

# Chapter 15

## Licensing, Franchising, and Other Contractual Strategies

**Learning Objectives** After studying this chapter, you should be able to:

- 15.1 Explain contractual entry strategies.
- 15.2 Understand licensing as an entry strategy.
- 15.3 Describe the advantages and disadvantages of licensing.
- 15.4 Understand franchising as an entry strategy.
- 15.5 Explain the advantages and disadvantages of franchising.
- 15.6 Understand other contractual entry strategies.
- 15.7 Understand infringement of intellectual property, a global problem.

### How LEGO Built Global Value in the Toy Industry, Block by Block

From putting together a bright red fire-fighting engine, to a medieval castle, to a railway station over several decades, millions of children have honed their imagination and mechanical skills using small, colorful plastic blocks: the LEGO sets. Some 75 billion bricks are sold each year in over 140 countries. LEGO, a family company in Billund, Denmark, remains the most trusted toymaker in the building-block toy sector, with a market share of 85 percent worldwide. Production quality, adaptation to buyer preferences and a careful licensing strategy are the key drivers of the company's spectacular success in the \$91.54 billion toy industry. And more than a third of the sales of toys and non-electronic games worldwide are generated through licenses.

LEGO is a late entrant in contractual licensing. Its management decided in 1999 that the company's traditional audience was changing in many respects: first,

pre-school and school-age users wanted themes that reminded them of their favorite heroes from action movies and video games. Second, adults were increasingly attracted towards life-size interlocking constructions, such as cars, tractors, and even caravans! LEGO had the technology to respond. What it lacked was themes and the capabilities to design them. This is where licensing was opening a new window of opportunity, which other toy makers like Mattel and Hasbro had already exploited. LEGO was late to join the race but a quick mover; very soon, it began making and distributing the Dungeon and the Desert Outpost of *Minecraft* and Luke and Darth Vader from *Star Wars*. The *Indiana Jones*, *Harry Potter*, and *The Lord of the Rings* settings; the Vet Clinic from *Friends*; and the Treetop Hideaway of the *Elves* are now part of its catalog of brick-based construction.



Source: Steve Davey Photography/Alamy Stock Photo

Hollywood is now an indispensable partner of toy makers, as it constantly provides new ideas for sets and characters that stimulate the imagination of their users, young and old. Most toy manufacturers, Mattel and Hasbro included, acquire properties from studios and grant licenses to regional or local production and marketing companies. LEGO has followed a similar pattern. Its first property acquisition was *Star Wars*, a license from Lucasfilm. Its licensing strategy is two-fold: inbound and outbound. Inbound licenses refer to themes developed by third parties, like Disney or Warner Bros. Outbound licenses are issued by LEGO to companies that want to use its patents, trademarks, logo, and *The LEGO Movie* for their own end-products. DK publishing, Merlin Entertainment Plc, and the LEGOLAND theme parks are among such licensees. These inbound license agreements were worth \$94 million in 2017. At the same time, outbound licenses cost LEGO nearly \$400 million.

Licensing of games has become vital for the industry over the past decade. In the United States, 27 percent of all traditional toys and games sold are licensed, generating a value of \$6 billion (€ 5.3 billion). The rate is higher in Asia, Latin America, and Turkey, where licensing

ranges from 30 to 40 percent of total sales and is expected to reach 60 percent by 2019. The average annual spending per buyer in these regions is \$28 (€24)—far below the \$439 (€387) toy expenditure per child in the United Kingdom. For LEGO, which operates factories in Europe, Mexico, and China and is present in 130 countries through a combination of own offices, licensed producers, and distributors, the emerging markets offer the most promising opportunity for growth through licensing. However, they are also fraught with challenges, such as IPR protection. LEGO has already lost a few legal battles in this area, as some of its original patents have expired.

Companies drive a hard bargain in licensing out their properties, and Hollywood studios are notoriously demanding. For example, Hasbro, LEGO's second biggest competitor after Mattel, recently paid Marvel Comics a basic fee of \$100 million (€88 million), with a potential for an additional \$140 (€123) million in royalties. LEGO's outbound licensing conditions are relatively modest—less than 100 million base fees plus variable royalties—as the company wants to maintain strict control over the quality of its licensees. However, when it comes to licensing in, it is as powerless as its competitors.



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The global monetary value of licensed toys and games is expected to grow annually at the rate of 2–3 percent till 2020. LEGO says that it is determined to secure a fair share without compromising its mission, which is to “redefine play and re-imagine learning.”

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**Questions**

- 15-1.** How does LEGO generate royalties by using contractual entry strategies?
- 15-2.** What are the advantages of licensing as described in the case?
- 15-3.** What risks does LEGO face from licensing its brand, logo, toy patents, and *The LEGO Movie*?

**SOURCES:** LEGO Group A/S company information, [www.lego.com](http://www.lego.com) September 2015; [www.LEGOFoundation.com](http://www.LEGOFoundation.com) September 2015; [www.kirkbi.com](http://www.kirkbi.com) September 2015; LEGO Group A/S Annual Report 2014, pp. 1–54; Jens Hansegard, “Oh, Snap! Lego Sales Surpass Mattel”, *The Wall Street Journal*, September 4, 2014; Michael Paterniti, “How Lego Built the Coolest Company in the World,” *Popular Mechanics*, March 19, 2015, [www.popularmechanics.com](http://www.popularmechanics.com); Graham Pomphrey, “Rebuilding Lego,” *License Global*, November 1, 2006; [www.licensemag.com](http://www.licensemag.com); Jonathan Ringer, “How Lego Became the Apple of Toys,” *Fast Company*, January 8, 2015, [www.fastcompany.com](http://www.fastcompany.com); Andy Robertson, “New York Toy Fair: The Best Lego Sets,” *Wired*, February 18, 2015, [www.wired.co.uk](http://www.wired.co.uk); Sam Thielman, “How Lego Became the Most Valuable Toy Company in the World,” *AdWeek*, April 15, 2013; [www.adweek.com](http://www.adweek.com); Joint Press Release by Warner Bros, Interactive Entertainment, TT Games and the LEGO Group, *Business Wire*, April 9, 2015 [www.businesswire.com](http://www.businesswire.com); “Key Global and Regional Trends Shaping Toys Licensing”, *Euromonitor International*, September 2015, pp. 6, 10, 16; Lucy Handley, “How Marketing Built Lego into the World’s Favorite Toy Brand,” *CNBC*, April 27, 2018, <https://www.cnn.com/2018/04/27/lego-marketing-strategy-made-it-world-favorite-toy-brand.html>; “Global Toy Sales Grow 4 per cent to Hit \$18.4bn in First Half of 2018,” *ToyNews*, <https://www.toynews-online.biz/retail/global-toy-sales-grow-4-per-cent-to-hit-18-4bn-in-first-half-of-2018>.

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**Contractual entry strategies in international business**

Cross-border exchanges in which the relationship between the focal firm and its foreign partner is governed by an explicit contract.

**Intellectual property**

Ideas or works that individuals or firms create, including discoveries and inventions; artistic, musical, and literary works; and words, phrases, symbols, and designs.

**Intellectual property rights**

The legal claim through which the proprietary assets of firms and individuals are protected from unauthorized use by other parties.

**Licensing**

Arrangement by which the owner of intellectual property grants a firm the right to use that property for a specific time period in exchange for royalties or other compensation.

Licensing—granting the right to others to use a legally protected property (a name, trademark, logo, design, etc.)—has grown enormously in international business. Transactions such as those between LEGO and *Star Wars* imply a contractual relationship between those who own the property and those given permission to use it. For companies that own licensable properties such as technology, artistic works, logos, and business systems, licensing can be a very lucrative business around the world.

In this chapter, we address licensing, franchising, and other types of cross-border contractual relationships. **Contractual entry strategies in international business** are cross-border exchanges in which the relationship between the focal firm and its foreign partner is governed by an explicit contract. **Intellectual property** describes ideas or works that individuals or firms create, including discoveries and inventions; artistic, musical, and literary works; and words, phrases, symbols, and designs. Intellectual property is safeguarded through **intellectual property rights**, the legal claim through which proprietary assets are protected from unauthorized use by other parties.<sup>1</sup>

**15.1 Explain contractual entry strategies.**

**Royalty**

A fee paid periodically to compensate a licensor for the temporary use of its intellectual property, often based on a percentage of gross sales generated from the use of the licensed asset.

**Contractual Entry Strategies**

Two common types of contractual entry strategies are licensing and franchising. **Licensing** is an arrangement by which the owner of intellectual property grants another firm the right to use that property for a specific time period in exchange for *royalties* or other compensation. As described in the opening case, a **royalty** is a fee paid periodically to compensate a licensor for the temporary use of its intellectual property. The royalty is usually a percentage of the gross sales generated from use of the licensed asset. As an entry strategy, licensing requires neither substantial capital investment nor extensive involvement of the licensor in the foreign market. Licensing is a relatively inexpensive way for the firm to establish a presence in foreign markets. Firms that use licensing often can avoid expensive entry as is usually required in foreign direct investment (FDI).