</p> <p>Because of the limited capital requirements, new products can be rapidly exploited, on a worldwide basis, before competition develops.</p> <p>The licensor can take immediate advantage of the licensee's local marketing and distribution organization and of existing customer contacts.</p> <p>Protects patents, especially in countries that give weak protection for products not produced locally.</p> <p>Local manufacture may also be an advantage in securing government contracts.</p>	<p>The licensor is ceding certain sales territories to the licensee for the duration of the contract; should it fail to live up to expectations, renegotiation may be expensive.</p> <p>When the licensing agreement finally expires, the licensor may find he or she has established a competitor in the former licensee.</p> <p>The licensee may prove less competent than expected at marketing or other management activities. Costs may even grow faster than income.</p> <p>The licensee, even if it reaches an agreed minimum turnover, may not fully exploit the market, leaving it open to the entry of competitors, so that the licensor loses control of the marketing operation.</p> <p>Danger of the licensee running short of funds, especially if considerable plant expansion is involved or an injection of capital is required to sustain the project. This danger can be turned to advantage if the licensor has funds available by a general expansion of the business through a partnership.</p> <p>License fees are normally a small percentage of turnover, about 5 per cent, and will often compare unfavourably with what might be obtained from a company's own manufacturing operation.</p> <p>Lack of control over licensee operations.</p> <p>Quality control of the product is difficult – and the product will often be sold under the licensor's brand name.</p> <p>Negotiations with the licensee, and sometimes with local government, are costly.</p> <p>Governments often impose conditions on transferral of royalties or on component supply.</p>

Table 9.3 continued

Intermediate entry mode	Advantages	Disadvantages
<i>Franchising</i> (seen from franchisor's viewpoint)	<p>Greater degree of control compared to licensing.</p> <p>Low-risk, low-cost entry mode (the franchisees are the ones investing in the necessary equipment and know-how).</p> <p>Using highly motivated business contacts with money, local market knowledge and experience.</p> <p>Ability to develop new and distant international markets, relatively quickly and on a larger scale than otherwise possible.</p> <p>Generating economies of scale in marketing to international customers.</p> <p>Precursor to possible future direct investment in foreign market.</p>	<p>The search for competent franchisees can be expensive and time consuming.</p> <p>Lack of full control over franchisee's operations, resulting in problems with cooperation, communications, quality control, etc.</p> <p>Costs of creating and marketing a unique package of products and services recognized internationally.</p> <p>Costs of protecting goodwill and brand name.</p> <p>Problems with local legislation, including transfers of money, payments of franchise fees and government-imposed restrictions on franchise agreements.</p> <p>Opening up internal business knowledge may create potential future competitor.</p> <p>Risk to the company's international profile and reputation if some franchisees underperform ('free riding' on valuable brand names).</p>
<i>Joint venture</i> (seen from parent's viewpoint)	<p>Access to expertise and contacts in local markets. Each partner agrees to a joint venture to gain access to the other partner's skills and resources. Typically, the international partner contributes financial resources, technology or products. The local partner provides the skills and knowledge required for managing a business in its country. Each partner can concentrate on that part of the value chain where the firm has its core competence.</p> <p>Reduced market and political risk.</p> <p>Shared knowledge and resources: compared to wholly owned subsidiary, less capital and fewer management resources are required.</p> <p>Economies of scale by pooling skills and resources (resulting in e.g. lower marketing costs).</p> <p>Overcomes host government restrictions.</p> <p>May avoid local tariffs and non-tariff barriers.</p> <p>Shared risk of failure.</p> <p>Less costly than acquisitions.</p> <p>Possibly better relations with national governments through having a local partner (meets host country pressure for local participation).</p>	<p>Objectives of the respective partners may be incompatible, resulting in conflicts.</p> <p>Contributions to joint venture can become disproportionate.</p> <p>Loss of control over foreign operations. Large investments of financial, technical or managerial resources favour greater control than is possible in a joint venture.</p> <p>Completion might overburden a company's staff.</p> <p>Partners may become locked into long-term investments from which it is difficult to withdraw.</p> <p>Transfer pricing problems as goods pass between partners.</p> <p>The importance of the venture to each partner might change over time.</p> <p>Cultural differences may result in possible differences in management culture among participating firms.</p> <p>Loss of flexibility and confidentiality.</p> <p>Problems of management structures and dual parent staffing of joint ventures. Nepotism perhaps the established norm.</p>
<i>Management contracting</i> (seen from contractor's viewpoint)	<p>If direct investment or export is considered too risky – for commercial or political reasons – this alternative might be relevant.</p> <p>As with other intermediate entry modes, management contracts may be linked together with other forms of operation in foreign markets.</p> <p>Allows a company to maintain market involvement, so puts it in a better position to exploit any opportunity that may arise.</p> <p>Organizational learning: if a company is in its early development stages of internationalization, a management contract may offer an efficient way of learning about foreign markets and international business.</p>	<p>Training future competitors: the management transfer package may in the end create a competitor for the contractor.</p> <p>Creates a great demand for key personnel. Such staff are not always available, especially in SMEs.</p> <p>Considerable effort needs to be put into building lines of communication at local level as well as back to contractor.</p> <p>Potential conflict between the contractor and the local government as regards the policy of the contract venture.</p> <p>Little control, which also limits the ability of a contractor to develop the capacity of the venture.</p>

Table 9.4 Advantages and disadvantages of different hierarchical entry modes

Hierarchical entry mode	Advantages	Disadvantages
<i>Domestic-based sales representatives</i>	<p>Better control of sales activities compared to independent intermediaries.</p> <p>Close contact with large customers in foreign markets close to home country.</p>	<p>High travel expenses.</p> <p>Too expensive in foreign markets, far away from home country.</p>
<i>Foreign sales, branch/sales and production subsidiary</i>	<p>Full control of operation.</p> <p>Eliminates the possibility that a national partner gets a 'free ride'.</p> <p>Market access (sales subsidiary).</p> <p>Acquire market knowledge directly (sales subsidiary).</p> <p>Reduce transport costs (production subsidiary).</p> <p>Elimination of duties (production subsidiary).</p> <p>Access to raw materials and labour (production subsidiary).</p>	<p>High initial capital investment required (subsidiary).</p> <p>Loss of flexibility.</p> <p>High risk (market, political and economic).</p> <p>Taxation problems.</p>
<i>Region centres/transnational organization</i>	<p>Achieves potential synergies on a regional/global scale.</p> <p>Regional/global scale efficiency.</p> <p>Leverage learning on a cross-national basis. Resources and people are flexible and can be put into operating units around the world.</p>	<p>Possible threats:</p> <ul style="list-style-type: none"> – increasing bureaucracy. <p>Limited national-level responsiveness and flexibility.</p> <p>A national manager can feel he or she has no influence.</p> <p>Missing communication between head office and region centres.</p>
<i>Acquisition</i>	<p>Rapid entry to new markets.</p> <p>Gaining quick access to:</p> <ul style="list-style-type: none"> – distribution channels; – a qualified labour force; – existing management experience; – local knowledge; – contacts with local market and government; – established brand names/reputation. 	<p>Usually an expensive option.</p> <p>High risk (taking over companies that are regarded as part of a country's heritage can raise considerable national resentment if it seems that they are being taken over by foreign interests).</p> <p>Possible threats:</p> <ul style="list-style-type: none"> – lack of integration with existing operation. Communication and coordination problems between acquired firm and acquirer.
<i>Greenfield investment</i>	<p>Possible to build in an 'optimum' format, i.e. in a way that fits the interests of the firm (e.g. integrating production with home base production).</p> <p>Possible to integrate state-of-the-art technology (resulting in increased operational efficiency).</p>	<p>High investment cost.</p> <p>Slow entry of new markets (time-consuming process).</p>

CASE
STUDY
9.1

Lysholm Linie Aquavit: International marketing of the Norwegian Aquavit brand

Aquavit, which translates as ‘water of life’, a slightly yellow or colourless alcoholic liquor, is produced in the Scandinavian countries by redistilling neutral spirits such as grain or potatoes and flavouring them with caraway seeds. It is often consumed as an aperitif.

The alcohol content in the various aquavits varies somewhat, starting at 37.5 per cent. Most brands contain about 40 per cent alcohol but Lysholm Linie Aquavit has an alcohol content of 41.5 per cent. (‘Lysholm’ is the name of the distillery in Trondheim where the aquavit is made, and from this point on the name ‘Linie Aquavit’ is used.)

The history of Aquavit

Originally, aquavit was used for medicinal purposes, but from the 1700s stills became commonplace in Scandinavian homes.

The definition of aquavit gets slightly complicated when you try to draw the line between it and other spirits popular in the northern climate. The term ‘schnapps’, for instance, is widely used in Germany, Switzerland and Scandinavia (the Danish say ‘snaps’) to mean any sort of neutral spirits, flavoured or otherwise. Then there’s ‘brannvin’ a term used similarly in Sweden. (Like the Dutch word ‘brandewijn’ from which we derive the word ‘brandy’ it means ‘burnt wine’.) The famous Swedish vodka Absolut began life in 1879 as a product called ‘Absolut Renat Brannvin’ which might be translated as ‘absolutely pure schnapps’, said to have been distilled ten times. However, when the Swedish government’s alcohol monopoly launched Absolut’s descendant as an international brand in 1979, it labelled it vodka.

Making Linie Aquavit

Caraway is the most important herb in aquavit, but the mixture of herbs varies from brand to brand. Linie Aquavit is derived from Norwegian potato alcohol blended with spices and herbal infusions, and caraway and aniseed predominate. After the



alcohol and the herbs have been mixed the aquavit is poured into 500-litre oak barrels, the choice of which has not been left to chance. Norwegian specialists travel to Spain for the express purpose of selecting the best barrels, from those used in the production of Oloroso sherry for several years. Sherry casks are used because they remove the rawer, more volatile aspects of the liquor; the aquavit takes on a golden hue, and the residual sherry imparts a gentle sweetness.

Many theories have been put forward to explain how the man behind Linie Aquavit, Jørgen B. Lysholm, came up with the idea of sending aquavit around the world on sailboats in order to produce a special flavour. History tells us that, in the early 1800s, his family tried to export aquavit to the West Indies, but the ship ‘Trondheim’s Prøve’ returned with its unsold cargo. That is when they

discovered the beneficial effects that the long ocean voyage and the special storage had had on the aquavit: the length of the journey, the constant gentle rocking of the boat and the variation in temperature on deck, all helped give Linie Aquavit its characteristic taste. Jørgen B. Lysholm subsequently commercialized his maturation method and this is still how things are done today.

Linie Aquavit has one of Norway’s long-established shipping companies as its steady travel partner. The first Wilhelmsen liner vessel carrying Lysholm Linie Aquavit set sail in 1927. Since that time, Wilhelmsen has been the sole carrier of this distinguished product. The barrels are tightly secured in specially designed cribs before being loaded onto containers, which remain on deck during the entire journey. The journey from Norway to Australia and back again takes four and a half months and crosses the equator (or the line, as sailors prefer to call it) twice. In fact, this is where Linie Aquavit gets its name. On the back of each label is the name of the ship and the date that it first crossed the equator.

International sales of Linie Aquavit

Arcus AS is Norway's sole manufacturer of hard liquor and it is this company which produces Linie Aquavit. The company also taps wine from wine producers all over the world and imports a select range of bottled wines. With a market share of about 30 per cent, Arcus AS is the leading player in the Norwegian wine and spirits market.

The international aquavit markets (primarily Sweden, Norway, Denmark, Germany and the United States) are dominated (except the last) by local Aquavit brands. At present Linie Aquavit is the market leader in Norway with a 20 per cent market share. In Denmark and Sweden the market share is 3–5 per cent. Germany is the most important export market, where Linie Aquavit holds 12 per cent of the aquavit market in competition with brands like Malteserkreutz and Bommerlunde.

Arcus is using export modes (foreign-based intermediaries) in all export markets. In 2000 the main distributors in Germany (Berentzen-Gruppe) and Denmark (Hans Just) became part-owners of Arcus AS, because they wanted to be sole distributors of

Linie Aquavit in their countries. In the German market Berentzen offers a whole range of different types of alcoholic drinks. The company ranked number three in spirits in 2001, with a volume share of 7 per cent. Berentzen aims to expand its international spirits business during the next few years, in order to achieve long-term growth.

Sources: www.arcus.no/english/; Christian Brink, Head of Marketing, Sales and R&D at Arcus AS.

Questions

- 1 What are the main advantages and disadvantages for Arcus of using export modes, compared to other entry modes, for its Linie Aquavit?
- 2 What are the advantages for Arcus of having distributors as part-owners?
- 3 What should be Arcus' main criteria for selecting new distributors, or cooperation partners, for Linie Aquavit in new markets?
- 4 Would it be possible to pursue an international branding strategy for Linie Aquavit?

For further exercises and cases, see this book's website at www.pearsoned.co.uk/hollensen



Questions for discussion

- 1 Why is exporting frequently considered the simplest way of entering foreign markets and is thus favoured by SMEs?
- 2 What procedures should a firm follow in selecting a distributor?
- 3 Why is it difficult – financially and legally – to terminate a relationship with overseas intermediaries? What should be done to prevent or minimize such difficulties?
- 4 What is the difference between direct and indirect exporting?
- 5 Discuss the financial and pricing techniques for motivating foreign distributors.
- 6 Which marketing tasks should be handled by the exporter and which ones by its intermediaries in foreign markets?
- 7 How can the carrier and the rider both benefit from a piggyback arrangement?
- 8 'When exporting to a market, you're only as good as your intermediary there.' Discuss.
- 9 Why are joint ventures preferred by host countries as an entry strategy for foreign firms?
- 10 Why are strategic alliances used in new product development?

- 11 Under what circumstances should franchising be considered? How do these circumstances vary from those leading to licensing?
- 12 Do you believe that licensing in represents a feasible long-term product development strategy for a company? Discuss in relation to in-house product development.
- 13 Why would a firm consider forming partnerships with competitors?
- 14 Apart from the management fees involved, what benefits might a firm derive from entering into management contracts overseas?
- 15 By what criteria would you judge a particular foreign direct investment activity to have succeeded or failed?
- 16 What are a firm's major motives in deciding to establish manufacturing facilities in a foreign country?
- 17 Is the establishment of wholly-owned subsidiaries abroad an appropriate international market development for SMEs?
- 18 What is the idea behind appointing a 'lead country' in a region?

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