CHAPTER 12

Strategies for Analyzing and Entering Foreign Markets

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AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

1. Discuss how firms analyze foreign markets.
2. Outline the process by which firms choose their mode of entry into a foreign market.
3. Describe forms of exporting and the types of intermediaries available to assist firms in exporting their goods.
4. Identify the basic issues in international licensing and discuss the advantages and disadvantages of licensing.
5. Identify the basic issues in international franchising and discuss the advantages and disadvantages of franchising.
6. Analyze contract manufacturing, management contracts, and turnkey projects as specialized entry modes for international business.
7. Characterize the greenfield and acquisition forms of foreign direct investment (FDI).

THE BUSINESS OF LUXURY

Christian Dior...Givenchy...Dom Pérignon...Louis Vuitton. To most of us, these names convey luxury, indulgence, the finer things in life. To Bernard Arnault, the chairman and chief executive officer (CEO) of the €28.1 billion fashion conglomerate LVMH Louis Vuitton Moët Hennessy SA—or more, simply, LVMH—it is his life's work. Like many French companies, LVMH is controlled by a family-owned group: In LVMH's case, the Arnault family owns 46.4 percent of its shares but 62.7 percent of the voting rights. Another 45 percent are owned by institutional investors in France, the United States, and other European countries. The remainder is owned by individuals.

LVMH is in the business of selling prestige. Consider the company's annual report: Displaying the company's portfolio of brands in glowing color, it looks more like a high-end fashion magazine than a boring compilation of the company's financial reports. LVMH plays on the ancient heritage of its brands. In 2010, for example, bottles of Veuve Clicquot were discovered amid the remains of a nineteenth-century shipwreck in the Baltic Sea. LVMH publicists let it be known that the submerged champagne retained its "admirable organoleptic qualities"—a word choice sure to appeal to Veuve Clicquot's target market. Its sister brand, Dom Pérignon, dates back to 1688, while Louis Vuitton's luggage business began in 1854. Tag Heuer, celebrating its 150th anniversary, reissued a watch line in 2010 based on its 1887 collection, and Chaumet launched its new Joséphine collection, named after its most important patron, the Emperor Napoleon's wife, to remind its customers of its imperial lineage.

LVMH is following a related-diversification strategy. It has stitched together a remarkable stable of luxury brands, organized into its Fashion and Leather Goods, Wines and Spirits, Perfumes and Cosmetics, Watches and Jewelry, and Selective Retailing strategic business units. LVMH has grown its portfolio of brands primarily by acquiring family-owned companies specializing in manufacturing and marketing luxury goods. Although it typically operates the acquired firms as stand-alone subsidiaries, the corporate parent tries to reduce their operating costs by centralizing sourcing, advertising, financing, and acquisition of real estate. In 2011, for example, LVMH purchased high-end Italian jeweler Bulgari for $6 billion. The Bulgari family swapped its 51 percent stake in Bulgari for 16.5 million LVMH shares. The Bulgari acquisition doubled LVMH's watch and jewelry revenues. Although Bulgari is being run independently, Arnault believes that the jeweler's profit margins will benefit from LVMH's expertise and economies of scale in finance, store location, sourcing, and other behind-the-scenes operations. LVMH will also help Bulgari expand its presence in Asia. Of course, LVMH is not always successful, as its attempt to purchase Hermès International demonstrated. LVMH had quietly purchased 20 percent of the company's shares, but the descendants of founder Thierry Hermès created a family holding company to counter the proposed buyout.

Despite the luxury nature of its product line, LVMH weathered the global recession well. Although the company suffered flat revenues and reduced earnings at the nadir of the global recession in 2009, its revenues and profits have subsequently boomed. In 2012, it earned €5.9 billion in profits, up almost 50 percent over their 2010 levels. Leading the way was its Fashion and Leather Goods group, which earned profits of €3.3 billion on revenues of €9.9 billion. The company believes its success rests on the "enduring values of our star brands, creativity as an absolute imperative, the quest for perfection in our products, and our efforts to ensure an environment of excellence."

For a company with a long and storied history in Europe, LVMH fully appreciates the need to broaden its appeal to customers outside the developed countries. Eleven percent of its revenues come from its home, France, and another 20 percent from the rest of Europe. The United States accounts for 23 percent of its revenues, and Japan another 8 percent. What may be surprising is that the rest of Asia contributes 28 percent of its revenues, a reflection of the growing importance of that region to the world economy and LVMH's commitment to meeting the aspirations of the region's consumers. LVMH expects China to be the largest market for luxury goods by 2020. For instance, China has provided Hennessy, the company's prestigious cognac, with double-digit growth the past three years. In recognition of the country's growing clout, Louis Vuitton featured Godfrey Gao, a Taiwanese-Canadian model and TV star, in its recent commercials for the company's man bag.[1]

Chapter 11 focused on the process by which a firm formulates its international strategy. This chapter discusses the next steps in the implementation of international strategy: choosing the markets the firm will enter and the modes of entry it will use to compete in these markets. As the opening case indicates, LVMH's primary mode of entry is to acquire purveyors of upscale goods that integrate easily into the company's portfolio of prestigious products. For some brands, LVMH operates its own retail outlets; for others, it relies on high-end retailers for distribution. In other cases, LVMH uses licensing agreements with local firms to promote its business interests or teams with local partners in joint ventures. As we discuss in this chapter, in deciding whether and how to enter a market, a well-managed firm will match its internal strengths and weaknesses to the unique opportunities and needs of that market. LVMH has successfully done this in the many national markets in which it participates.

Foreign Market Analysis

Regardless of their strategies, most international businesses have the fundamental goals of expanding market share, revenues, and profits. They often achieve these goals by entering new markets or by introducing new products into markets in which they already have a presence. A firm's ability to do this effectively hinges on its developing a thorough understanding of a given geographical or product market.[2] To successfully increase market share, revenue, and profits, firms must normally follow three steps: (1) assess alternative markets, (2) evaluate the respective costs, benefits, and risks of entering each, and (3) select those that hold the most potential for entry or expansion.

Assessing Alternative Foreign Markets

In assessing alternative foreign markets, a firm must consider a variety of factors, including the current and potential sizes of these markets, the levels of competition the firm will face, the markets' legal and political environments, and sociocultural factors that may affect the firm's operations and performance.[3] Table 12.1 summarizes some of the most important questions that firms need to address when analyzing new market opportunities.

Information about some of these factors is relatively objective and easy to obtain. For example, a country's currency stability is important to a firm contemplating exporting to or importing from that country or analyzing investment opportunities there. Objective information about this topic can be easily obtained from various published sources in the firm's home country or on the Internet. Other information about foreign markets is much more subjective and may be quite difficult to obtain. For instance, information about the honesty of local government officials or on the process of obtaining utility permits may be hard to acquire in the firm's home country. Obtaining such information often entails visiting the foreign location early in the decision-making process to talk to local experts, such as embassy staff and chamber of commerce officials, or contracting with a consulting firm to obtain the needed data.[4]

MARKET POTENTIAL The first step in foreign market selection is assessing market potential. Many publications, such as those listed in "Building Global Skills" in Chapter 2, provide data about population, gross domestic product (GDP), per capita GDP, public infrastructure, and ownership of such goods as automobiles and televisions. Such data permit firms to conduct a preliminary "quick-and-dirty" screening of various foreign markets.

The decisions a firm draws from this information often depend on the positioning of its products relative to those of its competitors. A firm producing high-quality products at premium prices will find richer markets attractive but may have more difficulty penetrating a poorer market. Conversely, a firm specializing in low-priced, lower-quality goods may find the poorer market even more lucrative than the richer market. (See "Venturing Abroad" for another aspect of this assessment.)

A firm must then collect data relevant to the specific product line under consideration. For instance, if Pirelli SpA is contemplating exporting tires to Thailand, its strategic managers must collect data about that country's transportation infrastructure, transportation alternatives, gasoline prices, and growth of vehicle ownership. Pirelli would also need data on the average age of motor vehicles and the production of automobiles in Thailand to assess whether to focus its marketing efforts on the replacement market or the original equipment manufacturer (OEM) market. In some situations, a firm may have to resort to using proxy data. For example, Whirlpool, in deciding whether to enter the dishwasher market in Indonesia, could examine sales of other household appliances, per capita electricity consumption, or the number of two-income families. Firms may also be concerned about the income distribution of the country.

But such data reflect the past, not the future. Firms must also consider the potential for growth in a country's economy by using both objective and subjective measures. Objective measures include changes in per capita income, energy consumption, GDP, and ownership of consumer durables such as private automobiles. More subjective considerations must also be taken into account when assessing potential growth. For example, following the collapse of communist economies in Central and Eastern Europe, many Western firms ignored the data indicating negative economic growth in these countries. Instead they focused on the prospects for future growth as these countries adopted new economic policies and programs. As a result,

EMERGING OPPORTUNITIES

THE BOTTOM OF THE PYRAMID

As Figure 2.1 indicated, the majority of the world's economic activity is generated by the developed countries: the European Union (EU), the United States, Canada, and the rich countries of Asia and Oceana—Japan, South Korea, Australia, New Zealand, Taiwan, Hong Kong, and Singapore. And there is little doubt that these lucrative markets have captured the attention of the world's entrepreneurs and international businesses.

C. K. Prahalad, in his influential 2004 book *The Fortune at the Bottom of the Pyramid*, argues that these businesspersons should turn their attention to the poorest of the 4 billion people in China, India, and other emerging markets who are now just becoming part of the market economy—what he calls the aspiring poor with incomes below $2 a day. After adjusting for purchasing power parity (PPP), Prahalad believes the potential size of this market is huge but recognizes that firms focused on developed markets may need to rethink how they make and market their products to meet the needs of the aspiring poor. For example, one simple approach is to sell products such as toothpaste or shampoo in single-use sizes. Nonetheless, he argues that firms can boost their profitability and help alleviate poverty by targeting the bottom of the pyramid.

Other scholars are not so sure. Aneel Karnani notes that adjusting the incomes of the poor for purchasing power may overstate the importance of the market to international businesses. After all, the revenue and profit potential of a market for multinational corporations (MNCs) denominated in their home currency is calculated using actual exchange rates, not PPP-adjusted rates. Thus, Karnani believes the size of the bottom of the pyramid market in emerging markets is much smaller than Prahalad estimates. Then there is the problem of actually making a profit. MNCs may find it difficult to reduce their costs of production to a level necessary to be able to sell to people at the bottom of the pyramid. Moreover, much of the incomes of people at the bottom of the pyramid is spent on food and other necessities. And operating costs are often unexpectedly high because of infrastructure deficiencies in emerging markets.

Sources: Aneel Karnani, "Fortune at the bottom of the pyramid: A mirage," *California Management Review*, Vol. 49, No. 4 (Summer 2007); C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (Wharton School Publishing, 2004).

China's economic boom.[5] Google, for instance, is targeting the continent, believing that Africa's current low Internet penetration rates create enormous growth potential as its infrastructure improves. Moreover, mobile phone use is exploding—Nigeria alone added 75 million cell phone subscribers during the 2000s—creating demand for company services such as Google maps and Gmail. Major global advertising groups like Publicis Groupe SA, WPP, and Omnicom are expanding their operations in numerous African countries or buying up local advertising agencies in response to their multinational clients' interest in marketing to African customers. Ghana, Kenya, Angola, and Nigeria have attracted particular attention, in addition to the continent's economic powerhouse, South Africa.[6]

LEVELS OF COMPETITION Another factor a firm must consider in selecting a foreign market is the level of competition in the market—both the current level and the likely future level. To assess the competitive environment, it should identify the number and sizes of firms already competing in the target market, their relative market shares, their pricing and distribution strategies, and their relative strengths and weaknesses, both individually and collectively. It must then weigh these factors against actual market conditions and its own competitive position. For example, Kia entered the crowded North American automobile market believing low labor costs at its Korean factories would allow it to charge lower prices than entrenched competitors such as GM, Ford, Toyota, and Volkswagen.

Most successful firms continually monitor major markets to exploit opportunities as they become available. This is particularly critical for industries undergoing technological or regulatory changes. The telecommunications industry provides an important example of this phenomenon. Once the home of inefficient, plodding state-owned monopolies, this industry is now the epicenter of the convergence of a variety of new technologies and products—fiber-optics, smartphones, tablets, 4G cellular service, satellite networks, and so on. Many of these firms—particularly in Europe and Latin America—have been privatized. Privatization has been coupled with the tumbling of regulatory barriers to entry and innovation, allowing firms to enter new geographic and product markets, as Telefónica SA has done in Latin America as detailed in Chapter 11's closing case, "The New Conquistador."

LEGAL AND POLITICAL ENVIRONMENT A firm contemplating entry into a particular market also needs to understand the host country's trade policies and its general legal and political environments. A firm may choose to forgo exporting its goods to a country that has high tariffs and other trade restrictions in favor of exporting to one that has fewer or less significant barriers. Conversely, trade policies or trade barriers may induce a firm to enter a market via FDI. For example, Ford, GM, Audi, and Mercedes-Benz built auto factories in Brazil to avoid that country's high tariffs and to use Brazil as a production platform to access other Mercosur members. And some countries require foreign firms wanting to establish local operations to work with a local joint-venture partner.

Government stability is an important factor in foreign market assessment. Some less-developed countries have been prone to military coups and similar disruptions. Government regulation of pricing and promotional activities may need to be considered. For example, many governments restrict advertising for tobacco and alcohol products, so foreign manufacturers of those products must understand how those restrictions will affect their ability to market their goods in those countries. Care also often needs to be taken to avoid offending the political sensibilities of the host nation. Consider the political implications of the language used to describe the island of Taiwan. The leadership of the People's Republic of China (PRC) refuses to recognize the Republic of China (ROC) as an independent nation, viewing Taiwan as a breakaway province. Labeling Taiwan as the Republic of China might discourage sales of this textbook in the PRC; failure to do so might hurt sales in the ROC/Taiwan.

SOCIOCULTURAL INFLUENCES Managers assessing foreign markets must also consider sociocultural influences, which, because of their subjective nature, are often difficult to quantify. To reduce the uncertainty associated with these factors, firms often focus their initial internationalization efforts in countries culturally similar to their home markets.[7] For example, Canada was the location of Starbucks' and Hollister's first international outlets.

If the proposed strategy is to produce goods in another country and export them to the market under consideration, the most relevant sociocultural factors are those associated with consumers. Firms that fail to recognize the needs and preferences of host country consumers often run into trouble. For example, Denmark's Bang & Olufsen, a well-known stereo system manufacturer, floundered in some markets because its designers stress style rather than function. Japanese competitors, meanwhile, stress function and innovation over style and design. Bang & Olufsen's Danish managers failed to realize that consumers in markets such as the United States are generally more interested in function than in design and that they are more willing to pay for new technology than for an interesting appearance.[8]

A firm considering FDI in a factory or distribution center must also evaluate sociocultural factors associated with potential employees.[9] It must understand the motivational basis for work in that country, the norms for working hours and pay, and the role of labor unions. By hiring—and listening to—local managers, foreign firms can often avoid or reduce cultural conflicts.

Evaluating Costs, Benefits, and Risks

The next step in foreign market assessment is a careful evaluation of the costs, benefits, and risks associated with doing business in a particular foreign market.

COSTS Two types of costs are relevant at this point: direct and opportunity. Direct costs are those the firm incurs in entering a new foreign market and include costs associated with setting up a business operation (leasing or buying a facility, for example), transferring managers to run it, and shipping equipment and merchandise. The firm also incurs opportunity costs. Because a firm has limited resources, entering one market may preclude or delay its entry into another. The profits it would have earned in that second market are its opportunity costs—the organization has forfeited or delayed its opportunity to earn those profits by choosing to enter another market first. Thus, the firm's planners must carefully assess all the alternatives available to it.

BENEFITS Entering a new market presumably offers a firm many potential benefits; otherwise, why do it? Among the most obvious potential benefits are the expected sales and profits from the market. Others include lower acquisition and manufacturing costs (if materials or labor are cheap), foreclosing of markets to competitors (which limits competitors' ability to earn profits), competitive advantage (which allows the firm to keep ahead of or abreast with its competition), access to new technology, and the opportunity to achieve synergy with other operations.

RISKS Of course, few benefits are achieved without some degree of risk. Many of the previous chapters provided overviews of the specific types of risks facing international businesses. Generally, a firm entering a new market incurs the risks of exchange rate fluctuations, additional operating complexity, and direct financial losses resulting from inaccurate assessment of market potential. In extreme cases, it also faces the risk of loss through government seizure of property or as a result of war or terrorism.

This list of factors a firm must consider when assessing foreign markets may seem burdensome. Nonetheless, successful international businesses carefully analyze these factors to uncover and exploit any and all opportunities available to them. At best, poor market assessments may rob a firm of profitable opportunities. At worst, a continued inability to reach the right decisions may threaten the firm's existence.

In Practice

- Globalization has created numerous opportunities for firms to increase their profits by expanding into new markets.
- Firms must carefully assess a variety of issues, including levels of competition, the host country's legal, political, and cultural environments, and the risks associated with doing business in that country.

For further consideration: Chapter 6 discussed Linder's country similarity theory. Do firms tend to enter markets that look like their home market out of laziness, fear, or careful analysis of the factors we have just discussed?

Choosing a Mode of Entry

Having decided which markets to enter, the firm is now faced with another decision: Which mode of entry should it use? Dunning's eclectic theory, discussed in Chapter 6, provides useful insights into the factors that affect the choice among either home country production (exporting), host country production in firm-owned factories (FDI and joint venture), or host country production performed by others (licensing, franchising, and contract manufacturing). Recall that the eclectic theory considers three factors: ownership advantages, location advantages, and internalization advantages.[10] Other factors a firm may consider include the firm's need for control, the availability of resources, and the firm's global strategy. The role of these factors in the entry mode decision is illustrated in Figure 12.1.

Ownership advantages are tangible or intangible resources owned by a firm that grant it a competitive advantage over its industry rivals. The ownership by Toronto-based Vale Canada, Ltd. (a subsidiary of Brazilian mining conglomerate Vale), of rich, nickel-bearing ores has allowed the firm to dominate the production of both primary nickel and nickel-based metal alloys. The luxury appeal of Dom Pérignon champagne and Christian Dior perfumes—both products of France's LVMH Louis Vuitton Moët Hennessy—although a more intangible resource than a nickel ore mine, similarly grants the Parisian firm a competitive advantage over its rivals in international markets. Assuming that local firms know more about their home turf than foreigners do, a foreign firm contemplating entry into a new market should possess some ownership advantage that allows it to overcome the liability of foreignness. **Liability of foreignness** reflects the informational, political, and cultural disadvantages that foreign firms face when trying to compete against local firms in the host country market. As discussed later in this chapter, the nature of the firm's ownership advantage affects its selection of entry mode. Embedded technology, for example, is often best transferred through an equity mode, while firms whose competitive advantage is based on a well-known brand name sometimes enter foreign markets through a licensing or franchising mode. Further, firm advantages are primary determinants of bargaining strength; thus, they can influence the outcome of entry mode negotiations.

Location advantages are those factors that affect the desirability of host country production relative to home country production. Firms routinely compare economic and noneconomic characteristics of the home market with those of the foreign market in determining where to

Exporting to Foreign Markets

Perhaps the simplest mode of internationalizing a domestic business is exporting, the most common form of international business activity. Its advantages and disadvantages, and those of the other modes of entry, are summarized in Table 12.2. Recall from Chapter 1 that exporting is the process of sending goods or services from one country to other countries for use or sale there. Merchandise exports in the world economy totaled $18.4 trillion in 2012, or 26 percent of the world's total economic activity, while service exports amounted to $4.4 trillion.

Exporting offers a firm several advantages. First, the firm can control its financial exposure to the host country market as it deems appropriate. Little or no capital investment may be needed if the firm chooses to hire a host country firm to distribute its products. In this case, the firm's financial exposure is often limited to start-up costs associated with market research, locating and choosing its local distributor, and local advertising plus the value of the goods and services involved in any given overseas shipment. Alternatively, the firm may choose to distribute its products itself to better control their marketing. If the firm opts for this approach, it is then able to raise its selling prices because a middleman has been eliminated. However, its investment costs and its financial exposure may rise substantially, for the firm will have to equip and operate its own distribution centers, hire its own employees, and market its products.

TABLE 12.2 Advantages and Disadvantages of Different Modes of Entry

Mode	Primary Advantages	Primary Disadvantages
Exporting	Relatively low financial exposure Permit gradual market entry Acquire knowledge about local market Avoid restrictions on foreign investment	Vulnerability to tariffs and nontariff barriers Logistical complexities Potential conflicts with distributors
Licensing	Low financial risks Low-cost way to assess market potential Avoid tariffs, nontariff barriers, restrictions on foreign investment Licensee provides knowledge of local markets	Limited market opportunities and profits Dependence on licensee Potential conflicts with licensee Possibility of creating future competitor
Franchising	Low financial risks Low-cost way to assess market potential Avoid tariffs, nontariff barriers, restrictions on foreign investment Maintain more control than with licensing Franchisee provides knowledge of local market	Limits market opportunities and profits Dependence on franchisee Potential conflicts with franchisee May be creating future competitor
Contract manufacturing	Low financial risks Minimize resources devoted to manufacturing Focus firm's resources on other elements of the value chain	Reduced control (may affect quality, delivery schedules, etc.) Reduced learning potential Potential public relations problems—may need to monitor working conditions, etc.
Management contracts	Focus firm's resources on its area of expertise Minimal financial exposure	Potential returns limited by contract May unintentionally transfer proprietary knowledge and techniques to contractee
Turnkey projects	Focus firm's resources on its area of expertise Avoid all long-term operational risks	Financial risks (cost overruns, etc.) Construction risks (delays, problems with suppliers, etc.)
Foreign direct investment	High profit potential Maintain control over operations Acquire knowledge of local market Avoid tariffs and nontariff barriers	High financial and managerial investments Higher exposure to political risk Vulnerability to restrictions on foreign investment Greater managerial complexity

Second, exporting permits a firm to enter a foreign market gradually, thereby allowing it to assess local conditions and fine-tune its products to meet the idiosyncratic needs of host-country consumers. If its exports are well received by foreign consumers, the firm may use this experience as a basis for a more extensive entry into that market. For example, the firm may choose to take over distribution of its product from the host country distributor or to build a factory in the host country to supply its customers there, particularly if it finds it can reduce its production and distribution costs or improve the quality of its customer service. For instance, Constellation Brands, the world's largest wine distributor, chose to develop its own marketing and distribution network in China to take advantage of the 20 percent annual growth in the Chinese consumption of wine.[18]

Firms may have proactive or reactive motivations for exporting. *Proactive motivations* are those that *pull* a firm into foreign markets as a result of opportunities available there. For example, San Antonio's Pace, Inc., a maker of Tex-Mex food products, began exporting proactively to Mexico after discovering that Mexican consumers enjoy its picante sauce as much as its U.S. customers do.[19] A firm also may export proactively to exploit a technological advantage or to spread fixed R&D expenses over a wider customer base, thereby allowing it to price its products more competitively in both domestic and foreign markets. For example, the breakeven price of commercial airliners produced by Airbus and Boeing would skyrocket if these firms limited their sales to their respective domestic markets.

Reactive motivations for exporting are those that *push* a firm into foreign markets, often because opportunities are decreasing in the domestic market. Some firms turn to exporting because their production lines are running below capacity or because they seek higher profit margins in foreign markets in the face of downturns in domestic demand. For instance, consider two suppliers of specialty services to the U.S. construction industry, which were battered by the U.S. housing crisis of 2008–2009. Hycrete Inc., a New Jersey firm that manufactures an additive to make concrete waterproof and corrosion proof, shifted its emphasis from its domestic market to the booming Middle Eastern, Asian, and Eastern European markets. Illinois-based ProMark Associates, which manufactures and installs commercial air purifiers, adopted a similar strategy in response to the slowdown in the U.S. construction market.[20]

Forms of Exporting

Export activities may take several forms (see Figure 12.2), including indirect exporting, direct exporting, and intracorporate transfers.

INDIRECT EXPORTING **Indirect exporting** occurs when a firm sells its product to a domestic customer, which in turn exports the product, in either its original form or a modified form. For example, if Kenworth, a leading U.S. truck manufacturer, buys diesel engines from Cummins (also a U.S. firm) and then exports the completed trucks to Colombia, Cummins' engines have been indirectly exported. Or a firm may sell goods to a domestic wholesaler who then sells them to an overseas firm. A firm also may sell to a foreign firm's local subsidiary, which then transports the first firm's products to the foreign country.

Some indirect exporting activities reflect conscious actions by domestic producers. For example, the Association of Guatemala Coffee Producers sells bags of coffee to passengers boarding international flights in Guatemala City to gain export sales and to build consumer awareness of its product. In most cases, however, indirect exporting activities are not part of a conscious internationalization strategy by a firm. Thus, they yield the firm little experience in conducting international business. Further, for firms that passively rely on the actions of others, the potential short-term and long-term profits available from indirect exporting are often limited.

DIRECT EXPORTING **Direct exporting** occurs through sales to customers—either distributors or end-users—located outside the firm's home country. Research suggests that in one-third of cases, a firm's initial direct exporting to a foreign market is the result of an unsolicited order. However, its subsequent direct exporting typically results from deliberate efforts to expand its business internationally. In such cases, the firm actively selects the products it will sell, the foreign markets it will service, and the means by which its products will be distributed in those markets. Through direct exporting activities, the firm gains valuable expertise about operating internationally and specific knowledge concerning the individual countries in which it operates. And export success often breeds additional export success. Increasing experience with exporting

Such transfers are also common in the service sector. For example, Dow Jones & Company publishes both Asian and European versions of the *Wall Street Journal* in addition to its U.S. edition. Although some of the stories in each edition are written locally and are intended for local audiences, others are written in one location and printed in all editions of the newspaper. The usage of stories first published by a Dow Jones subsidiary in one country by Dow Jones affiliates in other countries is an intracorporate transfer of services.

Additional Considerations

In considering exporting as its entry mode, a firm must consider many other factors besides which form of exporting to use, including (1) government policies, (2) marketing concerns, (3) logistical considerations, and (4) distribution issues.

GOVERNMENT POLICIES Export promotion policies, export financing programs, and other forms of home country subsidization encourage exporting as an entry mode. Conversely, host countries may impose tariffs and nontariff barriers (NTBs) on imported goods, thereby discouraging the firm from relying on exports as an entry mode. Similarly, Japan's imposition of voluntary export restraints (VERs) on Japanese automobiles reduced Japanese exports, but it also encouraged Japanese automakers to construct assembly plants in the United States.

MARKETING CONCERNS Marketing concerns, such as image, distribution, and responsiveness to the customer, may also affect the decision to export. Often foreign goods have a certain product image or cachet that domestically produced goods cannot duplicate. For example, buyers of Dom Pérignon champagne are purchasing, at least in part, the allure of one of France's finest champagnes. This allure would be lost should LVMH choose to produce the product in Lubbock, Texas, even though Lubbock vineyards yield a regionally acclaimed wine, Llano Estacado. Swiss watches, German automobiles, Italian shoes, Cuban cigars, and Scottish wool are among the other product groups whose allure is closely associated with specific countries.

The choice of exporting is also influenced by a firm's need to obtain quick and constant feedback from its customers. Such feedback is less important for standardized products whose designs change slowly, if at all, such as toothbrushes and coffeemakers. On the other hand, producers of goods such as personal computers and smartphones must continually monitor the marketplace to ensure that they are meeting the rapidly changing needs of their customers. ("Emerging Opportunities" provides additional insights into the importance of understanding the needs of local customers.) For example, Hyundai shifted its production of personal computers from factories in its Korean homeland to the United States because it needed to be closer to its U.S. customer base.

Raymond Reuter/CORBIS

The allure of some goods–particularly luxury ones–is reinforced by their country of origin. The demand for Swiss watches rests in large part on the reputation and craftsmanship of the skilled workers who carefully oversee their assembly.

VENTURING ABROAD

DNATA – GLOBAL GROWTH STRATEGY

Founded in 1959, Dnata is an international travel management services company based in Dubai. It provides services in aircraft and cargo-handling, and engineering, information technology, as well as travel-related services and in-flight and institutional catering. Dnata has mainly three divisions: Dnata Airport Operations, Dnata Cargo, and Dnata Agencies. It is the fourth largest combined air services provider in the world with approximately 20,000 employees across five continents. As a key member of the Emirates Group, Dnata provides the Emirates Airline and other world major airlines with ground-handling services at 73 airports internationally. Today its business has expanded to 38 countries.

Despite the recent global economic recession, Dnata's revenues have increased dramatically, and nearly quadrupled over the past few years. The success is attributed largely to Dnata management's forward thinking strategy and a global mindset. Dnata has been pursuing a global growth strategy and has structured its business units in line with the strategy. It has one dedicated administration and management division called Dnata International, which oversees a number of Dnata's business operations including wholly-owned and joint ventures in eight countries and a global network of sales offices outside the United Arab Emirates (UAE). Dnata has constantly scrutinized the world markets enabling it to capture opportunities to enter the markets based upon the strategic fit between the business opportunities, such as the growth pace of airline operations in a certain region and its existing resources. The president of Dnata described the approach as a result of extremely cautious planning with a focus on profitability. In 2004, Dnata entered the Singapore market, which boasts one of the world's busiest and largest airports, and acquired Changi International Airport Services, called Dnata Singapore after the acquisition. Dnata Singapore offers a comprehensive range of ground-handling services to more than 30 scheduled airlines in Singapore. Over the past few years, Dnata has acquired stakes and/or established a number of joint ventures in Australia, China, Pakistan, Philippines, Switzerland, United Kingdom, and Iraq. Among them, the most important joint ventures are Toll Dnata Airport Services (TDAS), a joint venture between Toll Holdings (Australia) and Dnata, and Xi'an Dnata Aviation Services Co. Ltd., a joint venture between Dnata and China West Airport Group that provides airport ground-handling services at Xi'an Xianyang International Airport. In addition to expanding its business internationally through a number of strategic acquisitions outside the UAE, Dnata has entered strategic alliances with many travel agencies globally and established an extensive global network of sales offices. These strategic alliances expand Dnata's international reach and create win-win business opportunities without involving significant financial investment.

Following its success worldwide, Dnata has most recently developed a new company logo and a mission statement in line with its brand strategy and brand architecture that are seen as an indication for further growth. The new mission statement emphasizes its global value and unifies its 20,000 employees around the world. When asked about how Dnata protects itself from an increasingly competitive and volatile aviation industry, the president of Dnata said, that making the business less Dubai-centric and more global has helped the company grow and sustain.

Sources: Dnata company website, www.dnata.com/english/; "Dnata reveals new brand identity following global success," *AMEinfo.com,* April 28, 2011, tinyurl.com/mrf6xou; "Dnata president on coping with Middle East and North Africa unrest," *BBC News UK,* May 8, 2011, www.bbc.co.uk/news/business-13314208.

LOGISTICAL CONSIDERATIONS Logistical considerations also enter into the decision to export. The firm must consider the physical distribution costs of warehousing, packaging, transporting, and distributing its goods, as well as its inventory-carrying costs and those of its foreign customers. Typically, such logistical costs will be higher for exported goods than for locally produced goods. But logistical considerations go beyond mere costs. Because exporting means longer supply lines and increased difficulties in communicating with foreign customers, firms choosing to export from domestic factories must ensure that they maintain competitive levels of customer service for their foreign customers.

DISTRIBUTION ISSUES A final issue that may influence a firm's decision to export is distribution. A firm experienced in exporting may choose to establish its own distribution networks in its key markets. For example, Japanese consumer electronics manufacturers such as Sony, Minolta, and Hitachi typically rely on wholly owned host country subsidiaries to distribute their products to wholesalers and retailers in the developed countries. The costs of establishing and operating these distribution networks are offset by two important benefits. First, a firm captures additional revenues by performing the distribution function. Second, it maintains control over the distribution process, thereby avoiding the problems that we discuss in the following paragraphs.

However, a firm—particularly a smaller business or one just beginning to export—often lacks the expertise to market its products abroad, so it will seek a local distributor to handle its products in the target market. Critical to the firm's success is the selection of this distributor, which must have sufficient expertise and resources (capital, labor, facilities, and local reputation) to successfully market the firm's products. However, often the best local distributors already handle the products of existing firms. Consequently, sometimes a firm must choose between an experienced local distributor and a less experienced one that will handle the firm's products exclusively.

The profitability and growth potential of exporting to a foreign market will be affected by the firm's agreement with the local distributor. The local distributor must be compensated for its services, of course. This compensation will reduce the exporter's profit margin. Further, the exporter and its local distributor depend on each other to ensure that a satisfactory business relationship is established and maintained. If the host country distributor inadequately markets, distributes, or services the exporter's products, it is the exporter that will suffer lost sales and damaged reputation. For example, Apple's initial share of the Japanese personal computer market was hurt by the performance of a Canon subsidiary hired to market and distribute the firm's products in Japan. Apple took over these tasks and quickly quintupled its market share.[23]

Problems may also arise if the business judgments of the local distributor and the exporter differ. The exporter and the importer may disagree on pricing strategies, with the exporter preferring lower retail prices to stimulate sales and the distributor favoring higher prices, which fatten its profit margins. The exporter may want its distributor to market its products more aggressively in hopes of building sales volume; the distributor may believe that the additional sales generated by this strategy will not cover the increased expenses incurred. Thus, the importance of selecting a distributor whose goals and business philosophy are compatible with those of the exporter cannot be overstressed.

Export Intermediaries

An exporter may also market and distribute its goods in international markets by using one or more **intermediaries**, third parties that specialize in facilitating imports and exports. These specialists may offer limited services such as handling only transportation and documentation. Or they may perform more extensive roles, including taking ownership of foreign-bound goods and/or assuming total responsibility for marketing and financing exports. Types of intermediaries that offer a broad range of services include export management companies, Webb-Pomerene associations, and international trading companies.

EXPORT MANAGEMENT COMPANY An **export management company (EMC)** is a firm that acts as its client's export department. Most are small operations that rely on the services of a handful of professionals. An EMC's staff typically is knowledgeable about the legal, financial, and logistical details of exporting and so frees the exporter from having to develop this expertise in-house. The EMC may also provide advice about consumer needs and available distribution channels in the foreign markets the exporter wants to penetrate.

EMCs usually operate in one of two ways. Some act as commission agents for exporters. They handle the details of shipping, clearing customs, and document preparation in return for an agreed-on fee. In this case, the exporter normally invoices the client and provides any necessary financing it may need. Others take title to the goods. They make money by buying the goods from the exporter and reselling them at a higher price to foreign customers. Such EMCs may offer customer financing and design and implement advertising and promotional campaigns for the product.

WEBB-POMERENE ASSOCIATION A **Webb-Pomerene association** is a group of U.S. firms that operate within the same industry and that are allowed by law to coordinate their export activities without fear of violating U.S. antitrust laws. First authorized by the Export Trade Act of 1918, a Webb-Pomerene association engages in market research, overseas promotional activities, freight consolidation, contract negotiations, and other services for its members. It may also directly engage in exporting by buying goods domestically from members and selling the goods in foreign markets on the association's behalf. Although such associations were originally designed to allow smaller, related firms to cooperate in promoting exports, most are now dominated by larger firms. In general, Webb-Pomerene associations have not played a major role in international business. Fewer than 25 such associations exist today, and they tend to be concentrated in raw materials such as wood pulp, sulfur, and phosphate rock.

INTERNATIONAL TRADING COMPANY An **international trading company** is a firm directly engaged in importing and exporting a wide variety of goods for its own account. It differs from an EMC in that it participates in both importing and exporting activities. An international trading company provides a full gamut of services, including market research, customs documentation, international transportation and host country distribution, marketing, and financing. Typically, international trading companies have agents and offices worldwide. The economic intelligence information they glean from these far-flung operations is one of their most potent competitive weapons.

The most important international trading companies in the global marketplace are Japan's *sogo shosha*, which are an integral part of Japan's *keiretsu* system. The sogo shosha have prospered for several reasons. Because of their far-flung operations, they continuously obtain information about economic conditions and business opportunities in virtually every corner of the world. As part of a keiretsu, a sogo shosha enjoys ready access to financing (from the keiretsu's lead bank) and a built-in source of customers (its fellow keiretsu members). This customer base reduces the sogo shosha's costs of soliciting clients and builds up its business volume, thereby allowing it to reap economies of scale in its transportation and information-gathering roles. Nonmembers of the keiretsu are then attracted to doing business with the sogo shosha because of its low-cost structure and international expertise. Moreover, many of the sogo shosha have made investments in the natural resource sector, which, as a result of the increases in commodity prices created by China's economic boom, have been extremely profitable in the past decade. Japan's international trading companies are among the world's largest service companies, measured by sales volume.[24] The five largest sogo shosha are featured in Table 12.3.

OTHER INTERMEDIARIES In addition to the intermediaries that provide a broad range of services to international exporters and importers, numerous other types offer more specialized services. **Manufacturers' agents** solicit domestic orders for foreign manufacturers, usually on a commission basis. **Manufacturers' export agents** act as a foreign sales department for domestic manufacturers, selling those firms' goods in foreign markets. **Export and import brokers** bring together international buyers and sellers of such standardized commodities as coffee, cocoa, and grains. **Freight forwarders** specialize in the physical transportation of goods, arranging customs documentation and obtaining transportation services for their clients. This list, however, is by no means complete. Indeed, specialists are available to provide virtually every service needed by exporters and importers in international trade.

In Practice

- Exporting is the dominant form of international business activity. In 2012, the world's exports of goods and services totaled $22.8 trillion.
- Intracorporate transfers account for about 31 percent of U.S. trade. They reflect the growing importance of multinational corporations in the world's economy.

For further consideration: Are international trade and foreign direct investment substitutes for one another, or do they complement one another?

International Licensing

Another means of entering a foreign market is **licensing**, in which a firm, called the **licensor**, leases the right to use its intellectual property—technology, work methods, patents, copyrights, brand names, or trademarks—to another firm, called the **licensee**, in return for a fee. This process is illustrated in Figure 12.3. The use of licensing as an entry mode may be affected by host country policies. Firms are not advised to use licensing in countries that offer weak protection for intellectual property because they may have difficulty enforcing licensing agreements in the host country's courts. On the other hand, the use of licensing may be encouraged by high tariffs and NTBs, which discourage imports, or by host country restrictions on FDI or repatriation of profits.

Licensing is a popular mode for entering foreign markets because it involves little out-of-pocket cost. A firm has already incurred the costs of developing the intellectual property to be licensed; thus, revenues received through a licensing agreement often go straight to the firm's bottom line. Licensing also allows a firm to take advantage of any location advantages of foreign production without incurring any ownership, managerial, or investment obligations.

Basic Issues in International Licensing

Nearly every international licensing arrangement is unique because of variations in corporate strategy, the levels of competition, the nature of the product, and the interests of the licensor and licensee. Normally the terms of a licensing agreement are specified in a detailed legal contract, which addresses such issues as (1) specifying the boundaries of the agreement, (2) determining compensation, (3) establishing rights, privileges, and constraints, and (4) specifying the duration of the contract.

SPECIFYING THE AGREEMENT'S BOUNDARIES The licensor and licensee must determine which rights and privileges are and are not being conveyed in the agreement. For example, Heineken is exclusively licensed to manufacture and sell Pepsi-Cola in the Netherlands. PepsiCo must either provide Heineken with the formula for its soft drink or supply concentrated cola syrup. Heineken is then allowed to add carbonated water to create the beverage, package it in appropriate containers, and distribute and sell it in the Netherlands. PepsiCo cannot enter into a competing licensing agreement with another firm to sell Pepsi-Cola in the Netherlands, nor can Heineken begin duplicating other products owned by PepsiCo (such as Lay's Potato Chips) without a separate agreement. Nor can it alter PepsiCo's formula, market the firm's products as its own, or ship them outside the geographic boundaries specified in the agreement.

DETERMINING COMPENSATION Compensation is another basic issue that is specified in a licensing agreement. Obviously, the licensor wants to receive as much compensation as possible, whereas the licensee wants to pay as little as possible. Yet each also wants the agreement to be profitable for the other so that both parties will willingly perform their contractual obligations. Licensees must be careful to ensure that they can reach their target levels of profitability after paying licensing fees; the licensor will attempt to establish a rate that allows it to recoup its variable costs of negotiating and enforcing the licensing agreement plus recover at least part of its fixed investment in the intellectual property being licensed. Of course, from the licensor's perspective, the license fee, after deducting these variable costs, should also exceed its opportunity costs—that is, the profits it would have earned had it entered the market via a different entry mode.

Compensation under a licensing agreement is called a **royalty**. The royalty is usually paid to the licensor in the form of a flat fee, a fixed amount per unit sold, or, most commonly, a percentage of the sales of the licensed product or service. Although the royalty amount is often determined by prevailing market forces, royalties between 3 and 5 percent of sales are typical and have long been viewed as reasonable and appropriate. Some licensing agreements also guarantee a minimum royalty payment to ensure that the foreign licensee will take full advantage of the market value of whatever has been licensed, rather than merely acquiring and then shelving it to keep domestic rivals from obtaining it.

ESTABLISHING RIGHTS, PRIVILEGES, AND CONSTRAINTS Other basic issues to be addressed in licensing agreements are the rights and privileges given to the licensee and the constraints imposed by the licensor. For example, if a licensee began using inferior materials as a way to boost its profit margin, the image of the licensor's product could be severely damaged. Similarly, if the agreement included the transfer of technology, production processes, or work methods, the licensee might be tempted to sell this information to another firm, thereby harming the licensor. Or the licensee could simply underreport licensed sales as a means of reducing its licensing fees.

To prevent these practices, licensing agreements usually limit the licensee's freedom to divulge information it has obtained from the licensor to third parties, specify the type and form of records the licensee must keep regarding sales of the licensed products or services, and define standards that will be adhered to regarding product and service quality. To avoid costly litigation, the licensing agreement should also detail how the parties will resolve any disagreements. Many licensing agreements require, for example, that disputes be resolved through the use of a third-party mediator.

SPECIFYING THE AGREEMENT'S DURATION The licensor may view the licensing agreement as a short-term strategy designed to obtain knowledge about the foreign market at low cost and with little risk. If sales of its products and services are strong, it may want to enter the market itself after the agreement has ended. Thus, the licensor may seek a short-term agreement. However, if the contract's duration is too short, the licensee may be unwilling to invest in necessary consumer research, distribution networks, or production facilities, believing that it will be unable to amortize its investment over the life of the licensing contract. Normally the licensor wants the licensee to undertake these market development efforts. Accordingly, the greater the investment costs incurred by the licensee, the longer is the likely duration of the licensing agreement. For example, the licensees that built Tokyo Disneyland insisted on a 100-year licensing agreement with the Walt Disney Company before agreeing to invest the millions of dollars necessary to build the park. However, in most cases the term of the licensing agreement is far shorter than this.

Advantages and Disadvantages of International Licensing

Licensing carries relatively low financial risk, provided the licensor fully investigates its market opportunities and the abilities of its licensees. It also allows the licensor to learn more about the sales potential of its products and services in a new market without significant commitment of financial and managerial resources. Licensees benefit through the opportunity to make and sell, with relatively little R&D cost, products and services that have been successful in other international markets. Nintendo game designers, for example, have the relative safety of knowing there are millions of game system units available that will play their games.

However, licensing does have opportunity costs. It limits the market opportunities for both parties. For example, as long as the licensing agreement between PepsiCo and Heineken is in effect, PepsiCo cannot enter the soft-drink market in the Netherlands and Heineken cannot sell competing soft drinks such as Coca-Cola. Further, licensor and licensee depend on each other to maintain product quality and to promote the product's brand image. Improper actions by one party can damage the other party. Further, if the licensee or licensor does not adhere to the agreement, costly and tedious litigation may hurt both parties.

No matter how carefully worded a licensing agreement may be, there is always the risk of problems and misunderstandings. For example, several years ago Oleg Cassini licensed Jovan, a U.S. subsidiary of London's GlaxoSmithKline, to market the Cassini beauty products line in the United States. After signing the agreement, Jovan was approached by Diane Von Furstenberg Cosmetics with a similar proposal but better terms. Jovan subsequently signed a licensing agreement with Von Furstenberg to make and market its products instead of Cassini's. Cassini was left without a licensee in the United States. To complicate things even further, a clause in the contract between Jovan and Cassini prevented Cassini from licensing its name to any other U.S. firm. Cassini sued Jovan for $789 million. The dispute was eventually settled out of court, but it was more than three years beyond Cassini's original target date when the firm finally got its products into the United States.[27] Laura Ashley ran into similar problems after it granted L'Oréal exclusive rights for 20 years to develop Laura Ashley–branded cosmetics, toiletries, and perfumes. The British company later sued the French cosmetics company, claiming that L'Oréal had failed to develop the true potential of the Laura Ashley brand after it had only marketed one perfume under the agreement in 6 years.[28]

A final concern is the long-term strategic implications of licensing a firm's technology. Many firms are concerned that sharing their technology will inadvertently create a future competitor. The licensee, by producing under the licensing agreement, may be able to learn the manufacturing secrets of the licensor or to develop new production tricks of its own. The licensee can also build an independent reputation for manufacturing quality and service excellence while operating under the contract. Although the licensing agreement may restrict the geographical area in which the licensee can manufacture and sell the product, once it expires, the former licensee may choose to expand its operations into the licensor's existing territory. This is a risk the licensor must take if it chooses to license its product.

In Practice

- International licensing can be profitable because the licensing firm can tap into new markets while incurring little additional commitment of cash or human resources.
- The downside to licensing is the loss of control over what the licensee will do when granted the license.

For further consideration: List three products that you believe could be successfully licensed. List three products that you believe could not be successfully licensed. Explain why.

International Franchising

Still another popular strategy for internationalizing a business is franchising, actually a special form of licensing. **Franchising** allows the franchisor more control over the franchisee and provides for more support from the franchisor to the franchisee than is the case in the licensor-licensee relationship. International franchising is among the fastest-growing forms of international business activity today. A franchising agreement allows an independent entrepreneur or organization, called the **franchisee**, to operate a business under the name of another, called the **franchisor**, in return for a fee. The franchisor provides its franchisees with trademarks, operating systems, and well-known product reputations, as well as continuous support services such as advertising, training, reservation services (for hotel operations), and quality assurance programs.

Basic Issues in International Franchising

International franchising is likely to succeed when certain market conditions exist. First, it may work when the franchisor has been successful domestically because of unique products and advantageous operating procedures and systems. McDonald's was successful initially because it provided a popular menu that was consistently prepared and service that was quick and efficient. Franchising may also be effective when the factors that contributed to domestic success are transferable to foreign locations. McDonald's prospered because "American" food is popular in other countries, efficiency and lower prices are valued by consumers worldwide, and foreign visitors to the United States usually seem to want to visit a McDonald's restaurant. Third, this may be a viable option if the franchisor has already achieved considerable success in franchising in its domestic market. For example, there were hundreds of franchised McDonald's restaurants in the United States before the first was built abroad. Finally, foreign investors must be interested in entering into franchise agreements. For well-established franchisors like McDonald's, this is typically not a problem.

Like licensing agreements, franchising agreements are spelled out in formal contracts, with a typical set of terms. The franchisor generally receives a fixed payment plus a royalty based on the franchisee's sales for the rights to use the franchisor's name, trademarks, formulas, and operating procedures. The franchisee usually agrees to adhere to the franchisor's requirements for appearance, financial reporting, and operating procedures. However, franchisors are likely to allow some degree of flexibility to meet local customs and tastes. In fact, as with other licensing arrangements, one of the services the franchisee offers the franchisor is knowledge about the local market's culture and customs. For example, McDonald's restaurants sell beer or wine in many European countries. Finally, the franchisor almost always helps the franchisee establish the new business; provides expertise, advertising, and a corporate image; and is usually able to negotiate favorable arrangements with suppliers.

Numerous MNCs rely on franchising to internationalize their operations. Fast-food firms such as McDonald's, Dunkin' Donuts, Baskin-Robbins, Pizza Hut, and KFC have franchised restaurants worldwide. Benetton relies on franchised retail stores to distribute its clothing in some 120 countries. And Japan's Bridgestone Corporation franchises both Bridgestone and Firestone tire retail outlets in the United States as well as several other countries.

Advantages and Disadvantages of International Franchising

On the plus side, franchisees can enter a business that has an established and proven product and operating system, and franchisors can expand internationally with relatively low risk and cost. A franchisor also can obtain critical information about local market customs and cultures from host country entrepreneurs that it otherwise might have difficulty obtaining. It further can learn valuable lessons from franchisees that apply to more than the host country. McDonald's, for example, benefited from this worldwide learning phenomenon (see Chapter 11). Its U.S. managers once believed that the firm's restaurants would be successful only if they were freestanding entities located in suburbs and smaller towns. A Japanese franchisee convinced the firm to allow him to open a restaurant in an inner-city office building. It quickly became one of the firm's most popular restaurants. Because of the insight of its Japanese franchisee, McDonald's now has restaurants in downtown locations in many cities throughout the world.

On the negative side, as with licensing, both parties to a franchising agreement must share the revenues earned at the franchised location. International franchising may also be more complicated than domestic franchising. For example, when McDonald's expanded to Moscow, it had to teach local farmers how to grow potatoes that met its standards. Moreover, control is also an issue in international franchising. McDonald's was once forced to revoke the franchise it had awarded a French investor because his stores were not maintained according to McDonald's standards.

In Practice

- Franchising is a fast-growing mode of entry into new markets. By franchising, a company such as McDonald's benefits from the local knowledge and local expertise of its franchisees.
- Franchisers need to monitor their franchisees to make sure that the franchisees' decisions do not diminish the brand name and brand image of the franchiser.

For further consideration: Franchising helps overcome the liability of foreignness. Would you expect that the more different two countries are, the more likely franchising will be used as a mode of entry? Why or why not?

Specialized Entry Modes for International Business

A firm may also use any of several specialized strategies to participate in international business without making long-term investments. Such specialized modes include contract manufacturing, management contracts, and turnkey projects.

Contract Manufacturing

Contract manufacturing is used by firms, both large and small, that outsource most or all of their manufacturing needs to other companies. This strategy reduces the financial and human resources firms need to devote to the physical production of their products. Nike, for example, has chosen to focus its corporate energies on marketing its products and has contracted with numerous factories throughout Southeast Asia to produce its athletic footwear and apparel. Similarly, retailers such as Victoria's Secret and J.C. Penney rely on contract manufacturers to fabricate their store-branded apparel. By using this approach, international businesses can focus on that part of the value chain where their distinctive competence lies and yet benefit from any location advantages generated by host-country production. However, they also surrender control over the production process, which can lead to quality problems or other unexpected surprises. Nike, for example, suffered a string of blows to its public image—including a series of unflattering *Doonesbury* cartoons—because of reports of unsafe and harsh working conditions in Vietnamese factories churning out Nike footwear. Similarly, companies such as Benetton and Loblaw found themselves in an unwanted spotlight as a result of sourcing apparel from a Bangladeshi factory complex that collapsed, killing more than 1,100 workers.[29] "Emerging Opportunities" discusses the growing importance of business process outsourcing, a service industry equivalent of contract manufacturing.

Management Contract

A **management contract** is an agreement whereby one firm provides managerial assistance, technical expertise, or specialized services to a second firm for some agreed-on time in return for monetary compensation. For its services the first firm may receive either a flat fee or a percentage of sales. The management contract may also specify performance bonuses based on profitability, sales growth, or quality measures. Management contracts allow firms to earn additional revenues without incurring any investment risks or obligations. A subsidiary of Hilton Hotels, for example, offers hotel management and reservation services to hotels that bear the Hilton logo but that are not company-owned. Similarly, major airlines such as Air France, British Airways, and Lufthansa often sell their management expertise to small state-owned airlines headquartered in developing countries.

Turnkey Project

Another specialized strategy for participating in international business is the turnkey project. A **turnkey project** is a contract under which a firm agrees to fully design, construct, and equip a facility and then turn the project over to the purchaser when it is ready for operation. The turnkey contract may be for a fixed price, in which case the firm makes its profit by keeping its costs below the fixed price. Or the contract may provide for payment on a cost-plus basis, which shifts the risk of cost overruns from the contractor to the purchaser.

International turnkey contracts often involve large, complex, multiyear projects such as construction of a nuclear power plant, an airport, or an oil refinery. Managing such complex construction projects requires special expertise. As a result, most are administered by large construction firms such as Bechtel, KBR, Hyundai Group, Daelim, New Zealand's Fletcher Challenge Ltd., and Germany's Friedrich Krupp GmbH. KBR, for example, was selected as the project manager for a $19-billion petrochemical complex being built by a joint venture between Saudi Aramco and Dow Chemical.[30] The awarding of lucrative turnkey projects is often based on the availability of home government financing, such as through the Eximbank of the United States, or on political ties between the host and home countries. U.S. construction engineering firms have secured many contracts in Saudi Arabia because of the friendly relations between the two countries, while French construction companies have done well in Francophone Africa.

An increasingly popular variant of the turnkey project is the so-called **B-O-T project**, in which the firm *builds* a facility, *operates* it, and later *transfers* ownership of the project to some other party. Through this approach, the contractor profits from operation and ownership of the project for some period of time but bears any financial risks associated with it during this period. For example, the government of Gabon wished to upgrade the quality of electrical service and fresh water delivered to its citizens. Aided by the International Finance Corporation, a branch of the World Bank Group discussed in Chapter 7, Gabon contracted with Ireland's Electricity Supply Board International and France's Compagnie Générale des Eaux to operate the country's electrical and water systems for 20 years. The two companies invested $600 million to improve these basic services. After the 20-year contract expires, ownership of these assets will be transferred to the government of Gabon.

EMERGING OPPORTUNITIES

BUSINESS PROCESS OUTSOURCING

Business process outsourcing (BPO) covers a variety of business functions, ranging from routine call centers focusing on telemarketing, customer service, and technical support to more sophisticated and expensive services like financial analysis, tax return preparation, and legal document review. India is the market leader in providing international BPO. Its initial success was based on the large supply of well-trained English-speaking graduates that its universities produce each year. However, the BPO market has expanded so much that Indian BPO providers are finding it increasingly difficult to fill newly created positions, particularly in Bangalore and New Delhi. As a result, wages in the sector have increased, as has labor turnover. In response Indian BPO providers have targeted higher-value-added markets to maintain their profitability. For example, some large MNCs, such as Citigroup and General Electric, have begun outsourcing routine legal work like contract preparation and patent filings to Indian BPO firms, who charge a quarter to a third what a U.S. law firm would bill for the work. Other Indian firms have entered the remote infrastructure management business, offering to monitor from afar who enters and exits a client's buildings or to protect a client's computer network when hackers attempt to penetrate it. Similarly, Tata Consultancy Services engineering-services division develops computer simulations for auto manufacturers wanting to examine the effects of acceleration and rapid deceleration (i.e., crashes) on their latest car designs.

Other countries have also benefited from the boom in BPO, often because they possess market-specific advantages unavailable to Indian firms. CendrisBSC, a Dutch call-center operator, has established a call center in Cape Town, South Africa, to service its customers in the Netherlands. Labor in the Netherlands is expensive, whereas South Africa suffers from high rates of unemployment—an estimated 30 to 40 percent. But low labor costs are not the country's only attraction. Europe and South Africa share a common time zone, and a new submarine fiber-optic cable laid in 2003 connecting Europe to South Africa reduced communications costs. More importantly, 6 million South African citizens speak Afrikaans, a language that evolved from seventeenth-century Dutch. CendrisBSC has found that most Afrikaans speakers need only three months of intense training to become fluent in Dutch, although some cultural readjustments must be made because South Africans usually exchange pleasantries before commencing a business conversation, whereas the Dutch often prefer to get down to business immediately.

Stockholm-headquartered Transcom Worldwide SA has adopted a different strategy. Taking advantage of the lower labor costs and language abilities of citizens of the EU's new entrants, Transcom has established call centers in the three Baltic republics, Hungary, and Poland. Many Estonians, for example, speak English, Estonian, Finnish, and Russian, allowing Transcom to serve the regional needs of clients such as FedEx, IBM, and Shell. French customers are served by its operations in francophone Morocco. And, ironically, its Spanish call centers serve the Swedish market, for Transcom finds there is no shortage of Swedes living there who are trying to escape the cold.

Sources: "On the turn," *The Economist*, January 19, 2013; "'Sunnyvale, you have a problem'," *Wall Street Journal*, May 18, 2006, p. B2; "U.S. law firms outsource to India," *Financial Times*, September 29, 2005, p. 30; "More U.S. legal work moves to India's low-cost lawyers," *Wall Street Journal*, September 28, 2005, p. B1; "Cape call center boom offers good hope for S. Africa jobs," *Financial Times*, June 1, 2005, p. 16; "Recruiting trails increasingly take call-center firms off beaten track," *Wall Street Journal*, March 15, 2005, p. A18; "Eastern Europe cuts in on India," *Wall Street Journal*, March 15, 2005, p. A18; "Africa eager for piece of call-center business," *Houston Chronicle*, February 3, 2005, p. D8.

In Practice

- Contract manufacturing allows firms to focus their efforts and their resources on that part of the value chain (see Chapter 11) in which they have the largest competitive advantage.
- Management contracts allow firms with specialized knowledge to enter new markets without having to invest their own capital.

For further consideration: Should Nike be held responsible if it hires a contract manufacturer who subjects its employees to harsh and unsafe working conditions?

Foreign Direct Investment

Exporting, licensing, franchising, and the specialized strategies just discussed all allow a firm to internationalize its business without investing in foreign factories or facilities. However, many firms prefer to enter international markets through ownership and control of assets in host countries. Other firms may first establish themselves in a foreign market through exporting, licensing, franchising, or contract manufacturing. After gaining knowledge of and expertise in operating in the host country, they may then want to expand in the market through ownership of production or distribution facilities, as was Baskin-Robbins' strategy in Russia.

Such FDI affords the firm increased control over its international business operations, as well as increased profit potential. Control is particularly important to the firm if it needs to closely coordinate the activities of its foreign subsidiaries to achieve strategic synergies, as IBM has long done, or if it determines that the control is necessary to fully exploit the economic potential of proprietary technology, manufacturing expertise, or some other intellectual property right.

In one study, for example, British subsidiaries of U.S.-headquartered MNCs were found to be more effective and successful competitors in the United Kingdom than a matched set of British-owned firms, primarily because the U.S. parents were able to transfer their technological and managerial expertise to their British affiliates.[31]

FDI is also beneficial if host country customers prefer dealing with local factories. Many firms and governments participate in programs that favor locally made products—for example, "Buy American" or "Buy Korean"— to promote their local economies. Equally important, many purchasing managers perceive that local production implies more reliable supply, faster service, and better communication with suppliers.

On the other hand, FDI exposes the firm to greater economic and political risks and operating complexity, as well as the potential erosion of the value of its foreign investments if exchange rates change adversely. A firm's decision to engage in FDI may also be influenced by government policies. As noted in Chapter 3, host countries may discourage FDI through direct controls on foreign capital, bans on the acquisition of local companies by foreigners, or restrictions on repatriation of dividends and capital; home countries can promote FDI through such devices as political risk insurance. Firms using FDI must also meet the standard challenges of managing, operating, and financing their foreign subsidiaries while facing the additional hurdle of doing so in political, legal, and cultural milieus different from their own.

There are three methods for FDI: (1) building new facilities (called the greenfield strategy), (2) buying existing assets in a foreign country (called the **acquisition strategy** or the **brownfield strategy**), and (3) participating in a joint venture.

The Greenfield Strategy

The **greenfield strategy** involves starting a new operation from scratch (the word *greenfield* arises from the image of starting with a virgin green site and then building on it). The firm buys or leases land, constructs new facilities, hires or transfers in managers and employees, and then launches the new operation. Samsung's semiconductor chip fabrication facility in Texas represents a greenfield investment, as does the Mercedes-Benz automobile assembly plant in Alabama and Nissan's factory in Sunderland, England.

The greenfield strategy has several advantages. For one thing, the firm can select the site that best meets its needs and construct modern, up-to-date facilities. Local communities often offer economic development incentives to attract such facilities because they will create new jobs; these incentives lower the firm's costs. The firm also starts with a clean slate. Managers do not have to deal with existing debts, nurse outmoded equipment, or struggle to modify ancient work rules protected by intransigent labor unions. For example, GM's managers considered a major advantage of its building a new factory in Eisenach in the former East Germany to be its ability to implement Japanese-style production techniques and labor policies without having to battle workers wedded to the old way of doing things. In addition, the firm can acclimate itself to the new national business culture at its own pace, rather than having the instant responsibility of managing a newly acquired, ongoing business. Research indicates that the greater the cultural differences between the home and host countries, the more likely a firm is to choose to build a new factory rather than purchase an existing firm.[32]

However, the greenfield strategy also has some disadvantages. For one thing, successful implementation takes time and patience. For another, land in the desired location may be unavailable or expensive. In building the new factory, the firm must also comply with various local and national regulations and oversee the factory's construction. It must also recruit a local workforce and train it to meet the firm's performance standards. And finally, by constructing a new facility, the firm may be more strongly perceived as a foreign enterprise.

Disney managers faced several of these difficulties in building Disneyland Paris. Although the French government sold the necessary land to Disney at bargain prices, Disney was not fully prepared to deal with French construction contractors. For example, Disney executives had numerous communications difficulties with a painter that applied 20 different shades of pink to a hotel before the firm approved the color. The park's grand opening was threatened when local contractors demanded an additional $150 million for extra work allegedly requested by Disney. And Disney clashed with its French employees, who resisted the firm's attempt to impose its U.S. work values and grooming standards on them.[33]

The Acquisition Strategy

A second FDI strategy is acquisition of an existing firm conducting business in the host country. Although the actual transaction may no doubt be complex—requiring bankers, lawyers, regulators, and mergers and acquisitions specialists from several countries—the basic motivation for it is quite simple. By acquiring a going concern, the purchaser quickly obtains control over the acquired firm's factories, employees, technology, brand names, and distribution networks. The acquired firm can continue to generate revenues as the purchaser integrates it into its overall international strategy. And, unlike the greenfield strategy, the acquisition strategy adds no new capacity to the industry. In times of overcapacity, this is an obvious benefit. As the chapter's opening case indicated, the acquisition strategy is the approach Bernard Arnault favored in building LVMH.

Sometimes international businesses acquire local firms simply as a means of entering a new market. For instance, Cemex SA's purchase of Britain's RMC Group for $5.8 billion, which made the Mexican company the world's largest manufacturer of ready-mix concrete, allowed it to swiftly benefit from RMC's dominance of the European cement and concrete market.[34] Similarly, Best Buy chose to enter the Chinese market by buying a controlling interest in Jiangsu Five Star Appliance Co. The purchase of the 136-store appliance and retailing chain allowed Best Buy to quickly establish a presence in that country and to capture economies of scale in sourcing, marketing, and distribution.[35] Although we noted previously in the chapter that Best Buy is shuttering its Chinese outlets bearing the Best Buy brand, the U.S. company is busily adding Five Star-branded stores, a format more attuned to the needs of Chinese consumers.[36]

At other times, acquisitions may be undertaken by a firm as a means of implementing a major strategic change. For example, the state-owned Saudi Arabian Oil Co. has tried to reduce its dependence on crude oil production by purchasing "downstream" firms, such as Petron Corporation, the largest petroleum refiner in the Philippines, and South Korea's Ssangyong Oil Refining Company. Similarly, to increase its presence in emerging markets and in noncarbonated beverages, PepsiCo agreed to pay $1.4 billion for 74 percent of Russia's largest juice producer, OAO Lebedyansky.[37]

The acquisition strategy does have some disadvantages, however. The acquiring firm assumes all the liabilities—financial, managerial, and otherwise—of the acquired firm. If the acquired firm has poor labor relations, unfunded pension obligations, or hidden environmental cleanup liabilities, the acquiring firm becomes financially responsible for solving the problem. For instance, Argentina's YPF SA is being sued by the state of New Jersey for actions of Maxus Energy Corporation, a firm it acquired in 1995. Maxus is accused of dumping dioxin, a carcinogenic pesticide, in the Passaic River in the 1950s and 1960s.[38] The acquiring firm must also spend substantial sums up front. For example, when Kraft purchased Britain's Cadbury PLC for $19 billion in 2010, it had to pay out this vast sum shortly after the deal was closed. The greenfield strategy, in contrast, may allow a firm to grow slowly and spread its investment over an extended period.

Joint Ventures

Another form of FDI is the joint venture. **Joint ventures (JV)** are created when two or more firms agree to work together and create a jointly owned separate firm to promote their mutual interests. The number of such arrangements is burgeoning as rapid changes in technology, telecommunications, and government policies outstrip the ability of international firms to exploit opportunities on their own. Because of the growing importance of international intercorporate cooperation, as well as the unique set of challenges it offers international firms, we devote Chapter 13 to this subject.

In Practice

- FDI to date totals more than $20 trillion. The bulk of FDI occurs through acquisitions of existing companies.
- A company using the acquisition approach must be careful to assess the potential liabilities it will be acquiring when it purchases an existing firm.

For further consideration: What are the advantages of the greenfield strategy? What are the disadvantages?

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CHAPTER REVIEW

Summary

An important aspect of international strategy formulation is determining which markets to enter. To make this decision, a firm must consider many factors, including market potential, competition, legal and political environments, and sociocultural influences. It must also carefully assess the costs, benefits, and risks associated with each prospective market. Once a firm has decided to expand its international operations and has assessed potential foreign markets, it must decide how to enter and compete most effectively in the selected foreign markets. An array of strategic options is available for doing this. Choosing an entry mode involves careful assessment of firm-specific ownership advantages, location advantages, and internalization advantages.

Exporting, the most common initial entry mode, is the process of sending goods or services from one country to other countries for use or sale there. Exporting continues to grow rapidly. There are several forms of exporting, including indirect exporting, direct exporting, and intracorporate transfer. In deciding whether to export, a firm must consider such factors as government policies, marketing concerns,

consumer information needs, logistical considerations, and distribution issues. Export intermediaries are often used to facilitate exporting. These include export management companies, Webb-Pomerene associations, international trading companies, and export trading companies.

International licensing, another popular entry mode, occurs when one firm leases the right to use its intellectual property to another firm. Basic issues in international licensing include negotiating mutually acceptable terms, determining compensation, defining the rights and privileges of and the constraints imposed on the licensee, and specifying the duration of the agreement.

International franchising is also growing rapidly as an entry mode. International franchising is an arrangement whereby an independent organization or entrepreneur operates a business under the name of another. Several market conditions must exist for a firm to successfully franchise. As with licensing agreements, the terms of a franchising agreement are usually quite detailed and specific.

Three specialized entry modes are contract manufacturing, the management contract, and the turnkey project. Contract manufacturing permits a firm to outsource physical production of its product and focus its energies on some other element of the value chain. A management contract calls for one firm to provide managerial assistance, technical assistance, or specialized services to another firm for a fee. A turnkey project involves one firm agreeing to fully design, construct, and equip a facility for another.

The most complex entry mode is FDI. FDI involves the ownership and control of assets in a foreign market. The greenfield strategy for FDI calls for the investing firm to start a totally new enterprise from scratch. The acquisition strategy, in contrast, involves buying an existing firm or operation in the foreign market. In joint ventures, a third form of FDI, ownership and control are shared by two or more firms.

Review Questions

12-1. What are the key indicators in understanding a market's potential?
12-2. What are the *global* and *local* competitive issues a firm seeking to enter a new market must address?
12-3. What is exporting? Why has it increased so dramatically in recent years?
12-4. What are the primary advantages and disadvantages of exporting?
12-5. What are three forms of exporting?
12-6. What is an export intermediary? What is its role? What are the various types of export intermediaries?
12-7. What is international licensing? What are its advantages and disadvantages?
12-8. How do firms address opportunities at the Bottom of the Pyramid?
12-9. What are three specialized entry modes for international business, and how do they work?
12-10. What is FDI? What are its three basic forms? What are the relative advantages and disadvantages of each?

Questions for Discussion

12-11. Do you think it is possible for someone to make a decision about entering a particular foreign market without having visited that market? Why or why not?
12-12. How do managers balance the need for control as a decision factor on the choice of entry modes if other factors are favorable?
12-13. How does each advantage in Dunning's eclectic theory specifically affect a firm's decision regarding entry mode?
12-14. Discuss the importance of location-specific advantages of global firms.
12-15. What specific factors could cause a firm to reject exporting as an entry mode?
12-16. What conditions must exist for an intracorporate transfer to be cost-effective?
12-17. Your firm is about to begin exporting. In selecting an export intermediary, what characteristics would you look for?
12-18. In today's era of technology-driven globalization, do you think export management companies can continue to provide valuable service to exporters?
12-19. What factors could cause you to reject an offer from a potential licensee to make and market your firm's products in a foreign market?
12-20. Under what conditions should a firm consider a greenfield strategy for FDI? An acquisition strategy?

Building Global Skills

Heineken is the third-largest brewer in the world, with sales of €18.4 billion. Eighty percent of these sales occur outside Western Europe, the regional home of the Amsterdam-headquartered firm. When Heineken enters a new market, it follows a basic set of steps designed to maximize its potential profits in that market:

- It often begins to export its beer into that market as a way to boost brand familiarity and image.
- If sales look promising, it then licenses its brands to a local brewer. Doing this allows Heineken to build its sales further while simultaneously becoming more familiar with local distribution networks.

- If this relationship also yields promising results, Heineken then either buys partial ownership of the local brewer or forms a new joint venture with that brewer.

The end result is a two-tier arrangement with the more expensive Heineken label at the top end of the market and the lower-priced local brands at the bottom, all sharing a common brewery, sales force, and distribution network.

After reading and thinking about Heineken's approach, break up into groups of four or five people each and proceed as follows:

12-21. Identify at least five products or brands you are familiar with that could use the same three-step approach perfected by Heineken for entering foreign markets. Develop a clear rationale to support each example.

12-22. Identify at least five products or brands that probably could not use that strategy. Develop a clear rationale to support each example.

12-23. Randomly list the 10 examples you identified, keeping the rationale for each hidden. Exchange lists with another group. Each group should discuss the list given to it by the other group and classify the various products or brands into one of two categories: "can copy Heineken's approach" and "cannot copy Heineken's approach." Be sure to have some rationale for your decision.

12-24. Each pair of groups that exchanged lists should form one new group. Compare lists and note areas in which the smaller groups agreed and disagreed on their classifications. Discuss the reasons for any disagreements in classification.

12-25. What are the specific factors that enable Heineken to use the approach described and simultaneously make it difficult for some other firms to copy it? What types of firms are most and least likely to be able to use this approach?

12-26. What does this exercise teach you about international business?

CLOSING CASE The House of Tata

As Chapter 1 indicated, the role of emerging markets in the world economy is growing. It should come as no surprise that multinational enterprises (MNEs) headquartered in emerging markets are also playing a growing role. *Fortune's* Global 500 contained only 21 such firms in 2002. In 2012, that number has grown to 81.

One of the most important of these emerging market MNEs is the Mumbai-based Tata Group. Founded in 1868 by Jamsetji Tata, the Tata Group now consists of 90 companies focused on seven business segments that span industrial products, consumer goods, and high technology. Thirty-one of these companies, such as information-technology specialist Tata Consultancy Services, trade as publicly listed firms; the remainder are privately held. The Tata Group generated $100 billion in revenues in 2012 and employed more than 456,000 workers. About 59 percent of its revenue is produced outside the domestic Indian market.

In some ways, the organizational structure of the Tata Group is typical of many businesses in the world. In most countries, the predominant form of large corporate organization is a family-owned, family-centered, or bank-centered conglomerate, typified by Korea's *chaebol*, Japan's *keiretsu*, or Latin America's *grupos*. Indeed, other than in the Anglo-Saxon countries that inherited British traditions, the Anglo-American model of a stand-alone firm with dispersed shareholders run by professional managers is the exception, rather than the rule. This chapter's opening case, for example, highlights the international expansion strategy of France's LVMH Louis Vuitton Moët Hennessy, a large family-controlled conglomerate that specializes in luxury brands.

Particularly in emerging markets, such diversified conglomerates may exist because of institutional voids in a domestic economy. In nations in which the rule of law is weak or in which markets for capital or executive talent are nonexistent, the group form of organization may arise to overcome these voids. Instead of acquiring resources through the marketplace, the firm internalizes these exchanges through group member to group member transactions.

The Tata Group differs from the family-owned conglomerate model in some interesting ways, however. The group has always had a strong social commitment. Founder Jamsetji Tata was among the first in India to implement progressive work practices such as shorter work hours. He established the JN Tata Endowment in 1892 to support Indian students seeking higher education. Other trusts, including the Sir Ratan Tata Trust and the Sir Dorabji

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12-32. Discuss the factors that a firm should consider in deciding whether or not to enter a foreign market.

12-33. Discuss the primary modes of entering a foreign market. What are the advantages and disadvantages of each of these modes?

12-34. Mymanagementlab Only—comprehensive writing assignment for this chapter.

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