International Business 7e

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Chapter 14

Entry Strategy and Strategic Alliances

Introduction

Firms expanding internationally must decide:

- which markets to enter
- when to enter them and on what scale
- which entry mode to use

Entry modes include:

- exporting
- licensing or franchising to a company in the host nation
- international joint venture with a local company
- new wholly owned subsidiary
- Acquiring/merging (MAs)with an established enterprise

Introduction

Several factors affect the choice of entry mode:

- ❖transport costs
- ❖trade barriers
- ❖political risks
- ❖economic risks
- ❖costs
- ❖firm strategy

❖The optimal mode varies by situation – what makes sense for one company might not make sense for another

Basic Entry Decisions

Firms entering foreign markets make three basic decisions:

1. which markets to enter

2. when to enter those markets

3. on what scale to enter those markets

1. Which Markets to Enter?

❖The choice of foreign markets depends on their long run profit potential

❖Favorable markets are politically stable developed and developing nations with free market systems and relatively low inflation rates and private sector debt

❖Less desirable markets are politically unstable developing nations with mixed or command economies, or developing nations with excessive levels of borrowing

❖Markets are also more attractive when the product in question is not widely available and satisfies an unmet need

2. When to Enter: Timing Of Entry

❖Once attractive markets are identified, the firm must consider the timing of entry

❖Entry is early when the firm enters a foreign market before other foreign firms. First / early movers advantage – Market Leader

❖Entry is late –Market Follower, when the firm enters the market after other firms have already established themselves in the market

Timing Of Entry: First Mover Advantages

- First mover advantages are the advantages associated with entering a market early

First mover advantages include the ability to:

- pre-empt rivals and capture demand by establishing a strong brand name
- build up sales volume in that country and achieve economies of scale ahead of rivals and gain a cost advantage over later entrants
- create switching costs that tie customers into products or services making it difficult for later entrants to win business

Timing Of Entry: First Mover Disadvantages

❖First mover disadvantages are disadvantages associated with entering a foreign market before other international businesses

❖**First mover disadvantages include:**

▪pioneering costs arise when the foreign business system is so different from that in a firm's home market that the firm must devote considerable time, effort and expense to learning the rules of the game

Pioneering costs include:

▪the costs of business failure if the firm, due to its ignorance of the foreign environment, makes some major mistakes

▪ the costs of promoting and establishing a product offering, including the cost of educating customers

3. Scale Of Entry And Strategic Commitments

- After choosing which market to enter and the timing of entry, firms need to decide on the scale of market entry

- Entering a foreign market on a significant scale is a major strategic commitment that changes the competitive playing field

- Firms that enter a market on a significant scale make a long-term strategic commitment to the market

- Small-scale entry has the advantage of allowing a firm to learn about a foreign market while simultaneously limiting the firm's exposure to that market

1.a. Exporting

- **Exporting** is a common first step in the international expansion process for many manufacturing firms

- Later, many firms may switch to another mode to serve the foreign market

1.b. Exporting

Exporting is attractive because:

- it avoids the costs of establishing local manufacturing operations
- it helps the firm achieve economies of scale

Exporting is unattractive because:

- there may be lower-cost manufacturing locations
- high transport costs and tariffs can make it uneconomical
- agents in a foreign country may not act in exporter's best interest

2.a Turnkey Projects

- **Turnkey project**: the contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel

- At completion of the contract, the foreign client is handed the "key" -- turnkey -- to a plant that is ready for full operation

- Turnkey projects are common in the chemical, pharmaceutical, petroleum refining, and metal refining industries

2.b. Turnkey Projects

❖Turnkey projects are attractive because:

- they are a way of earning economic returns from the know-how required to assemble and run a technologically complex process
- they can be less risky than conventional FDI

❖Turnkey projects are unattractive because:

- the firm that enters into a turnkey deal will have no long-term interest in the foreign country
- the firm that enters into a turnkey project may create a competitor
- if the firm's process technology is a source of competitive advantage, then selling this technology through a turnkey project is also selling competitive advantage to potential and/or actual competitors

3.a. Licensing

❖ Licensing agreement: is an arrangement whereby a licensor grants the rights to intangible property to another entity (the licensee) for a specified time period, and in return, the licensor receives a royalty fee from the licensee

❖ Intangible property rights include patents, inventions, formulas, processes, designs, copyrights, and trademarks

3.b. Licensing

❖Licensing is attractive because:

- the firm does not have to bear the development costs and risks associated with opening a foreign market

- the firm avoids barriers to investment

- firms with intangible property that might have business applications can capitalize on market opportunities without developing those applications themselves

3.c. Licensing

❖Licensing is unattractive because:

- the firm doesn't have the tight control over manufacturing, marketing, and strategy required for realizing economies of scale and location advantages

- it limits a firm's ability to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another

- proprietary (or intangible) assets could be lost

- To reduce these risks: Cross-licensing Agreements. A firm licenses intangible property to a foreign partner, but requests that the foreign partner license some of its valuable know-how to the firm in addition to a royalty payment

4.a. Franchising

- **Franchising** *is a specialized form of licensing* in which the franchisor not only sells intangible property to the franchisee, but also insists that the franchisee agree to abide by strict rules as to how it does business

- Franchising is used primarily by service firms

4.b. Franchising

❖ Franchising is attractive because:

- Firms avoid many costs and risks of opening up a foreign market
- Firms can quickly build a global presence

❖ Franchising is unattractive because:

- It may inhibit the firm's ability to take profits out of one country to support competitive attacks in another
- the geographic distance of the firm from its foreign franchisees can make poor quality difficult for the franchisor to detect

5.a. Joint Ventures (J.Vs)

- **Joint Venture** (International): the establishment of a firm that is jointly owned by two or more otherwise independent firms

- Most joint ventures are 50:50 partnerships

- **Why Joint Ventures?**

1. Leverage Resources: A joint venture can take advantage of the combined resources of both companies to achieve the goal of the venture. One company might have a well-established manufacturing process, while the other company might have superior distribution channels

5.b. Joint Ventures (J.Vs)

2. Cost Savings: By using economies of scale, both companies in the J.V. can leverage their production at a lower per-unit cost than they would separately. This is particularly appropriate with technology advances that are costly to implement. Other cost savings as a result of a JV can include sharing advertising or labor costs

3. Combined Expertise: Two companies or parties forming a joint venture might each have unique backgrounds, skillsets, and expertise. When combined through a JV, each company can benefit from the other's expertise and talent within their company

4. Enter a Foreign Market: Some countries also have restrictions on foreigners entering their market, making a J.V. with a local entity almost the only way to do business in the country

5.b. Joint Ventures

❖Joint ventures are attractive because:

- they allow the firm to benefit from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems, and business systems
- the costs and risks of opening a foreign market are shared with the partner
- When political considerations make joint ventures the only feasible entry mode

❖Joint ventures are unattractive because:

- the firm risks giving control of its technology to its partner
- the firm may not have the tight control over subsidiaries need to realize "*experience effects*" or location economies
- shared ownership can lead to conflicts and battles for control if goals and objectives differ or change over time

6.a. Wholly Owned Subsidiaries

❖ **Wholly owned subsidiary**: the firm owns 100 percent of the stock

❖ Firms can establish a wholly owned subsidiary in a country by:

- a greenfield strategy - building a subsidiary from the ground up
- an acquisition/mergers strategy (M&As)

6.b. Wholly Owned Subsidiaries

❖Wholly owned subsidiaries are attractive because they:

- reduce the risk of losing control over core competencies
- give a firm the tight control over operations in different countries that is necessary for engaging in global strategic coordination
- may be required in order to realize location economies and experience effects

❖Wholly owned subsidiaries are unattractive because:

- the firm bears the full cost and risk of setting up overseas operations

6.d. Wholly Owned Subsidiary: Pros And Cons Of Greenfield Ventures

❖The main advantage of a Greenfield Venture: is that it gives the firm a greater ability to build the kind of subsidiary company that it wants

❖ Disadvantages of Greenfield Ventures: (i) are slower to establish, (ii) are also risky

6.e. Wholly Owned Subsidiary: Pros And Cons of Acquisition

❖ Acquisitions/Mergers are attractive because:

- they are quick to execute
- they enable firms to preempt their competitors
- acquisitions may be less risky than Greenfield ventures

6.f. Wholly Owned Subsidiary: Pros And Cons of Acquisition

❖ Acquisitions can fail when:

- the acquiring firm overpays for the acquired firm
- the cultures of the acquiring and acquired firm clash
- attempts to realize synergies run into roadblocks and take much longer than forecast
- there is inadequate pre-acquisition screening

❖ To avoid these problems, firms should:

- carefully screening the firm to be acquired
- move rapidly once the firm is acquired to implement an integration plan

Selecting An Entry Mode: Summary

Entry Mode	Advantages	Disadvantages
Exporting	Ability to realize location and experience curve economies	High transport costs Trade barriers Problems with local marketing agents
Turnkey contracts	Ability to earn returns from process technology skills in countries where FDI is restricted	Creating efficient competitors Lack of long-term market presence
Licensing	Low development costs and risks	Lack of control over technology Inability to realize location and experience curve economies Inability to engage in global strategic coordination
Franchising	Low development costs and risks	Lack of control over quality Inability to engage in global strategic coordination
Joint ventures	Access to local partner's knowledge Sharing development costs and risks Politically acceptable	Lack of control over technology Inability to engage in global strategic coordination Inability to realize location and experience economies
Wholly owned subsidiaries	Protection of technology Ability to engage in global strategic coordination Ability to realize location and experience economies	High costs and risks

Entry Mode: Core Competencies and Costs Reduction

❖**1. Core Competencies**: The optimal entry mode depends to some degree on the nature of a firm's core competencies

- When a firm's competitive advantage is based on proprietary technological know-how, the firm should avoid licensing and joint venture arrangements unless it believes its technological advantage is only transitory, or that it can establish its technology as the dominant design in the industry

- When a firm's competitive advantage is based on management know-how, the risk of losing control over the management skills is not high, and the benefits from getting greater use of brand names is significant →Licensing, Franchising

Entry Mode: Pressures for Cost Reductions

- 2. **Pressure for cost reductions:** firms are more likely to pursue some combination of exporting and wholly owned subsidiaries

- This will allow the firm to achieve location and scale economies as well as retain some degree of control over its worldwide product manufacturing and distribution

- Firms pursuing global standardization or transnational strategies prefer wholly owned subsidiaries

Strategic Alliances

- **Strategic Alliances:** agreements between potential or actual competitors

- Strategic alliances range from formal joint ventures to short-term contractual agreements

- The number of strategic alliances has exploded in recent decades

The Advantages Of Strategic Alliances

Strategic Alliances:

- facilitate entry into a foreign market
- allow firms to share the fixed costs (and associated risks) of developing new products or processes
- bring together complementary skills and assets that neither partner could easily develop on its own
- can help a firm establish technological standards for the industry that will benefit the firm
- Strategic alliances can give competitors low-cost routes to new technology and markets, but unless a firm is careful, it can give away more than it receives

Chapter 15

Exporting, Importing and Countertrade

Introduction

- Large and small firms export

- Exporting is on the rise thanks to the decline in trade barriers under the WTO and regional economic agreements such as the EU and NAFTA

- Exporting firms need to
  - identify market opportunities
  - deal with foreign exchange risk
  - navigate import and export financing
  - understand the challenges of doing business in a foreign market

The Promise And Pitfalls Of Exporting

❖Promise: Exporting is a way to increase market size

❖Large firms are proactive: seek new export opportunities

❖Many smaller firms are reactive: (i) wait for the world to come to them. (ii) they fail to realize the potential of the export market. (iii) are often intimidated by the complexities of exporting and initially run into problems

The Promise And Pitfalls Of Exporting

- Common pitfalls include:
  - poor market analysis
  - poor understanding of competitive conditions
  - lack of customization for local markets
  - poor distribution program
  - poorly executed promotional campaigns
  - problems securing financing
  - a general underestimation of the differences and expertise required for foreign market penetration
  - an underestimation of the amount of paperwork and formalities involved

Improving Export Performance

- There are various ways to gain information about foreign market opportunities and avoid the pitfalls associated with exporting

- Some countries provide direct assistance to exporters

- Export Management Companies (EMC) can also help with the export process

Export Strategy

❖ To reduce the risks of exporting, firms should

- hire an EMC or export consultant, to help identify opportunities and navigate through the tangled web of paperwork and regulations so often involved in exporting
- focus on one, or a few, markets at first
- enter a foreign market on a fairly small scale in order to reduce the costs of any subsequent failures
- recognize the time and managerial commitment involved
- develop a good relationship with local distributors and customers
- hire locals to help establish a presence in the market
- be proactive
- consider local production

Export And Import Financing

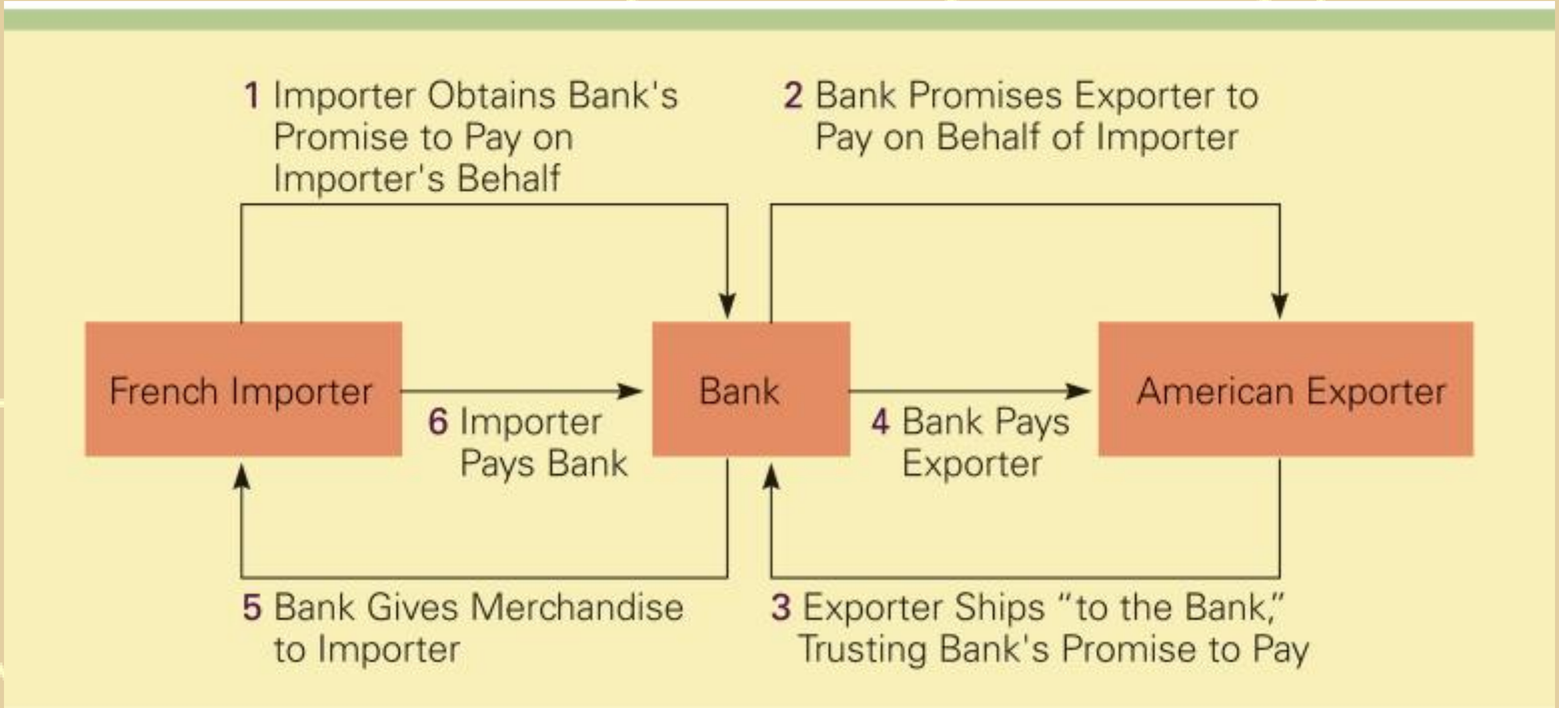
- Over time, various mechanisms for financing exports and imports have evolved in response to a problem that can be particularly acute in international trade: the lack of trust that exists when one **must put faith in a stranger**

- Many international transactions are facilitated by a third party (normally a reputable bank)

- By including the third party, an element of trust is added to the relationship

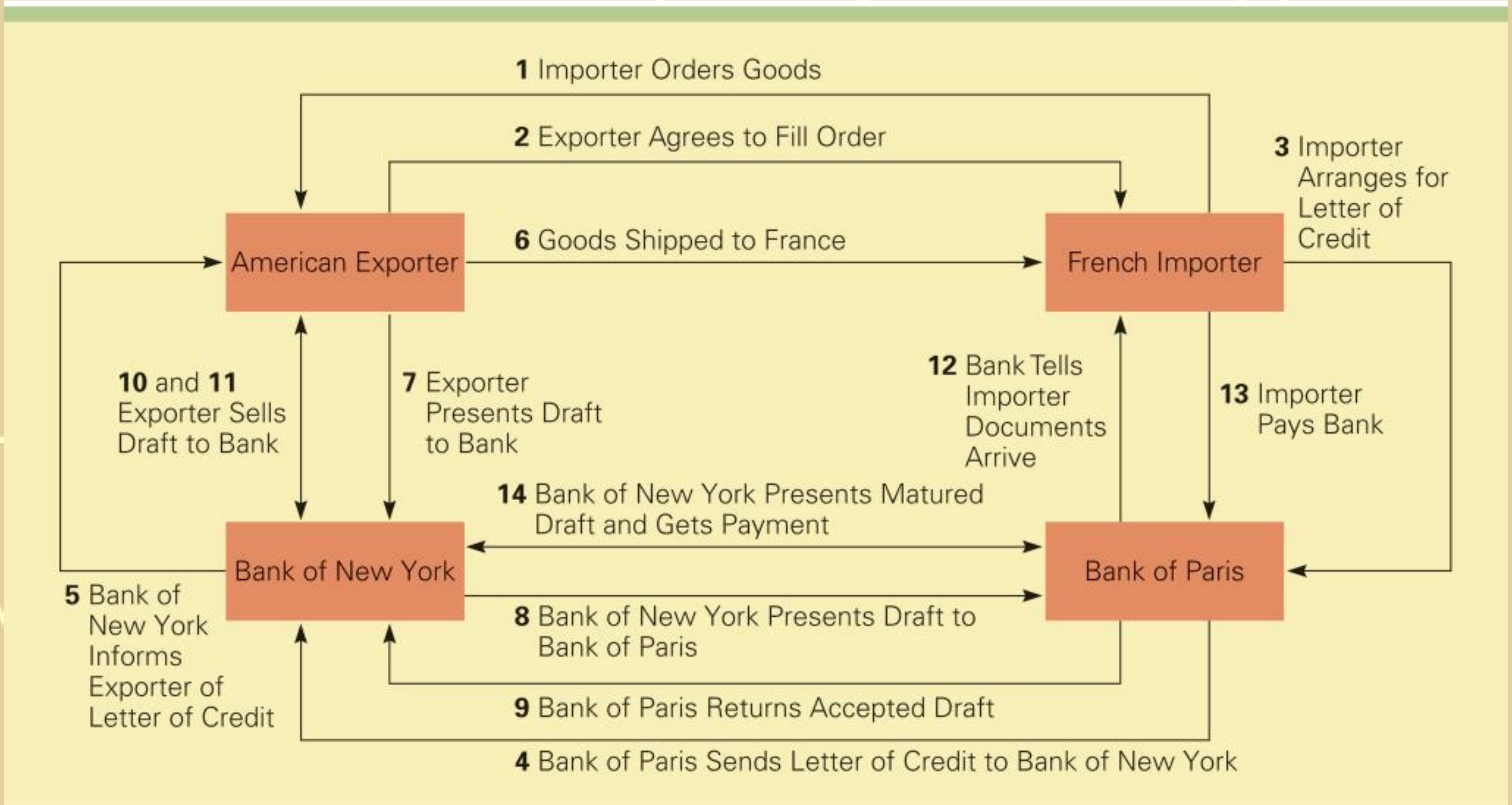
Export And Import Financing

Figure 15.3:



A Typical International Trade Transaction

The typical international trade transaction involves 14 steps



Countertrade

- When conventional means of payment are difficult, costly, or nonexistent, some firms may turn to countertrade

- Countertrade refers to a range of barter-like agreements that facilitate the trade of goods and services for other goods and services when they cannot be traded for money

The Incidence Of Countertrade

- During the1960s, when the Soviet Union and the Communist states of Eastern Europe had nonconvertible currencies, countertrade emerged as a means purchasing imports

- During the 1980s, the technique grew in popularity among many developing nations that lacked the foreign exchange reserves required to purchase necessary imports

- There was a notable increase in the volume of countertrade after the Asian financial crisis of 1997

The Incidence Of Countertrade

There are five distinct versions of countertrade:

1. barter
2. counterpurchase
3. offset
4. compensation or buyback
5. switch trading

The Incidence Of Countertrade

1. Barter is a direct exchange of goods and/or services between two parties without a cash transaction

- Barter is the most restrictive countertrade arrangement
- It is used primarily for one-time-only deals in transactions with trading partners who are not creditworthy or trustworthy

2. Counterpurchase is a reciprocal buying agreement

- It occurs when a firm agrees to purchase a certain amount of materials back from a country to which a sale is made

The Incidence Of Countertrade

3. Offset is similar to counterpurchase insofar as one party agrees to purchase goods and services with a specified percentage of the proceeds from the original sale

- The difference is that this party can fulfill the obligation with any firm in the country to which the sale is being made

4. A buyback occurs when a firm builds a plant in a country—or supplies technology, equipment, training, or other services to the country—and agrees to take a certain percentage of the plant's output as a partial payment for the contract

The Incidence Of Countertrade

5. Switch trading refers to the use of a specialized third-party trading house in a countertrade arrangement

- When a firm enters a counterpurchase or offset agreement with a country, it often ends up with what are called counterpurchase credits, which can be used to purchase goods from that country
- Switch trading occurs when a third-party trading house buys the firm’s counterpurchase credits and sells them to another firm that can better use them

The Pros And Cons Of Countertrade

- Countertrade is attractive because

  - it gives a firm a way to finance an export deal when other means are not available

  - if a firm is unwilling to enter a countertrade agreement, it may lose an export opportunity to a competitor that is willing to make a countertrade agreement

  - in some cases, a countertrade arrangement may be required by the government of a country to which a firm is exporting goods or services

The Pros And Cons Of Countertrade

❖Countertrade is unattractive because:

- it may involve the exchange of unusable or poor-quality goods that the firm cannot dispose of profitably

- it requires the firm to establish an in-house trading department to handle countertrade deals

- countertrade is most attractive to large, diverse multinational enterprises that can use their worldwide network of contacts to dispose of goods acquired in countertrade deals