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Chapter 12

Entering Foreign Markets

Introduction

Question: How can firms enter foreign markets?

- Firms can enter foreign markets through
  - exporting
  - licensing or franchising to host country firms
  - a joint venture with a host country firm
  - a wholly owned subsidiary in the host country to serve that market
- The advantages and disadvantages of each entry mode is determined by
  - transport costs and trade barriers
  - political and economic risks
  - firm strategy

Basic Entry Decisions

Question: What are the basic entry decisions for firms expanding internationally?

- A firm expanding internationally must decide
  - which markets to enter
  - when to enter them and on what scale
  - how to enter them (the choice of entry mode)

Which Foreign Markets?

- Firms need to assess the long run profit potential of each market
- The most favorable markets are politically stable developed and developing nations with free market systems, low inflation, and low private sector debt
- The less desirable markets are politically unstable developing nations with mixed or command economies, or developing nations where speculative financial bubbles have led to excess borrowing
- Success firms usually offer products that have not been widely available in the market and that satisfy an unmet need

Timing of Entry

- After a firm identifies which market to enter, it must determine the timing of entry
- Entry is early when an international business enters a foreign market before other foreign firms
- Entry is late when a firm enters after other international businesses have already established themselves in the market

Timing of Entry

- Firms entering a market early can gain first mover advantages including
  - the ability to pre-empt rivals and capture demand by establishing a strong brand name
  - the ability to build up sales volume in that country and ride down the experience curve ahead of rivals and gain a cost advantage over later entrants
  - the ability to create switching costs that tie customers into their products or services making it difficult for later entrants to win business

Timing of Entry

- First mover disadvantages are the disadvantages associated with entering a foreign market before other international businesses
- These may result in pioneering costs (costs that an early entrant has to bear that a later entrant can avoid) such as
  - 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 the customers

Scale of Entry and Strategic Commitments

- Firms that enter foreign markets on a significant scale make a major strategic commitment that changes the competitive playing field
  - This involves decisions that have a long term impact and are difficult to reverse
- Small-scale entry can be attractive because it allows the firm to learn about a foreign market, but at the same time it limits the firm's exposure to that market

Summary

- There are no “right” decisions with foreign market entry, just decisions that are associated with different levels of risk and reward
- Firms in developing countries can learn from the experiences of firms in developed countries

Classroom Performance System

The time and effort in learning the rules of a new market, failure due to ignorance, and the liability of being a foreigner are all examples of

a) First mover advantages

b) Strategic commitments

c) Pioneering costs

d) Market entry costs

Entry Modes

Question: What is the best way to enter a foreign market?

- Firms can enter foreign market through
  1. Exporting
  2. Turnkey projects
  3. Licensing
  4. Franchising
  5. Joint ventures
  6. Wholly owned subsidiaries
- Each mode has advantages and disadvantages

Exporting

1. Exporting is often the first method firms use to enter foreign market

- Exporting is attractive because
  - it is relatively low cost
  - firms may achieve experience curve economies
- Exporting is not attractive when
  - lower-cost manufacturing locations exist
  - transport costs are high
  - tariff barriers are high
  - foreign agents fail to in the exporter's best interest

Turnkey Projects

2. Turnkey projects involve a contractor that 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" to a plant that is ready for full operation

Turnkey Projects

Turnkey projects are attractive because
- They allow firms to earn great economic returns from the know-how required to assemble and run a technologically complex process
- They are less risky in countries where the political and economic environment is such that a longer-term investment might expose the firm to unacceptable political and/or economic risk

- Turnkey projects are not attractive when
  - The firm's process technology is a source of competitive advantage

Licensing

3. Licensing 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 includes patents, inventions, formulas, processes, designs, copyrights, and trademarks
- Licensing is attractive when
  - The firm does not have to bear the development costs and risks associated with opening a foreign market
  - The firm avoids barriers to investment
  - It allows a firm with intangible property that might have business applications, but which doesn't want to develop those applications itself, to capitalize on market opportunities

Licensing

- Licensing is unattractive when
  - the firm doesn't have the tight control over manufacturing, marketing, and strategy necessary to realize experience curve and location economies
  - the firm's ability to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another is compromised
- There is the potential for loss of proprietary (or intangible) technology or property
  - To reduce this risk, firms can use cross-licensing agreements or link the agreement with the decision to form a joint venture

Franchising

4. Franchising is a form of licensing in which the franchisor sells intangible property to the franchisee, and requires the franchisee agree to abide by strict rules as to how it does business

- Franchising is attractive because
  - firms avoid many costs and risks of opening up a foreign market
- 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

Joint Ventures

5. Joint ventures involve the establishment of a firm that is jointly owned by two or more otherwise independent firms

- Joint ventures are attractive because
  - a firm can 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
  - they can help firms avoid the risk of nationalization or other adverse government interference

Joint Ventures

- Joint ventures can be unattractive because
  - the firm risks giving control of its technology to its partner
  - the firm may not have the tight control over subsidiaries that it might need to realize experience curve or location economies
  - shared ownership can lead to conflicts and battles for control if goals and objectives differ or change over time

Wholly Owned Subsidiaries

6. Wholly owned subsidiaries involve 100 percent ownership of the stock of the subsidiary

- Firms establishing a wholly owned subsidiary can
  - set up a new operation in that country
  - acquire an established firm

Wholly Owned Subsidiaries

- Wholly owned subsidiaries are attractive because
  - they reduce the risk of losing control over core competencies
  - they gives the firm the tight control over operations in different countries that is necessary for engaging in global strategic coordination
  - they may be required if a firm is trying to realize location and experience curve economies
- Wholly owned subsidiaries are unattractive because firms bear the full costs and risks of setting up overseas operations

Classroom Performance System

Most firms begin their foreign expansion with

a) Exporting

b) Joint ventures

c) Licensing or franchising

d) Wholly owned subsidiaries

Selecting an Entry Mode

Question: How should a firm choose a specific entry mode?

- All entry modes have advantages and disadvantages
- The optimal choice of entry mode involves trade-offs

Selecting an Entry Mode

Advantages and Disadvantages of Entry Modes

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 Inabilty to realize location and experience economies
Wholly owned subsidiaries	Protection of technology Ability to engage in global strategic coordination Abiltiy to realize location and experience economies	High costs and risks

Core Competencies and Entry Mode

- The optimal entry mode depends to some degree on the nature of a firm's core competencies
- Core competencies can involve

1. technological know-how
2. management know-how

Core Competencies and Entry Mode

1. Technological Know-How

- When competitive advantage is based on proprietary technological know-how, firms should avoid licensing and joint venture arrangements in order to minimize the risk of losing control over the technology
- However, if a technological advantage is only transitory, or the firm can establish its technology as the dominant design in the industry, then licensing may be attractive

Core Competencies and Entry Mode

2. Management Know-How

- The competitive advantage of many service firms is based upon management know-how
  - International trademark laws are generally effective for protecting trademarks
- Since the risk of losing control over management skills to franchisees or joint venture partners is not high, the benefits from getting greater use of brand names is significant

Pressures for Cost Reductions and Entry Mode

- Firms facing strong pressures for cost reductions are likely to pursue some combination of exporting and wholly owned subsidiaries
- This will allow the firms to achieve location and scale economies as well as retain some degree of control over worldwide product manufacturing and distribution

Classroom Performance System

A firm that wants the ability to engage in global strategic coordination should choose

a) Franchising

b) Joint ventures

c) Licensing

d) Wholly owned subsidiaries

Greenfield or Acquisition?

Question: Should a firm establish a wholly owned subsidiary in a country by building a subsidiary from the ground up (greenfield strategy), or by acquiring an established enterprise in the target market (acquisition strategy)?

- The number of cross border acquisitions are increasing
- Over the last decade, 50-80 percent of all FDI inflows have been mergers and acquisitions

Pros and Cons of Acquisitions

- Acquisitions
  - are quick to execute
  - enable firms to preempt their competitors
  - can be less risky than green-field ventures
- However, many acquisitions are not successful

Pros and Cons of Acquisitions

Question: Why do acquisitions fail?

- Acquisitions fail when
  - the firm overpays for the assets of the acquired firm
  - there is a clash between the cultures of the acquiring and acquired firm
  - attempts to realize synergies by integrating the operations of the acquired and acquiring entities run into roadblocks and take much longer than forecast
  - there is inadequate pre-acquisition screening

Pros and Cons of Acquisitions

Question: How can firms reduce the problems associated with acquisitions?

- Firms can reduce the problems associated with acquisitions
  - through careful screening of the firm to be acquired
  - by moving rapidly once the firm is acquired to implement an integration plan

Pros and Cons of Greenfield Ventures

- Question: Why are greenfield ventures attractive?

- Greenfield ventures are attractive because they allow the firm to build the kind of subsidiary company that it wants
- However, greenfield ventures
  - are slower to establish
  - are risky because they have no proven track record
  - can be problematic if a competitor enters via acquisition and quickly builds market share

Classroom Performance System

Which of the following is not an advantage of acquisitions as compared to greenfield investments?

a) They are quicker to execute

b) Attempts to realize synergies by integrating the operations of the acquired entities can be challenging and take time

c) They enable firms to preempt their competitors

d) They may be less risky

Critical Discussion Question

1. Review the Management Focus on Tesco. Then answer the following questions:

a) Why did Tesco's initial international expansion strategy focus on developing nations?

b) How does Tesco create value in its international operations?

c) In Asia, Tesco has a long history of entering into joint venture agreements with local partners. What are the benefits of doing this for Tesco? What are the risks? How are those risks mitigated?

d) In March 2006, Tesco announced that it would enter the United States. This represents a departure from its historic strategy of focusing on developing nations. Why do you think Tesco made this decision? How is the U.S. market different from others Tesco has entered? What are the risks here? How do you think Tesco will do?

Critical Discussion Question

2. Licensing propriety technology to foreign competitors is the best way to give up a firm's competitive advantage. Discuss.

Critical Discussion Question

3. Discuss how the need for control over foreign operations varies with firms' strategies and core competencies. What are the implications for the choice of entry mode?

Critical Discussion Question

4. A small Canadian firm that has developed some valuable new medical products using its unique biotechnology know-how is trying to decide how best to serve the European Community market. Its choices are given below. The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but it is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?

Manufacture the product at home and let foreign sales agents handle marketing.

Manufacture the products at home but set up a wholly owned subsidiary in Europe to handle marketing.

Enter into a strategic alliance with a large European pharmaceutical firm. The product would be manufactured in Europe by a 50/50 joint venture, and marketed by the European firm.