

## 1. Introduction

IKEA is a retail company and the leading player in the worldwide furniture industry. Operating in the entire value chain, the company expanded across countries and continents offering its customers functional, flat packed home furniture and accessories at affordable prices. The company is famous for its large network of suppliers who manufacture and deliver products to IKEA's distribution centers and stores. However, IKEA also owns some manufacturing activities that are located outside the home country, mostly in Central and Eastern Europe. Poland plays an important role in IKEA's sourcing strategy. 19 percent of the manufacturing output comes from Poland and 16 factories producing components and products are located in this country.

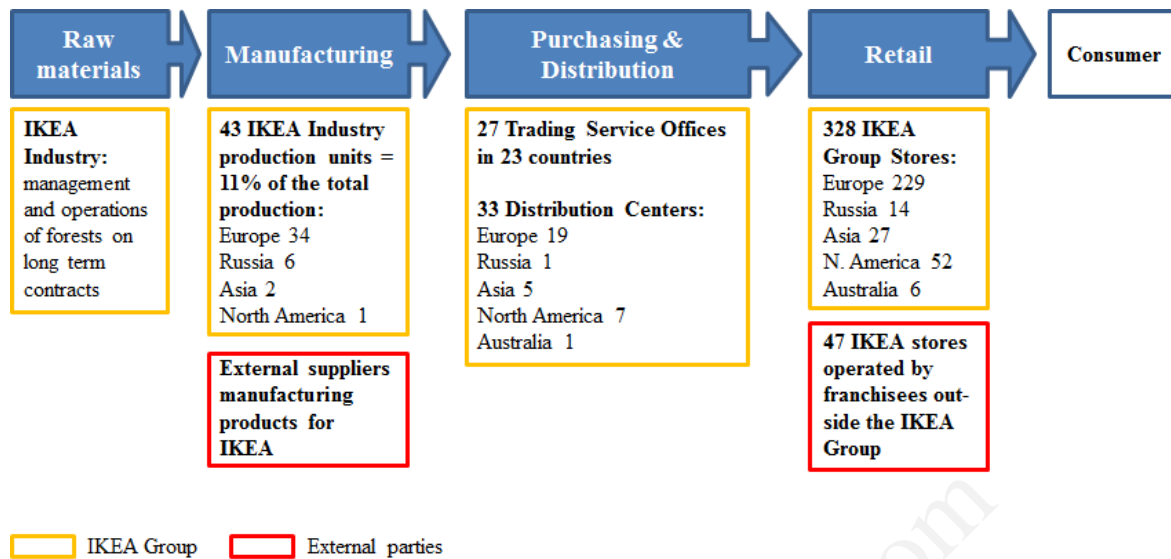
Based on the example of IKEA's latest investment in Orla in Eastern Poland, the following case study aims to discuss the motives behind IKEA undertaking some of their foreign production in the form of a direct investment. This case study can be used for teaching purposes in international management classes at bachelor level. It has been written to facilitate students' understanding of the motives and theories of foreign production (e.g. Dunning's eclectic **paradigm** of international production) and to support their recognition of different modes of internationalization.

## 2. IKEA - a multinational giant in the furniture retailing industry

IKEA, a well-known furniture company worldwide, was founded in a small village in Sweden in 1943 by 17-year-old Ingvar Kamprad. Initially the company sold pens, wallets, picture frames and nylon stockings. In 1948 it began to sell furniture made by local manufacturers. In 1958, IKEA opened its first store in Sweden. Over the next three decades, the company expanded across Europe opening stores in Norway, Denmark, Switzerland, Germany, Austria, the Netherlands, France, Belgium, the UK, Italy, and on other continents (Australia, Canada, and the US). In the 1990s, IKEA continued its international expansion, opening stores in Hungary, Czech Republic, Poland, Spain, China followed by Russia (in 2000), Portugal (2004) and Japan (2006). Currently, IKEA has 375 stores in 47 countries across the world and generates total sales of EUR 31.9 billion (Financial Year 2015).

IKEA's strong global brand attracts key consumer groups. The company's business model is to sell furniture, appliances and home accessories that are of simple designs and at affordable prices. According to the company's vision, IKEA's products feature the perfect balance between function, quality, design and price. The company offers the same quality and nearly the same product range worldwide and benefits from economies of scale (e.g. reducing costs of raw materials through bulk-buying). To cut down on costs and the use of packaging most of IKEA's products are flat packed and ready to be assembled by the customer. Today IKEA carries a range of 9,500 products sold in IKEA stores and via online shop.

IKEA operates along the entire value chain and is involved in all functions from forest management to retail (see Figure 1).



**Figure 1: IKEA's value chain (Financial Year 2015)**

Source: own presentation based on [www.ikea.com](http://www.ikea.com)

### Sourcing of raw materials

Since wood is the main raw material in IKEA's products (approx. 60% of IKEA's products contain wood in some form), the company belongs to the largest wood purchasers in the world. In a first stage of its value chain, the company focuses on forestry, timber production and sawmills. IKEA either owns forests (e.g. in Eastern Europe) or has leases around the world to log wood from forests on long term contracts sometimes being the sole customer.

### Manufacturing

Designers of IKEA's products come from Sweden and other Nordic countries, while manufacturing mostly takes place in other countries. Following the statement of the IKEA purchasing executive: "We don't buy products, we buy production capacities" (Bartlett/Nanda, 1996), the company works closely with a vast number of suppliers that do not belong to the IKEA Group. When developing long-term alliances with external suppliers, IKEA often offers financial or technical support, e.g. setting up operations or buying equipment. In this way the company aims to ensure product quality and to drive down manufacturing costs. Today, IKEA has 978 suppliers in 50 countries (Financial Year 2015). Over 50% of IKEA's products are delivered directly from suppliers to IKEA stores.

But the company does not only rely on external suppliers. 11% of the total production value comes from manufacturing sites owned by IKEA Group and concentrated in the IKEA Industry division. IKEA Industry has 43 production units, most of which are located in Europe. This division manufactures wood-based furniture and boards. In total, IKEA Industry has 20,500 co-workers in production units located in 11 countries and produces more than 100 million pieces of furniture every year.

The international expansion of IKEA's manufacturing activities started in 1991 when IKEA founded Swedwood. Mainly through acquisition of sawmills or factories of previous suppliers the industrial group Swedwood was created to produce wood-based furniture. In the '90s Swedwood experienced a rapid growth by acquiring further factories and establishing new production facilities mainly in Eastern European countries. Today, Swedwood has operations in Sweden, Russia, Latvia, Lithuania, Poland, Germany, Slovakia, Hungary, Ukraine, Portugal, China and the USA. This backward integration in IKEA's supply chain ensures operational reliability, reduces costs and helps to manage input resources efficiently.

The second part of IKEA's manufacturing unit is Swedspan, the company formed as a spin-off from furniture maker Swedwood in 2008. Swedspan manufactures lightweight and environmentally friendly

wood based panels and has locations in Sweden, France, Slovakia, Lithuania, Poland, and Russia. As of September 1<sup>st</sup> 2013, IKEA restructured its manufacturing operations and consolidated Swedwood and Swedspan into one division called IKEA Industry.

In 2015, 60% of IKEA's purchasing value came from Europe, followed by Asia (35%), North America (3%), Russia (2%), and South America (1%) (% does not add up to 100 due to rounding). The three main manufacturing locations were China (25% of the purchasing value), Poland (19%), and Italy (8%). Purchasing value is the total volume of home furnishing articles purchased from suppliers. It includes both IKEA Industry production units and external suppliers (Financial Year 2015).

### **Purchasing & distribution**

The company's international expansion presents an enormous challenge for purchasing and distribution divisions that are integrated part of the IKEA Group. 27 trading service offices negotiate terms and conditions with suppliers and check the quality of materials and products. Employees in regional trading offices have regular contact with suppliers and keep an eye on working conditions at factories as well as support suppliers with meeting environmental requirements (IKEA Sustainability Report).

IKEA stores were served by 34 highly automated distribution centers. They analyze the supply chain to efficiently accommodate the volume of goods required by stores. The goal is to secure the highest product availability to the customer with the lowest possible supply chain costs. Sharply increasing Internet shopping requires quick and flexible distribution solutions.

### **Retail**

Currently IKEA has 328 own stores worldwide. Additional 47 stores are operated by franchisees outside the IKEA Group. All stores operate under franchise agreements with the worldwide IKEA franchisor Inter IKEA Systems B.V., the owner of the IKEA Concept (IKEA Group Yearly Summary 2015).

To summarize, it can be emphasized that IKEA operates along the entire value chain. Although most of the IKEA stores are part of the IKEA Group and distribution function fully being in company's own-ership, manufacturing activities are internalized only to some extent. Only 11% of the total purchase volume is produced in factories being part of the IKEA Group. All other products are manufactured by external suppliers. IKEA's retail stores are company's core business; therefore most of them are part of the Group. However, 47 stores are operated by external franchisees e.g. in Singapore, Turkey, Greece, United Arab Emirates, Qatar, Kuwait, and Saudi Arabia. Purchasing and distribution are crucial to the company implementing the low cost strategy and therefore these functions are fully internalized.

## **3. IKEA in Poland: important consumer market or cheap sourcing country?**

The first store in Poland IKEA opened in Warsaw in 1991, shortly after the collapse of communism and as a response to the opening of the Polish market to foreign investors. Today, the company has 9 stores in Poland, which is still a small number as compared e.g. to Germany with its 47 stores. An additional store is currently under construction and will be opened in 2016 in Lublin.

Even though the first store in Poland was opened in the early 1990s, IKEA's business relationship with Poland dates much earlier. The first furniture from a Polish manufacturer IKEA ordered already in 1961. At that time, IKEA's sales rocketed in signaling the start of its expansion in the Swedish market and abroad. However, a strong response followed from Swedish furniture retailers. IKEA's competitors could not stand the price pressure and tried to force Swedish producers to stop supplying IKEA. IKEA's response was to go looking for suppliers abroad. Thus, the first agreements with Polish manufacturers were signed, starting many business relationships that still exist today. Since then, Polish furniture industry has been an important partner to the IKEA Group.

Today, Poland accounts for 19% of IKEA's manufacturing output, which is a significant share. IKEA has 16 factories in Poland and cooperates closely with about 60 local suppliers.

Currently IKEA has the following activities in Poland:

- **IKEA Retail:** 9 stores - 2 in Warsaw and 1 in each of the following cities: Gdańsk, Poznań, Katowice, Kraków, Wrocław, Łódź, and Bydgoszcz.
- **IKEA Industry Poland Sp. z o. o.** is part of IKEA Industry Group and consists of 15 furniture assembly factories and one factory manufacturing furniture components.
- **IKEA Distribution Services S.A. (Warsaw)** is responsible for warehouse and transport management, quality control of transported goods and administration of custom duties.
- **IKEA Business Service Center Sp. z o. o. (Poznań)** was founded in 2011 and provides accounting and HR services to IKEA companies.
- **Inter IKEA Centre Poland S.A.** owns eight shopping centers in Poland located in Warsaw, Gdańsk, Poznań, Wrocław, Katowice, Łódź and Lublin. The company is part of Inter IKEA Centre Group (IICG) that develops, owns and manages shopping centers in partnership with IKEA.

Poland's role as a manufacturing location seems to be more important for IKEA, although retail activities are gradually being developed. Figure 2 shows the location of IKEA's manufacturing plants and stores in Poland.



Figure 2: IKEA's manufacturing activities and stores in Poland as of August 2015

Source: Own presentation

#### 4. IKEA's investment in Orla: setting new standards in lightweight board technology

IKEA In June 2010 IKEA started the construction of its new factory in Orla commune (see Figure 2) in Podlaskie voivodship in Eastern Poland. Since no suitable targets for acquisition were available in this region, IKEA decided to build the factory on a green field. The total investment cost was about EUR 140 million. Roughly 25% of the funding was granted by the EU's "Innovative Economy Program". According to PALiZ (Polish Information and Foreign Investment Agency), the factory was the largest foreign investment in Poland in 2010.

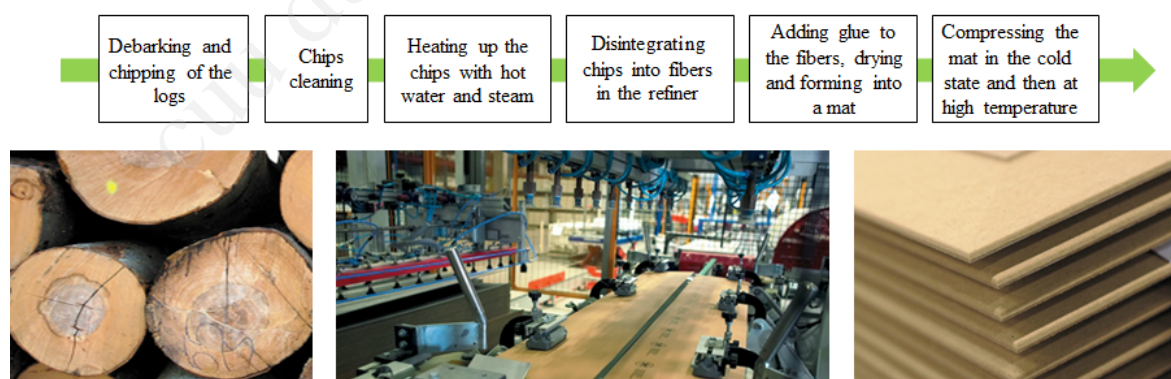
During the construction phase, many local firms were involved in the construction process. In July 2011 first fiber board sheets left the factory and in June 2012 the factory began regular production. Following IKEA's investment, several new jobs have been created in Orla commune and in Podlaskie region, in the new factory itself as well as at local providers of maintenance and repair, cleaning, security, catering and housing services.

##### 4.1 The product: high density fiber board

The factory in Orla produces Ultra-Thin High Density Fiber boards (UT-HDF) in the thickness range from 1 to 3 mm. This furniture component is used in many different parts such as drawer bottoms, sandwich board constructions or back-panels (e.g. in picture frames).

UT-HDF boards manufactured in Orla are produced using low-grade pulpwood from local forests (see Figure 3 for single production steps). The process starts with the debarking and chipping of the logs. Then, the chips are cleaned and heated up before being disintegrated into fibers in the refiner. During the next stage of the production process the glue is added to the fibers and finally they are dried and formed into a mat that is compressed. The final product is a board with outstanding thickness tolerances and superior surface qualities. In the value added production facility the boards can be cut to size. Additionally, foiled boards in many decors and formats will be offered in the future.

The plant in Orla uses the most up to date technological know-how delivered by the German company Dieffenbacher that is supplying the complete process technology - from wood preparation and drying through the gluing and forming station, and finally the finishing line.



**Figure 3: Production process of UT-HDF boards**

Source: Based on [www.swedspan.com](http://www.swedspan.com); accessed on 11.8.2014

Following the idea that the future of the wood industry will be based on ultra-thin and ultra-light base materials, a new R&D center has been established in Orla in addition to the manufacturing plant. In this new laboratory, engineers work on innovative UT-HDF applications for wood fibers and develop and test new production methods. Furthermore, the company conducts research on surface finishing technology. Two lines (lacquering and foiling) were installed at the tech center. The lines are the basis for IKEA's surfacing laboratory activities where different types of foils and glues (including UV based lacquers) can be tested under industry process conditions.



Beside the production of UT-HDF boards the factory in Orla is running a sawmill producing 60,000 m<sup>3</sup> of sawn timber annually. The sawmill was built as a greenfield investment and the manufactured timber is applied by the suppliers cooperating with IKEA and other companies on the Polish market.

In line with IKEA's policy of sustainability and eco-efficient production, the company installed a co-generation power plant which supplies the heat needed for the production of boards and green electrical energy for the plant and the public grid. The power plant is completely fueled with biomass, which consists mainly of the wood residues from the production process.

The key facts of the factory can be summarized as follows:

- Number of employees: 270
- Factory area: 60 hectares
- Buildings: 48,000 m<sup>2</sup>
- Output of the production facility: up to 250,000 m<sup>3</sup> boards a year
- Sawmill capacity: 60,000 m<sup>3</sup> sawn timber a year
- Output of the value added production facility: up to 80,000 m<sup>3</sup> foiled boards a year

About 70% of the boards manufactured in Orla are delivered to companies from the IKEA Group and used for IKEA's own furniture production. Other 30% are sold to external customers, mainly to suppliers manufacturing products for IKEA. For this reason issues like quality control and cost supervision play an important role in IKEA's strategy. Manufacturers of the final wood products (furniture and other home products) order boards with customized size, thickness, and surface.

Prior to the investment in Orla, IKEA had two main suppliers of UT-HDF boards in Poland, Krono and Pfeiderer Grajewo. Locating boards' production inside the IKEA Group enables efficient and fast communication and delivery.

## 4.2 Eastern Poland as a location for the investment

Podlaskie voivodship has nearly 1.2 million inhabitants, which makes up only 3.1% of Poland's population (GUS - Polish Main Statistical Office). It has an area of 20,187 km<sup>2</sup> and has the lowest population density of the sixteen Polish voivodships. The unemployment rate is high in this region and accounts for 12.9% (11.4% in Poland as of the end of December 2014 according to GUS). Labor costs are relatively low, which makes 90% of national average pay per month or approx. EUR 800.

Eastern Poland offers an access to extensive forest resources. 70% of the wood used in the IKEA factory comes from Belarus, 14% from Polish State Forests, 12% from private forests, and the remainder from Lithuania and Ukraine. The next border crossing between Poland and Belarus is 35 km away and a railroad line is situated next to the factory. Other IKEA Industry manufacturing units and several external firms manufacturing wooden products for IKEA are also located in Poland. Land prices in Eastern Poland are relatively low in comparison to other regions in Poland.

Even though IKEA did not receive any tax allowances for the investment, local authorities of Orla commune showed a supportive attitude to IKEA as a potential investor and supported the company enormously. Since this region is famous for its forest resources and wood industry, several small and mid-size Polish wood and furniture manufacturers are located there. Also, German board manufacturer Pfeiderer located its laminated board business in this region. Local authorities see IKEA's investment as a main step for the development of the region and will try to attract other companies from the wood industry to set up activities in Podlaskie voivodship in the future.

Orla commune has about 3,200 inhabitants. Following IKEA's investment Orla jumped up in the ranking of Polish communities from rank 423 in 2011 to rank 45 in 2012 in terms of tax income per inhabit-

ant ([www.gazeta.pl](http://www.gazeta.pl)). This additional income will be spent on investments in water pipes and sewage water systems, renovation of a water treatment plant and development of the roads system.

#### **4.3 The recruitment process**

There are currently 270 workers employed at IKEA's factory in Orla and 90% of the workforce comes from the Podlaskie voivodship. Production line employees work in a three shift model. Despite the high unemployment rate in the region, IKEA faced several challenges in the recruiting phase. The lack of qualified and experienced candidates able to operate a modern production line was one of the main problems. New employees working in the production line were sent to Diffenbacher in Germany for training, which incurred additional costs. Another problem was the lack of workforce trained to operate specialized vehicles, e.g. pallet transporters. Also, as most skilled and experienced candidates with fluent English lived in the nearby towns, it was difficult to find those willing to work outside the urban areas and commute to work to rural Orla. And lastly, since building the factory happened relatively fast, the additional challenge was to recruit adequate staff in a very short period of time.

It needs to be emphasized that some factors helped IKEA overcome the obstacles during the recruitment phase. These were mainly: a high unemployment rate, strong brand and a good image of IKEA in the Polish market and community. Working for a famous, global and reliable company was seen as prestigious by many potential candidates, which helped them make personal choices regarding their employment. Additionally, they were offered permanent employment agreements, including all social benefits and training.

#### **4.4 Environmental challenges**

Podlaskie voivodship is a home to the primal Białowieża Forest and National Park and is known for its largely unspoiled nature. Around 30% of the area is under legal protection and the forest has been designated a UNESCO World Heritage Site and UNESCO Biosphere Reserve.

Since IKEA's factory is located close to the Białowieża Forest in the ecologically clean area known as "The Green Lungs of Poland", the company has to pay huge attention to the environmental issues. The first environmental challenge IKEA faced already during the process of setting up the factory. After plant opening, the nearby Biała River got polluted and some local sources tried to pin the responsibility on IKEA's new investment. In the end, no such connection had been found and the Regional Prosecutor's Office decided to discontinue the proceedings, concluding that no criminal offense was committed by the company.

In its daily business, IKEA strives to implement production processes that minimize emissions initiated during wood processing. The company established a very strict standard for emissions from the UT-HDF boards used in its furniture production. IKEA's goal is to reduce emissions to the natural emission level of wood.

### **5. Determinants of foreign production: Dunning's eclectic paradigm**

The eclectic paradigm developed by J. H. Dunning in the mid-1950s and presented in 1976 at a Nobel Symposium in Stockholm is a framework for analyzing the determinants of international production undertaken by Multinational Enterprises (MNEs) (Dunning 2001). According to Dunning, foreign production (of goods or services) that takes place in form of foreign direct investment can be explained by the configuration of three factors: ownership advantage (O), localization advantage (L) and internalization advantage (I) (Dunning 2000 and 2001).

Firstly, to overcome “the risk of foreignness” and successfully compete against local players, MNEs have to possess certain competitive advantages over local companies when entering the new market. These advantages, called “ownership advantages” are firm’s capabilities that are transferable across borders and can arise from company’s organizational structure, its access to resources like proprietary technology and managerial know-how, or sharing resources (brand name or business model) across business units. Dunning’s ownership advantages arise from the monopolistic advantage theory developed by Hymer (Hymer 1976).

Secondly, there must be certain location factors that allow MNEs to move production to a foreign country instead of locating it at home country. MNEs search for such a location for their production that offers compelling advantages to doing business. The more these specific location factors favor a presence in a foreign country, the more MNEs firms choose to utilize their O advantages through engaging in FDI. These so called “location advantages” can be of institutional matter (e.g. barriers to trade, governmental incentives to attract FDI), market oriented factors (e.g. market size and growth, presence of key consumers) or location-bound resources such as skilled or/and cheaper labor force, existence of certain natural resources or cheap inputs, etc.

Even if an MNE possesses certain O advantages and at the same time L advantages are available abroad, it could theoretically resign from exploiting them internally and sell the rights to an external party on the free market (e.g. via licensing). Dunning’s third determinant of the foreign production refers to the “internalization advantage”. The company will locate its production abroad in the form of FDI and will avoid licensing, if it is more efficient to internalize activities instead of outsourcing production to the foreign partner in a given country. Because of market failures and associated transaction costs resulting e.g. from information asymmetry or because of the dissemination risk in case of outsourcing of complex manufacturing processes or licensing of technological know-how, MNEs prefer to internalize high value added activities. Internalization advantages are based on the internalization theory formulated by Buckley and Casson (Buckley/Casson 1976). The internalization theory is built on the transaction cost theory which says that transactions are made within an institution if the transaction costs on the free market are higher than the internal costs.

According to Dunning, the possession of certain resource endowments – ownership-specific and location-specific – enables MNEs to supply either a foreign or domestic market from a foreign production base. In addition, high transaction costs force companies to internalize activities when producing in foreign market. These factors explain why foreign direct investments are undertaken by MNEs.

Despite numerous critics, the eclectic paradigm has been for a long time the most influential framework for empirical investigation of determinants of FDI. Opponents argue that there are interdependencies and/or redundancies between OLI variables, e.g. company’s access to cheaper resources abroad (defined as a location advantage) can be used as an ownership advantage by the MNE. Also, learning effects and experience gained during the internationalization process of the company are seen as ownership advantages leading to the argument that competitive advantages are not only the premise for an internationalization process but can also be acquired through an internationalization process. Moreover, some argue that the approach is couched in static terms and does not consider the role of strategy. According to Dunning, the role of the eclectic paradigm is “not to offer a full explanation of all kinds of international production” but rather to explain particular types of foreign value-added activity using a generic set of variables (Dunning 2001). A new approach has been recently presented by Li and Gammelgaard, suggesting that corporate entrepreneurship, institutions of the host country and regulatory focus have to be integrated into the framework when explaining firm internationalization (Gammelgaard/Li 2014).