

## Intermediate entry modes

### Contents

- 11.1 Introduction
- 11.2 Contract manufacturing
- 11.3 Licensing
- 11.4 Franchising
- 11.5 Joint ventures/strategic alliances
- 11.6 Other intermediate entry modes
- 11.7 Summary

### Case studies

- 11.1 Ka-Boo-Ki
- 11.2 Bayer and GlaxoSmithKline
- 11.3 Video case study: Marriott

### Learning objectives

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

- Describe and understand the main intermediate entry modes:
  - contract manufacturing;
  - licensing;
  - franchising; and
  - joint venture/strategic alliances.
- Discuss the advantages and disadvantages of 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.

### 11.1 Introduction

So far we have assumed that the firm entering foreign markets is supplying them from domestic plants. This is implicit in any form of exporting. However, sometimes the firm may find it either impossible or undesirable to supply all foreign markets from domestic production. Intermediate entry modes 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 the way 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.

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 11.1 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.

## 11.2 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.

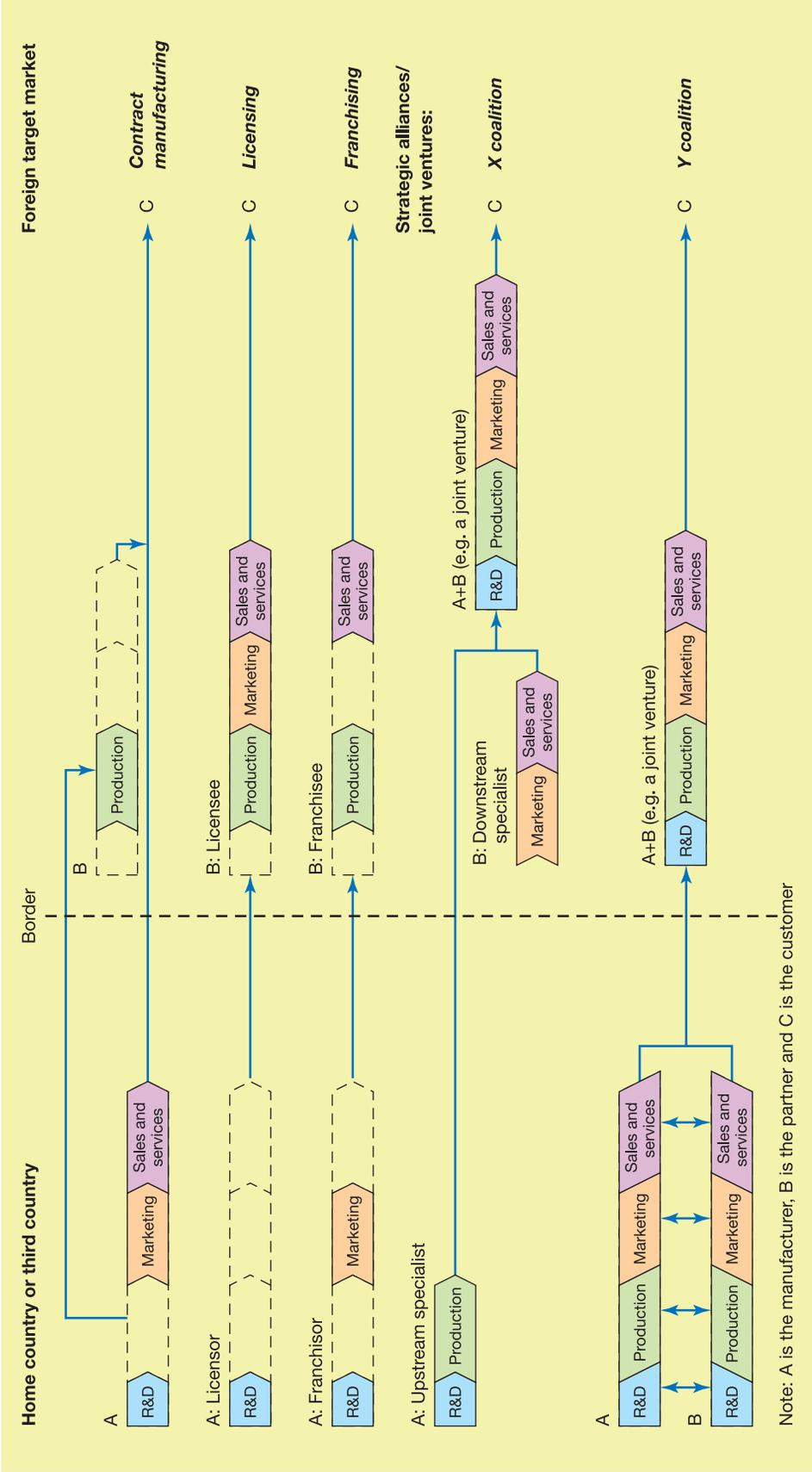
**Contract manufacturing** enables the firm to have foreign sourcing (production) without making a final commitment. Management may lack resources or be unwilling to invest equity to establish and complete manufacturing and selling operations. Yet contract manufacturing keeps the way open for implementing 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 products in international markets, while handing over responsibility for production to a local firm (see Figure 11.1).

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.

Figure 11.1 Intermediate modes



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.

## 11.3 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 11.1).

### 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).

When setting the price for the agreement the costs of licensing should not be underestimated. Table 11.1 presents a breakdown of costs of licensing out by Australian firms.

### 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).

**Table 11.1** Relative costs of licensing overseas (%)

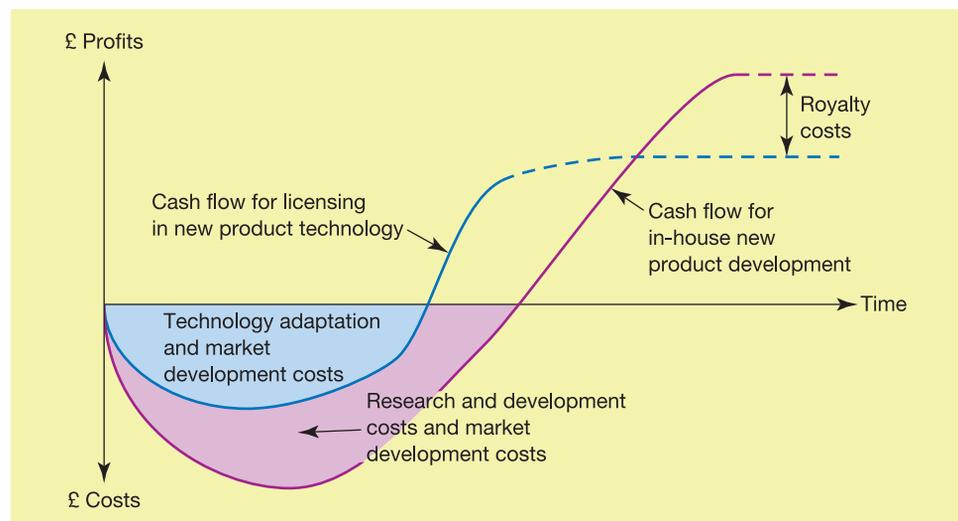
<b>Breakdown of total costs of licensing overseas</b>	
Protection of industrial property	24.4
Establishment of licensing agreement	46.6
Maintenance of licensing agreement	29.0
	<u>100.0</u>
<b>Breakdown of establishment costs</b>	
Search for suitable licensee	22.8
Communication between involved parties	44.7
Adoption and testing of equipment for licensee	9.9
Training personnel for licensee	19.9
Other (additional marketing activity and legal expenses)	2.7
	<u>100.0</u>
<b>Breakdown of maintenance costs</b>	
Audit of licensee	9.7
Ongoing market research in market of licensee	7.2
Back-up services for licensee	65.0
Defence of industrial property rights in licensee's territory	11.0
Other	7.1
	<u>100.0</u>

Sources: based on Carstairs and Welch (1981) and Young *et al.* (1989), p. 132.

As Figure 11.2 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 11.5 (see section 11.6) summarizes the advantages and disadvantages of licensing for the licensor.

**Figure 11.2** Life cycle benefits of licensing



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

## 11.4 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 subfranchisor. 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.

The package may also include the right for the local entity, a subfranchisor, to establish and service its own subsystem of subfranchisees within its appointed territory.

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, subfranchisees and subfranchisors can also receive subsupplies from the franchisor 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 11.2.

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.

**Table 11.2** 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.
Licensees 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.
Licensees 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.

The fast-food business is taken as an example of franchising in the value chain approach of Figure 11.1. 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, 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.

### **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).

## 11.5 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.

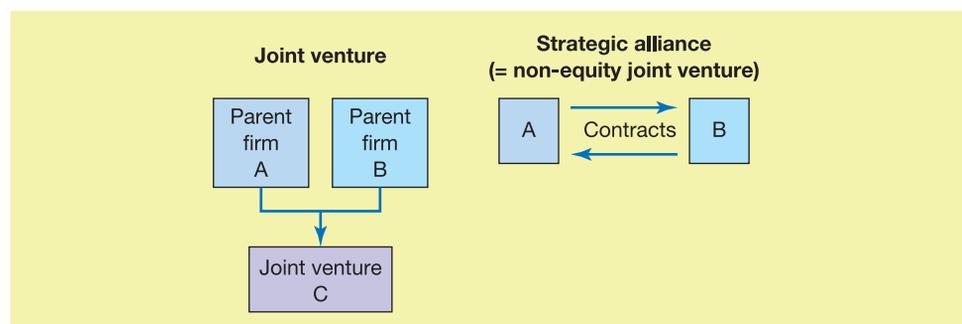
In a contractual joint venture no joint enterprise with a separate personality is formed. Two or more companies form a partnership to share the cost of investment, the risks and the long-term profits. An equity joint venture involves the creation of a new company in which foreign and local investors share ownership and control. Thus, according to these definitions, strategic alliances and non-equity joint ventures are more or less the same (Figure 11.3).

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.

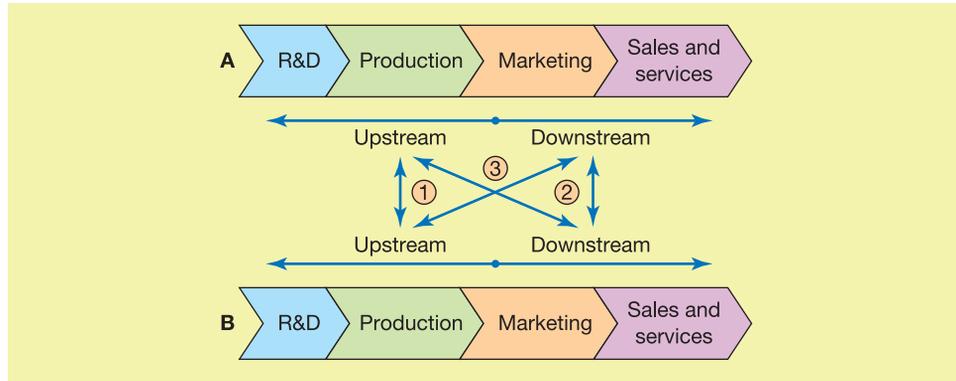
In Figure 11.4 two different types of coalition are shown in the value chain perspective. These are based on the possible collaboration pattern along the value chain. In Figure 11.4 we see two partners, A and B, each having its own value chain. Three different types of value chain partnership, appear:

- 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.

Figure 11.3 Joint ventures and strategic alliances



**Figure 11.4** Collaboration possibilities for partners A and B in the value chain



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

3 *Upstream/downstream-based collaboration.* A and B have different but complementary competences at each end of the value chain.

Types 1 and 2 represent the so-called **Y coalition** and type 3 represents the so-called **X coalition** (Porter and Fuller, 1986, pp. 336–7):

**Y-coalitions**

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-coalitions**

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.

- *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.

**Stages in joint-venture formation**

The various stages in the formation of a joint venture are shown in Table 11.3.

**Step 1: Joint-venture objectives**

Joint ventures are formed for a variety of reasons: entering new markets, reducing manufacturing costs, and developing and diffusing new technologies rapidly. Joint ventures are also used to accelerate product introduction and overcome legal and trade

**Table 11.3** Stages in joint-venture formation

<b>1 Joint venture objectives</b>	Establish strategic objectives of the joint venture and specify time period for achieving objectives.
<b>2 Cost/benefit analysis</b>	Evaluate advantages and disadvantages of joint venture compared with alternative strategies for achieving objectives (e.g. licensing) in terms of: <ul style="list-style-type: none"> <li>(a) financial commitment;</li> <li>(b) synergy;</li> <li>(c) management commitment;</li> <li>(d) risk reduction;</li> <li>(e) control;</li> <li>(f) long-run market penetration; and</li> <li>(g) other advantages/disadvantages.</li> </ul>
<b>3 Selecting partner(s)</b>	<ul style="list-style-type: none"> <li>(a) profile of desired features of candidates;</li> <li>(b) identifying joint-venture candidates and drawing up short list;</li> <li>(c) screening and evaluating possible joint-venture partners;</li> <li>(d) initial contact/discussions; and</li> <li>(e) choice of partner.</li> </ul>
<b>4 Develop business plan</b>	Achieve broad agreement on different issues.
<b>5 Negotiation of joint-venture agreement</b>	Final agreement on business plan.
<b>6 Contract writing</b>	Incorporation of agreement in legally binding contract, allowing for subsequent modifications to the agreement.
<b>7 Performance evaluation</b>	Establish control systems for measuring venture performance.

Source: Adapted from Young *et al.*, 1989, p. 233.

barriers expeditiously. In this period of advanced technology and global markets implementing strategies quickly is essential. Forming alliances is often the fastest, most effective method of achieving objectives. Companies must be sure that the goal of the alliance is compatible with their existing businesses, so their expertise is transferable to the alliance. Firms often enter into alliances based on opportunity rather than linkage with their overall goals. This risk is greatest when a company has a surplus of cash.

There are three principal objectives in forming a joint venture:

- 1 *Entering new markets.* Many companies recognize that they lack the necessary marketing expertise when they enter new markets. Rather than trying to develop this expertise internally the company may identify another organization that possesses those desired marketing skills. Then, by capitalizing on the product development skills of one company and the marketing skills of the other, the resulting alliance can serve the market quickly and effectively. Alliances may be particularly helpful when entering a foreign market for the first time because of the extensive cultural differences that may abound. They may also be effective domestically when entering regional or ethnic markets.
- 2 *Reducing manufacturing costs.* Joint ventures may allow companies to pool capital or existing facilities to gain economies of scale or increase the use of facilities, thereby reducing manufacturing costs.
- 3 *Developing and diffusing technology.* Joint ventures may also be used to build jointly on the technical expertise of two or more companies in developing products that are technologically beyond the capability of the companies acting independently.

### **Step 2: Cost/benefit analysis**

A joint venture/strategic alliance may not be the best way of achieving objectives. Therefore this entry mode should be evaluated against other entry modes. Such an analysis could be based on the factors influencing the choice of entry mode (see section 9.3).

### **Step 3: Selecting partner(s)**

If it is accepted that a joint venture is the best entry mode for achieving the firm's objectives, the next stage is the selection of the joint-venture partner. This normally involves five stages.

#### ***Establishing a desired partner profile***

Companies frequently search for one or more of the following resources in a partner:

- development know-how;
- sales and service expertise;
- low-cost production facilities;
- strategically critical manufacturing capabilities;
- reputation and brand equity;
- market access and knowledge;
- cash.

#### ***Identifying joint-venture candidates***

Often this part of partner selection is not performed thoroughly. The first candidate, generally discovered through contacts established by mail, arranged by a banker or a business colleague already established in the country, is often the one with whom the company undertakes discussions. Little or no screening is done, nor is there an in-depth investigation of the motives and capabilities of the candidate. At other times the personal network that executives maintain with senior managers from other firms shapes the set of prospective joint-venture partners that companies will generally consider. All too often, however, alliances are agreed upon informally by these top managers without careful attention to how appropriate the partner match may be. Instead of taking this reactive approach the firm should proactively search for joint-venture candidates. Possible candidates can be found among competitors, suppliers, customers, related industries and trade association members.

#### ***Screening and evaluating possible joint-venture partners***

Relationships get off to a good start if partners know each other. Table 11.4 gives some criteria that may be used to judge a prospective partner's effectiveness.

These suggestions form only an outline sketch of the type of information that can be used to grade partners. They cover areas where there is a reasonable chance of forming a view by the appraisal of published information and by sensible observation and questioning.

#### ***Initial contacts/discussions***

Since relationships between companies are relationships between people it is important that the top managers of the firm meet personally with top managers from the remaining two or three possible partners. It is important to highlight the personal side of a business relationship. This includes discussion of personal and social interests to see if there is a good 'chemistry' between the prospective partners.

#### ***Choice of partner***

The chosen partner should bring the desired complementary strength to the partnership. Ideally the strengths contributed by the partners will be unique, for only these

**Table 11.4** Analysis of prospective partners: examples of criteria that may be used to judge a prospective partner's effectiveness by assessing existing business ventures and commercial attitudes

<p><b>1 Finance</b> Financial history and overall financial standing (all the usual ratios). Possible reasons for successful business areas. Possible reasons for unsuccessful business areas.</p> <p><b>2 Organization</b> Structure of organization. Quality and turnover of senior managers. Workforce conditions/labour relations. Information and reporting systems; evidence of planning. Effective owner's working relationship with business.</p> <p><b>3 Market</b> Reputation in marketplace and with competitors. Evidence of research/interest in service and quality. Sales methods; quality of sales force. Evidence of handling weakening market conditions. Results of new business started.</p>	<p><b>4 Production</b> Condition of existing premises/works. Production efficiencies/layouts. Capital investments and improvements. Quality control procedures. Evidence of research (internal/external); introduction of new technology. Relationship with main suppliers.</p> <p><b>5 Institutional</b> Government and business contacts (influence). Successful negotiations with banks, licensing authorities, etc. Main contacts with non-national organizations and companies. Geographical influence.</p> <p><b>6 Possible negotiating attitudes</b> Flexible or hardline. Reasonably open or closed and secretive. Short-term or long-term orientation. Wheeler-dealer or objective negotiator. Positive, quick decision making or tentative. Negotiating experience and strength of team support.</p>
--	--

Sources: Walmsley, 1982; Paliwoda, 1993.

strengths can be sustained and defended over the long term. The goal is to develop synergies between the contributions of the partners, resulting in a win-win situation for both. Moreover, the partners must be compatible and willing to trust one another.

It is important that neither partner has the desire to acquire the other partner's strength, or the necessary mutual trust will be destroyed. Dow Chemical Company, a frequent and successful alliance practitioner, uses the negotiation process to judge other corporate cultures and, consequently, their compatibility and trustworthiness.

Commitment to the joint venture is essential. This commitment must be both financial and psychological. Unless there is senior management endorsement and enthusiasm at the operating level an alliance will struggle, particularly when tough issues arise.

#### Step 4: Develop business plan

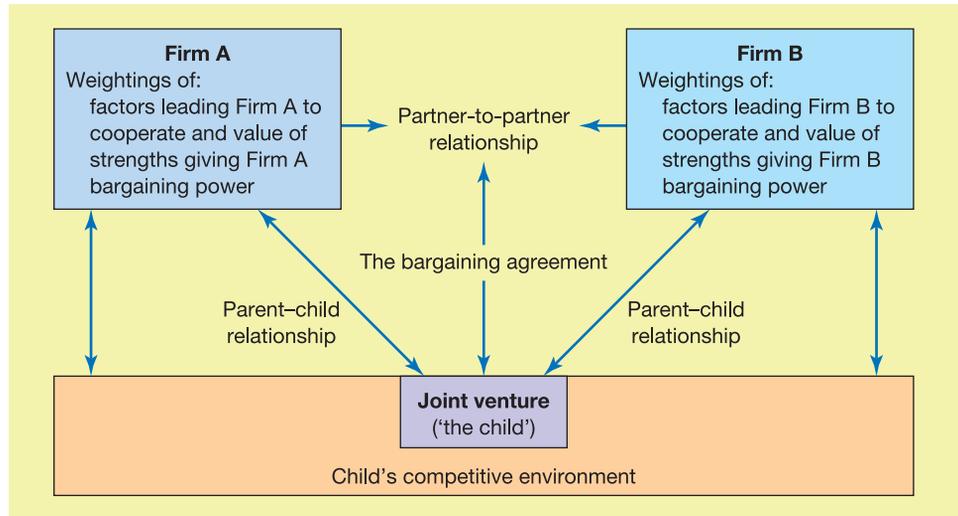
Issues that have to be negotiated and determined prior to the establishment of the joint venture include the following:

- ownership split (majority, minority, 50–50);
- management (composition of board of directors, organization, etc.);
- production (installation of machinery, training, etc.);
- marketing (the 4-Ps, organization).

#### Step 5: Negotiation of joint-venture agreement

As Figure 11.5 shows, the final agreement is determined by the relative bargaining power of both prospective partners.

Figure 11.5 Partner-to-partner relationships creating a joint venture



Source: Harrigan, 1985, p. 50.

### Step 6: Contract writing

Once the joint-venture agreement has been negotiated it needs to be written into a legally binding contract. Of course, the contract should cover the 'marriage' conditions of the partners, but it should also cover the 'divorce' situation, such as what happens with 'the child' (the joint venture).

### Step 7: Performance evaluation

Evaluating joint-venture performance is a difficult issue. Managers often fall into the trap of assessing partnerships as if they were internal corporate divisions with unambiguous goals operating in low-risk, stable environments. Bottom-line profits, cash flow, market share and other traditional financially oriented output measures become standard indicators of performance. These measures may be inappropriate for two reasons. First, they reflect a short-term orientation, and maximization of initial output too soon can jeopardize the prospects for alliances positioned for the long term. Second, the goals of many alliances may not be readily quantifiable. For instance, a partnership's objectives may involve obtaining access to a market or blocking a competitor.

Many alliances need considerable time before they are ready to be judged on conventional output measures. Only after partnerships mature (i.e. when the operations of the alliance are well established and well understood) can managers gradually shift to measure output, such as profits and cash flows.

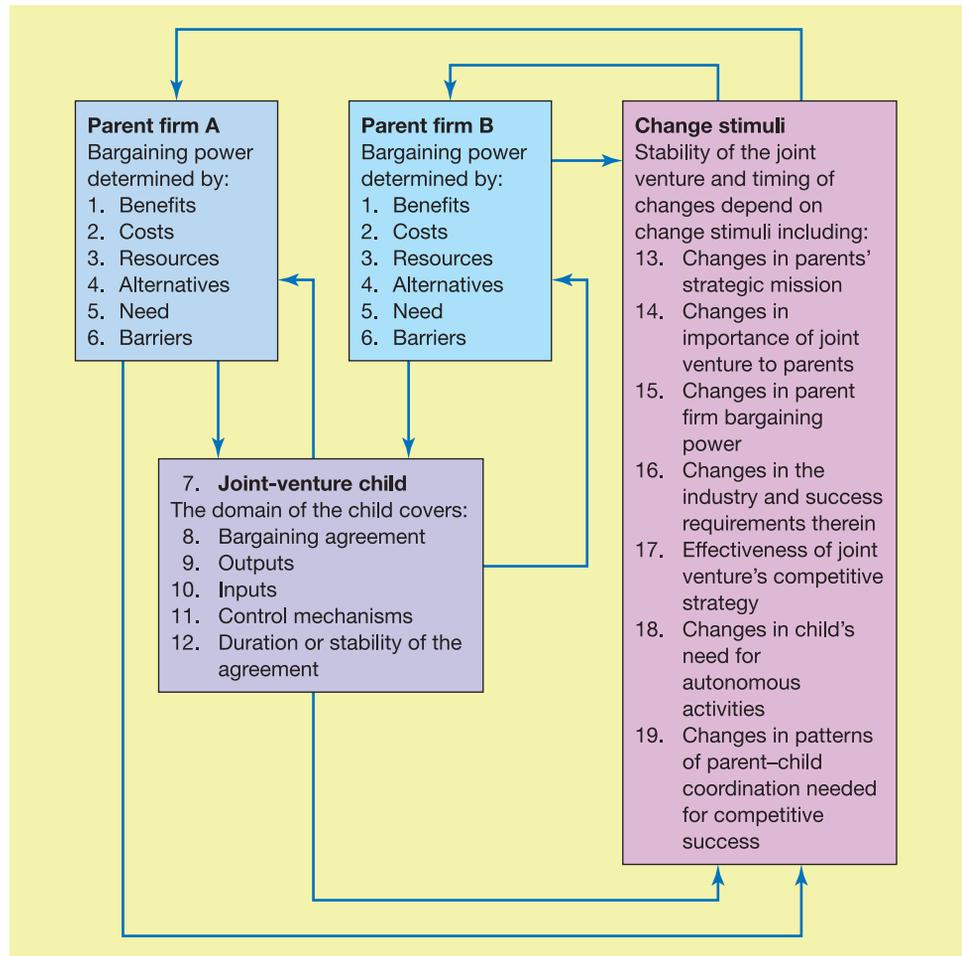
Thus expecting too much too soon in terms of profit and cash flows from an alliance working under risky conditions can endanger its future success.

### Managing the joint venture

In recent years we have seen an increasing number of cross-border joint ventures. 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.

Harrigan's model (Figure 11.6) can be used as a framework for explaining this high 'divorce rate'.

Figure 11.6 Model of joint-venture activity



Source: Harrigan, 1985, p. 52.

### 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 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.

## 11.6 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 11.5.

**Table 11.5** Advantages and disadvantages of the different intermediate modes

Intermediate entry mode	Advantages	Disadvantages
<b>Contract manufacturing (seen from the contractor's viewpoint)</b>	<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&amp;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>
<b>Licensing (seen from the licensor's viewpoint)</b>	<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 11.5 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.</p> <p>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>

Other management contracts may be part of a deal to sell a processing plant as a project or a turnkey operation. This issue will be dealt with more intensively in section 13.8.

### Exhibit 11.1 McDonald's + Coca-Cola + Disney = a powerful alliance

Today business is being driven by two fashionable ideas: globalization and core competences. The first compels companies to look for ways to sell their product in as many different places as possible, which often requires other people to help them. The second, the fashion for a firm sticking to what it does best, means that they must often let outsiders help them with everything else.

The ties binding Coca-Cola, McDonald's and Disney vary enormously.

#### McDonald's ↔ Disney

In 1997 McDonald's and Disney began a formal ten-year alliance. The first specific outcome was a Disney film, *Flubber*, whose box-office returns were helped by tie-ins at McDonald's. In July 1998 a promotion started of *Armageddon*, a \$111 million film starring Bruce Willis, with McDonald's selling tickets and special 'Astromeals' at each of its 23,500 restaurants worldwide. This time the target was not children but young adults – a market in which McDonald's is weaker.

#### McDonald's ↔ Coca-Cola

This alliance has no formal agreement – no piece of paper to fall back on. Although Coca-Cola sells drinks to other restaurants, its relationship with McDonald's goes far beyond that of a mere supplier. It has helped its partner to set up new operations around the world. Coca-Cola is sold in almost twice as many countries as McDonald's.

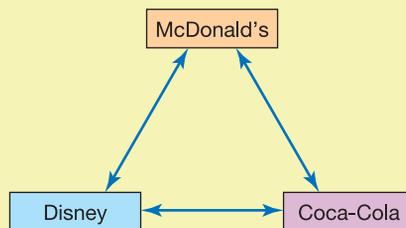
#### Coca-Cola ↔ Disney

Coca-Cola's ties to Disney are probably the weakest of the three – but they are still considerable. Coca-Cola has been the sole provider of soft drinks at Disney parks since 1955, and it has had a marketing alliance in place since 1985. Coca-Cola has also helped Disney overseas.

#### Questions

- 1 What is it that makes the Coca-Cola–Disney–McDonald's triumvirate so powerful in the globalization process?
- 2 Which factors could make the alliance of Coca-Cola–Disney–McDonald's break up?

Figure 11.7 McDonald's + Coca-Cola + Disney = a powerful alliance



## 11.7 Summary

The advantages and disadvantages of the different intermediate entry modes are summarized in Table 11.5.

CASE  
STUDY  
11.1

## Ka-Boo-Ki: Licensing in the LEGO brand

The Danish toy manufacturer LEGO is known worldwide for its LEGO bricks. LEGO is a strong and well-known brand. At the end of 1991 LEGO management received the result of three consumer surveys:

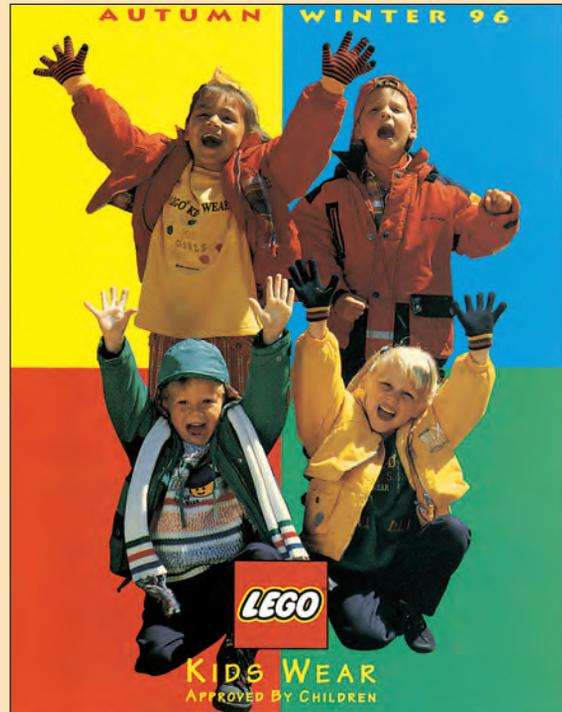
- 1 Landour Associates completed a survey at the end of 1991 of the best brands' 'image power' among 11,000 representatively chosen adults aged between 18 and 65 in the United States, Japan and Europe (Belgium, France, the Netherlands, Italy, Spain, the United Kingdom and Sweden). 'Image power' is a measure of brands' impact, where consumers' awareness of the world's leading brands is combined with their judgement of the brands' quality. In the United States and Japan LEGO was not placed among the top ten, but the results from Europe were impressive. Here LEGO was placed at number 5 after four car brands: Mercedes-Benz, Rolls-Royce, Porsche and BMW. LEGO was in front of brands such as Nestlé, Rolex, Jaguar and Ferrari.
- 2 A US survey, conducted in Europe, the United States and Japan, showed that LEGO is number 13 in the list of most appreciated brands.
- 3 A survey by a German market analysis institute showed that LEGO is one of the most well-known brands in toys in the new German Federal Republic, with an awareness share of 67 per cent. Matchbox is number 2 with 41 per cent.

The LEGO management has decided to exploit this strong brand image. A managing director for the new business area LEGO Licensing A/S has been appointed. The company's objective is to generate income from licensing suitable partners, which will use the LEGO brand in marketing their own products.

The LEGO management has noticed that Coca-Cola has an income of Dkr3 billion from licensing alone. Coca-Cola's strategy can be characterized as 'brand milking', where a brand is sold to the highest bidder in each product area.

### Ideas become viable

In 1993 the idea of licensing the LEGO brand became viable for the Danish textile firm Ka-Boo-Ki, as it was given the rights to use the LEGO brand in



Children in Ka-Boo-Ki clothes (Lego licence)

connection with the production and sale of children's clothes. For Ka-Boo-Ki's Managing Director, Torben Klausen, the idea of producing children's clothes is not new. He was earlier employed in LEGO's international marketing department, where he was in charge of coordinating the European marketing of LEGO bricks. From this position he was able to follow the development of the licensing concept. Since 1993 things have been developing very fast. In mid-1997 Ka-Boo-Ki, which has invested a considerable amount of money in the R&D of LEGO children's clothes, was selling to approximately 900 shops, primarily in Scandinavia and England.

Torben Klausen says:

We received a strong international brand from the first day. But in selling LEGO children's comes an obligation to live up to the LEGO company's unique quality demands. LEGO must approve all new models that are put on the market, and that is between 350 and 400 a year.

LEGO children's clothes distinguish themselves from other brands by being functional and having strong colours and an uncompromising quality. This means a relatively high price for the clothes, and that the products are not sold in discount shops. The clothes are sold on the basis of a shop-in-shop concept, where merchandising and display facilities are very important.

### Questions

You have just been employed by LEGO Licensing A/S in connection with the development of the licensing data. You are given the following assignments.

- 1 What are the most important factors determining future market demand for LEGO children's clothes from Ka-Boo-Ki?
- 2 Which other products could be considered for licensing out the LEGO brand?
- 3 List some criteria for choosing suitable licensees and future products for the LEGO brand (licensing out).
- 4 What values/benefits can LEGO transfer to the licensee (e.g. Ka-Boo-Ki) apart from the use of the LEGO brand?
- 5 What values/benefits can the licensee transfer to the licensor?

## CASE STUDY 11.2

### Bayer and GlaxoSmithKline: Can the X-coalition and the product Levitra challenge Viagra's market leader position?

In November 2001 Bayer and GlaxoSmithKline (GSK) signed a worldwide co-promotion and co-development agreement ([www.bayergsk.com](http://www.bayergsk.com)) to launch a new treatment for men seeking to improve their erectile function, Levitra. Since then both companies were working together on the development and future marketing of the product. Under the terms of a joint promotion agreement Bayer would mainly take care of up-stream activities (manufacturing the product and being responsible for all regulatory work required to obtain product approval), whereas GSK would take care of down-stream activities by promoting Levitra worldwide. Selling and future development expenses, along with all the profits, will be shared by the two companies. If Bayer was seeking sales force (down-stream) strength in the alliance, it seemed to be a wise decision. GSK's US sales force is the largest of all the pharmaceutical companies, with 8,000 representatives. But on 10 January 2005 something happened. Both GSK and Bayer announced that Bayer had taken back control of the ex-US rights for Levitra. Bayer said it had paid \$272

million to buy out GSK as joint promoter of the treatment in Europe, Asia, the Pacific, Latin America and Canada. GSK will continue jointly to promote Levitra in the United States with Bayer through its distributor, Schering-Plough, and has retained the rights in a few other markets including Italy.

It seems that the main driver of this deal was the poor sales of Levitra in the context of the rest of the ED (erectile dysfunction) market.

The battle for dominance in a condition that affects about one in five men is fierce. Cialis, a drug

from Indianapolis-based Eli Lilly/Ico, a joint venture between Eli Lilly & Co. ([www.lilly.com](http://www.lilly.com)) and Icos Corp. ([www.icos.com](http://www.icos.com)) won European approval in 2002 and hit pharmacies in the United States the following year.

Leverkusen-based Bayer is still suffering from the 2001 withdrawal of the cholesterol lowering drug Lipobay. The company that invented aspirin said in 2002 it was prepared to merge its drugs business with a larger rival.

### The Drug Treatment market for ED

As many as half of men over 40 have at least mild or occasional impotence, but Pfizer estimates that only about 15 per cent of those men get prescriptions for Viagra, Cialis or Levitra in a given year. Many men are still reluctant to ask their doctors about Viagra and Pfizer wants to remove any stigma still associated with erectile dysfunction. However, the stigma associated with impotence drugs has greatly lessened since Viagra was introduced, in part because of advertising featuring famous athletes and celebrities (e.g. the politician Bob Dole). Viagra, the first impotence drug in pill form, generated enormous interest even before Pfizer began selling it in May 1998. With the market saturated, the original sales estimates now appear to have been too high. The roughly \$4.0 billion in worldwide sales for Cialis, Levitra and Viagra last year made up about 0.7 per cent of total prescription drug spending. In the United States, the biggest market for drugs, doctors prescribe impotence drugs about 17 million times a year, to fewer than 5 million men, compared with nearly 40 million prescriptions for osteoporosis medicines and 100 million for anti-depressants, which are among the most widely prescribed medicines.

The comparison between the three products shows the following differences:

- Levitra provides a slight improvement to Viagra. It can be taken with food, takes 30 minutes to take effect and lasts up to five hours (Viagra lasts for four hours).

**Table 1** The world market for ED Drug treatment

Region	World market for ED drug treatment (\$billion)
USA	2.0
Rest of the world	2.0
Total	4.0
Major players	Market share (%)
Viagra (Pfizer)	60 (main market: USA)
Cialis (Eli Lilly/Icos)	25 (main market: Europe, Asia)
Levitra (Bayer/GSK)	15 (main market: Europe)
Total	100

- Levitra has many of the same side effects as Viagra, including vision changes, but with a lower incident rate.
- Levitra works well in diabetes patients suffering from ED.
- Cialis has some advantages over the other two drugs. A single pill can have an erection effect for up to 36 hours.
- Cialis' long action duration reduces the need for planning around sexual activity, and has earned the drug the affectionate title of 'Le Weekend' by the French.

Table 1 shows how the world market for ED Drug treatment looked like in 2005.

The market share of Viagra has decreased from 80 per cent in 2003, to 70 per cent in 2004 and 60 per cent in 2005. Levitra is placed third globally in the erectile dysfunction category.

Sources: Agovino, T. (2006) 'Levitra, Viagra running new ad campaigns', *ABC News – The Associated Press*, 2 May; Berenson, A. (2005) 'Sales of Impotence Drugs Fall, Defying Expectations', *New York Times*, 4 December.

### Questions

- 1 Explain the term 'X-coalition' (Figure 11.1), by describing the original role of the two partners – Bayer and GSK – in the alliance.
- 2 What were the advantages and the disadvantages of the alliance for each partner?
- 3 What can Levitra do to turn the negative development in global sales?

VIDEO  
CASE STUDY  
11.3

download from  
[www.pearsoned.co.uk/hollensen](http://www.pearsoned.co.uk/hollensen)

## Mariott

Mariott ([www.mariott.com](http://www.mariott.com)) is a worldwide operator and franchisor of 2,741 hotels and related facilities in 67 countries. Quality and consistent service is Marriott's main focus and keeps the company in the top position in its industry. The company is responsible for pioneering segmentation in the hospitality industry. With a wide array of hotels, Marriott meets the needs of various customer segments. Before developing any additional hotel chains and their respective brands, the company always tests properties first. Marriott is active in soliciting feedback from its customer base and focuses on really understanding its customer targets.

### Questions

- 1 What could be the main motives for Marriott in using franchising, compared to other entry modes and operation forms?
- 2 Identify several major categories of segmentation used by Marriott. For each relate specific examples of hotel services tailored to various target markets. [www.marriott.com](http://www.marriott.com) offers a brief description of thirteen brands of various Marriott hotels catering to different types of customers.

For further exercises and cases, see this book's website at [www.pearsoned.co.uk/hollensen](http://www.pearsoned.co.uk/hollensen)



## Questions for discussion

- 1 Why are joint ventures preferred by host countries as an entry strategy for foreign firms?
- 2 Why are strategic alliances used in new product development?
- 3 Under what circumstances should franchising be considered? How do these circumstances vary from those leading to licensing?
- 4 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.
- 5 Why would a firm consider forming partnerships with competitors?
- 6 Apart from the management fees involved, what benefits might a firm derive from entering into management contracts overseas?

## References

- Bleeke, J. and Ernst, D. (1994) *Collaborating to Compete: Using strategic alliances and acquisitions in the global marketplace*, John Wiley, New York.
- Bradley, F. (1995) *International Marketing Strategy* (2nd edn), Prentice Hall, Hemel Hempstead.
- Carstairs, R.T. and Welch, L.S. (1981) *A Study of Outward Foreign Licensing of Technology by Australian Companies*, Licensing Executives Society of Australia, Canberra.
- Harrigan, K.R. (1985) *Strategies for Joint Ventures*, Lexington Books and D.C. Heath, Lexington, MA.
- Hennert, J.-F., Zeng, M. (2005) 'Structural determinants of joint venture performance', *European Management Review*, 2, pp. 105–115.
- Lorange, P. and Roos, J. (1995) *Strategiske allianser i globale strategier*, Norges Eksportråd, Oslo.

- Lowe, J. and Crawford, N. (1984) *Technology Licensing and the Small Firm*, Gower, Aldershot.
- Luostarinen, R. and Welch, L. (1990) *International Business Operations*, Helsinki School of Economics, Helsinki.
- Nanda, A. and Williamson, P.J. (1995) 'Use joint ventures to ease the pain of restructuring', *Harvard Business Review*, November–December, pp. 119–128.
- Paliwoda, S. (1993) *International Marketing*, Heinemann, Oxford.
- Perkins, J.S. (1987) 'How licensing and franchising differ', *Les Nouvelles*, 22(4), pp. 155–158.
- Porter, M.E. and Fuller, M.B. (1986) 'Coalition and global strategy', in Porter, M.E. (ed.), *Competition in Global Strategies*, Harvard Business School Press, Boston, MA.
- Walmsley, J. (1982) *Handbook of International Joint Ventures*, Graham & Trotman Ltd, London.
- Young, S., Hamill, J. Wheeler, S. and Davies, J.R. (1989) *International Market Entry and Development*, Harvester Wheatsheaf/Prentice Hall, Hemel Hempstead.