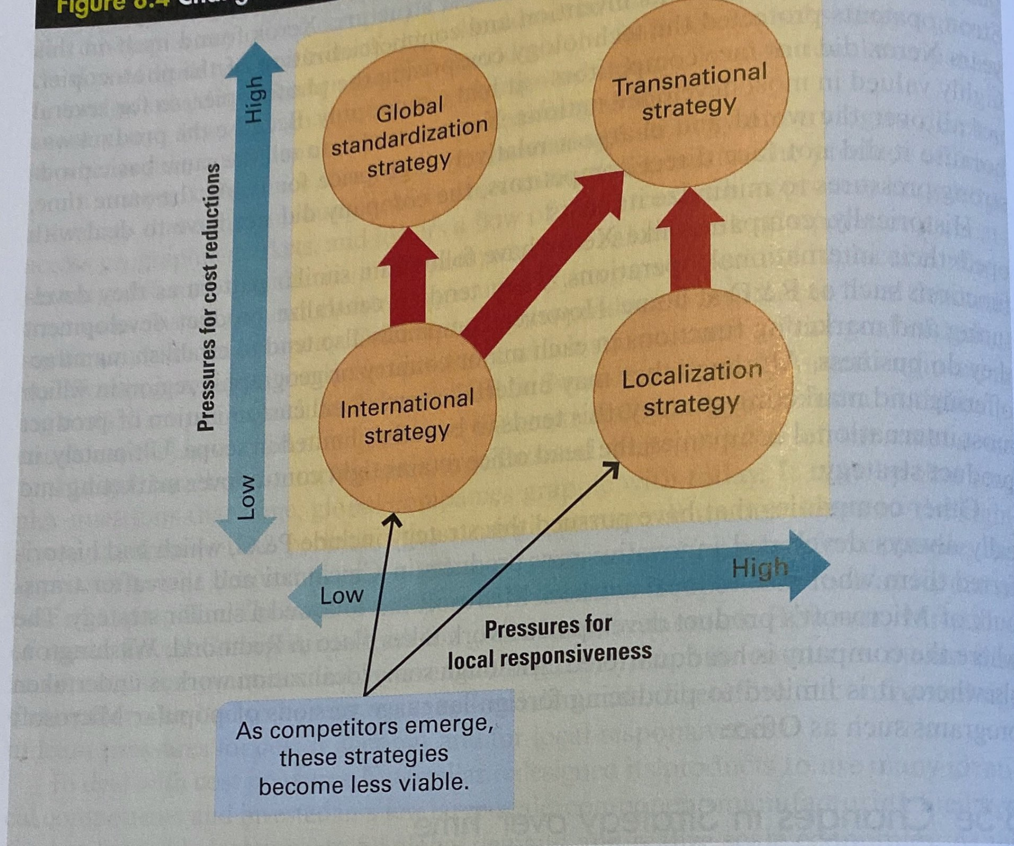
Figure 8.4 Changes over Time



8-6 THE CHOICE OF ENTRY MODE

Any firm contemplating entering a different national market must determine the best mode or vehicle for such entry. There are five primary choices of entry mode: exporting, licensing, franchising, entering into a joint venture with a host-country company, and setting up a wholly-owned subsidiary in the host country. Each mode has advantages and disadvantages, and managers must weigh these carefully when deciding which mode to use.[20]

8-6a Exporting

Most manufacturing companies begin their global expansion as exporters and only later switch to one of the other modes for serving a foreign market. Exporting has two distinct advantages: It avoids the costs of establishing manufacturing operations in the host country, which are often substantial, and it may be consistent with scale economies and location economies. By manufacturing the product in a centralized location and then exporting it to other national markets, a company may be able to realize substantial scale economies from its global sales volume. That is how Sony came to dominate the global television market, how many Japanese auto companies originally made inroads into the U.S. auto market, and how Samsung gained share in the market for computer memory chips.

There are a number of drawbacks to exporting. First, exporting from the company's home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad (that is, if the company can achieve location economies by moving production elsewhere). Thus, particularly in the case of a company pursuing a global standardization or transnational strategy, it may pay to manufacture in a location where conditions are most favorable from a value creation perspective and then export from that location to the rest of the globe. This is not so much an argument against exporting as it is an argument against exporting from the company's home country. For example, many U.S. electronics companies have moved some manufacturing to Asia because low-cost but highly skilled labor is available there. They export from Asia to the rest of the globe, including the United States (as Apple does with the iPhone).

Another drawback is that high transport costs can make exporting uneconomical, particularly in the case of bulk products. One way of alleviating this problem is to manufacture bulk products on a regional basis, thereby realizing some economies from large-scale production while limiting transport costs. Many multinational chemical companies manufacture their products on a regional basis, serving several countries in a region from one facility.

Tariff barriers, too, can make exporting uneconomical, and a government's threat to impose tariff barriers can make the strategy very risky. Indeed, the implicit threat from the U.S. Congress to impose tariffs on Japanese cars imported into the United States led directly to the decision by many Japanese auto companies to set up manufacturing plants in the United States.

Finally, a common practice among companies that are just beginning to export also poses risks. A company may delegate marketing activities in each country in which it does business to a local agent, but there is no guarantee that the agent will act in the company's best interest. Often, foreign agents also carry the products of competing companies and thus have divided loyalties. Consequently, agents may not perform as well as the company would if it managed marketing itself. One way to solve this problem is to set up a wholly-owned subsidiary in the host country to handle local marketing. In this way, the company can reap the cost advantages that arise from manufacturing the product in a single location and exercise tight control over marketing strategy in the host country.

8-6b Licensing

International licensing is an arrangement whereby a foreign licensee purchases the rights to produce a company's product in the licensee's country for a negotiated fee (normally, royalty payments on the number of units sold). The licensee then provides most of the capital necessary to open the overseas operation.[21] The advantage of licensing is that the company does not have to bear the development costs and risks associated with opening up a foreign market. Licensing therefore can be a very attractive option for companies that lack the capital to develop operations overseas. It can also be an attractive option for companies that are unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market where political risks are particularly high.

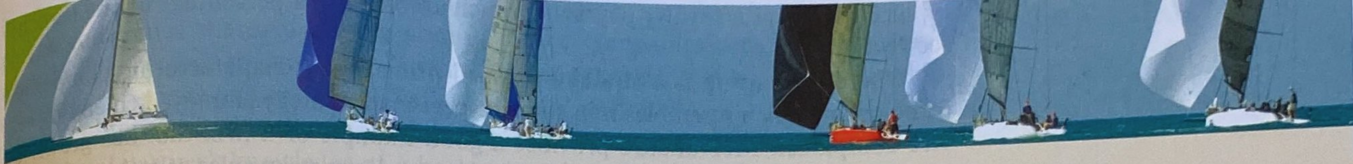
Licensing has some serious drawbacks, however. First, it does not give a company the tight control over manufacturing, marketing, and strategic functions in foreign countries that it needs to have in order to realize scale economies and location economies—as companies pursuing both global standardization and transnational strategies try to do. Typically, each licensee sets up its manufacturing operations. Hence, the company stands little chance of realizing scale economies and location economies by manufacturing its product in a centralized location. When these economies are likely to be important, licensing may not be the best way of expanding overseas.

Second, competing in a global marketplace may make it necessary for a company to coordinate strategic moves across countries so that the profits earned in one country can be used to support competitive attacks in another. Licensing, by its very nature, severely limits a company's ability to coordinate strategy in this way. A licensee is unlikely to let a multinational company take its profits (beyond those due in the form of royalty payments) and use them to support an entirely different licensee operating in another country.

Third, there is risk associated with licensing technological knowhow to foreign companies. For many multinational companies, technological knowhow forms the basis of their competitive advantage, and they want to maintain control over how this competitive advantage is put to use. By licensing its technology, a company can quickly lose control over it. RCA, for instance, once licensed its color television technology to a number of Japanese companies. The Japanese companies quickly assimilated RCA's technology and then used it to enter the U.S. market, where they soon gained a larger share of the U.S. market than the RCA brand holds.

There are ways of reducing this risk. One way is by entering into a cross-licensing agreement with a foreign firm. Under a cross-licensing agreement, a firm might license some valuable, intangible property to a foreign partner and, in addition to a royalty payment, also request that the foreign partner license some of its valuable knowhow to the firm. Such agreements are reckoned to reduce the risks associated with licensing technological knowhow, as the licensee realizes that if it violates the spirit of a licensing contract (by using the knowledge obtained to compete directly with the licensor), the licensor can do the same to it. Put differently, cross-licensing agreements enable firms to hold each other hostage, thereby reducing the probability that they will behave opportunistically toward each other.[22] Such cross-licensing agreements are increasingly common in high-technology industries. For example, the U.S. biotechnology firm Amgen licensed one of its key drugs, Neupogen, to Kirin, the Japanese pharmaceutical company. The license gives Kirin the right to sell Neupogen in Japan. In return, Amgen receives a royalty payment, and through a licensing agreement it gains the right to sell certain Kirin products in the United States.

Finally, a licensee can degrade or damage the brand of the company that it is licensing from if it pursues strategies that are not in the best interests of the licensee. For example, the luxury apparel company Burberry licensed Sanyo Shokai of Japan to sell its branded products in Japan. However, Sanyo Shokai ultimately started to damage Burberry's global brand by charging a much lower price for Burberry branded products in Japan that elsewhere in the world (see Strategy in Action 8.2 for details). Burberry responded to this problem by terminating its licensing arrangement with Sanyo Shokai and setting up its own wholly-owned stores in the country.



8.2 STRATEGY IN ACTION

Burberry Shifts its Strategy in Japan

Burberry, the iconic British luxury apparel company best known for its high-fashion outerwear, has been operating in Japan for nearly half a century. Until recently, its branded products were sold under a licensing agreement with Sanyo Shokai. The Japanese company had considerable discretion as to how it utilized the Burberry brand. It sold everything from golf bags to miniskirts and Burberry-clad Barbie dolls in its 400 stores around the country, typically at prices significantly below those Burberry charged for its high-end products in the United Kingdom.

For a long time, it looked like a good deal for Burberry. Sanyo Shokai did all of the market development in Japan, generating revenues of around $800 million a year and paying Burberry $80 million in annual royalty payments. However, by 2007, Burberry CEO Angela Ahrendts was becoming increasingly dissatisfied with the Japanese licensing deal and 22 others like it in countries around the world. In Ahrendts's view, the licensing deals were diluting Burberry's core brand image. Licensees such as Sanyo Shokai were selling a wide range of products at a much lower price point than Burberry charged for products in its own stores. "In luxury, "Ahrendts once remarked, "ubiquity will kill you—it means that you're not really luxury anymore." Moreover, with an increasing number of customers buying Burberry products online and on trips to Britain, where the brand was considered very upmarket, Ahrendts felt that it was crucial for Burberry to tightly control its global brand image.

Ahrendts was determined to rein in licensees and regain control of Burberry's sales in foreign markets, even if it mean taking a short-term hit to sales. She started off the process of terminating licensees before leaving Burberry to run Apple's retail division in 2014. Her hand-picked successor as CEO, Christopher Bailey, who rose through the design function at Burberry, has continued to pursue this strategy.

In Japan, the license was terminated in 2015. Sanyo Shokai was required to close nearly 400 licensed Burberry stores. Burberry is not giving up on Japan, however. After all, Japan is the world's second-largest market for luxury goods. Instead, the company will now sell products through a limited number of wholly-owned stores. The goal is to have 35 to 50 stores in the most exclusive locations in Japan by 2018. They will offer only high-end products such as Burberry's classic $1,800 trench coat. In general, the price point will be 10 times higher than was common for most Burberry products in Japan. The company realizes the move is risky and fully expects sales to initially fall before rising again as it rebuilds its brand, but CEO Bailey argues that the move is absolutely necessary if Burberry is to have a coherent global brand image for its luxury products.

Sources: Kathy Chu and Megumi Fujikawa, "Burberry Gets a Grip on Brand in Japan," *The Wall Street Journal*, August 15–16, 2015; Angela Ahrendts, "Burberry's CEO on Turning an Aging British Icon into a Global Luxury Brand," *Harvard Business Review*, January–February 2013; Tim Blanks, "The Designer Who Would be CEO," *The Wall Street Journal Magazine*, June 18, 2015.

8-6c Franchising

In many respects, franchising is similar to licensing, although franchising tends to involve longer-term commitments than licensing. Franchising is basically a specialized form of licensing in which the franchiser not only sells intangible property to the franchisee (normally a trademark), but also insists that the franchisee abide by strict rules governing how it does business. The franchiser will often assist the franchisee run the business on an ongoing basis. As with licensing, the franchiser typically receives a royalty payment, which amounts to a percentage of the franchisee revenues.

Whereas licensing is a strategy pursued primarily by manufacturing companies, franchising, which resembles it in some respects, is a strategy employed chiefly by service companies. McDonald's provides a good example of a firm that has grown by using a franchising strategy. McDonald's has set down strict rules as to how franchisees should operate a restaurant. These rules extend to controlling the menu, cooking methods, staffing policies, and restaurant design and location. McDonald's also organizes the supply chain for its franchisees and provides management training and financial assistance.[23]

The advantages of franchising are similar to those of licensing. Specifically, the franchiser does not need to bear the development costs and risks associated with opening up a foreign market on its own, for the franchisee typically assumes those costs and risks. Thus, using a franchising strategy, a service company can build up a global presence quickly and at a low cost.

The disadvantages of franchising are less pronounced than in licensing. Because service companies often use franchising, there is no reason to consider the need for coordination of manufacturing to achieve experience curve and location economies. But franchising may inhibit the firm's ability to take profits out of one country to support competitive attacks in another. A more significant disadvantage of franchising is quality control. The foundation of franchising arrangements is that the firm's brand name conveys a message to consumers about the quality of the firm's product. Thus, a business traveler checking in at a Four Seasons hotel in Hong Kong can reasonably expect the same quality of room, food, and service that would be received in New York, Hawaii, or Ontario, Canada. The Four Seasons name is assumed to guarantee consistent product quality. This presents a problem in that foreign franchisees may not be as concerned about quality as they are supposed to be, and the result of poor quality can cascade beyond lost sales in a particular foreign market to a decline in the firm's worldwide reputation. For example, if a business traveler has a bad experience at the Four Seasons in Hong Kong, he or she may never go to another Four Seasons hotel, and may urge colleagues to avoid the chain as well. The geographical distance of the firm from its foreign franchisees can make poor quality difficult to detect. In addition, the numbers of franchisees—in the case of McDonald's, tens of thousands—can make quality control difficult.

To reduce these problems, a company can set up a subsidiary in each country or region in which it is expanding. The subsidiary, which might be wholly-owned by the company or a joint venture with a foreign company, then assumes the rights and obligations to establish franchisees throughout that particular country or region. The combination of proximity and the limited number of independent franchisees that need to be monitored reduces the quality control problem. Because the subsidiary is at least partly owned by the company, it can place its own managers in the subsidiary to ensure the level of quality monitoring it demands. This organizational arrangement has proved very popular in practice; it has been used by McDonald's, KFC, and Hilton Worldwide to expand international operations, to name just three examples.

8-6d Joint Ventures

Establishing a joint venture with a foreign company has long been a favored mode for entering a new market. The most typical form of joint venture is a 50/50 joint venture, in which each party takes a 50% ownership stake and a team of managers from both parent companies shares operating control. Some companies seek joint ventures wherein they become the majority shareholder (for example, a 51 to 49% ownership split), which permits tighter control by the dominant partner.[24]

Joint ventures have several advantages. First, a company may feel that it can benefit from a local partner's knowledge of a host country's competitive conditions, culture, language, political systems, and business systems. Second, when the development costs and risks of opening up a foreign market are high, a company might gain by sharing these costs and risks with a local partner. Third, in some countries, political considerations make joint ventures the only feasible entry mode. For example, historically, many U.S. companies found it much easier to obtain permission to set up operations in Japan if they joined with a Japanese partner than if they tried to enter on their own.

Despite the advantages, there are major disadvantages with joint ventures. First, as with licensing, a firm that enters into a joint venture risks yielding control of its technology to its partner. Thus, a proposed joint venture in 2002 between Boeing and Mitsubishi Heavy Industries to build Boeing's new, wide-body jet (the 787) raised fears that Boeing might unwittingly give its commercial airline technology to the Japanese. However, joint-venture agreements can be constructed to minimize this risk. One option is to hold majority ownership in the venture. This allows the dominant partner to exercise great control over its technology—but it can be difficult to find a foreign partner who is willing to settle for minority ownership. Another option is to "wall off" from a partner technology that is central to the core competence of the firm while sharing other technology.

A second disadvantage is that a joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience-curve or location economies. Nor does it give a firm the control over a foreign subsidiary it might need for engaging in coordinated, global attacks against its rivals. Consider the entry of Texas Instruments (TI) into the Japanese semiconductor market. When TI established semiconductor facilities in Japan, it did so for the dual purpose of checking Japanese manufacturers' market share and limiting the cash they had available for invading TI's global market. In other words, TI was engaging in global strategic coordination. To implement this strategy, TI's subsidiary in Japan had to be prepared to take instructions from corporate headquarters regarding competitive strategy. The strategy also required the Japanese subsidiary to run at a loss if necessary. Few, if any, potential joint-venture partners would have been willing to accept such conditions, as it would have necessitated a willingness to accept a negative return on investment. Indeed, many joint ventures establish a degree of autonomy that would make such direct control over strategic decisions all but impossible to establish.[25] Thus, to implement this strategy, TI set up a wholly-owned subsidiary in Japan.

8-6e Wholly-Owned Subsidiaries

A wholly-owned subsidiary is one in which the parent company owns 100% of the subsidiary's stock. To establish a wholly-owned subsidiary in a foreign market, a company can either set up a completely new operation in that country or acquire an established host-country company to promote its products in the host market.

Setting up a wholly-owned subsidiary offers three advantages. First, when a company's competitive advantage is based on its control of a technological competency, a wholly-owned subsidiary will normally be the preferred entry mode because it reduces the company's risk of losing this control. Consequently, many high-tech companies prefer wholly owned subsidiaries to joint ventures or licensing arrangements. Wholly-owned subsidiaries tend to be the favored entry mode in the semiconductor, computer, electronics, and pharmaceutical industries.

Second, a wholly-owned subsidiary gives a company the kind of tight control over operations in different countries that it needs if it is going to engage in global strategic coordination—taking profits from one country to support competitive attacks in another.

Third, a wholly-owned subsidiary may be the best choice if a company wants to realize location economies and the scale economies that flow from producing a standardized output from a single or limited number of manufacturing plants. When pressures on costs are intense, it may pay a company to configure its value chain in such a way that value added at each stage is maximized. Thus, a national subsidiary may specialize in manufacturing only part of the product line, or certain components of the end product, exchanging parts and products with other subsidiaries in the company's global system. Establishing such a global production system requires a high degree of control over the operations of national affiliates. Different national operations must be prepared to accept centrally determined decisions as to how they should produce, how much they should produce, and how their output should be priced for transfer between operations. A wholly owned subsidiary would have to comply with these mandates, whereas licensees or joint-venture partners would most likely shun such a subservient role.

On the other hand, establishing a wholly-owned subsidiary is generally the costliest method of serving a foreign market. The parent company must bear all the costs and risks of setting up overseas operations—in contrast to joint ventures, where the costs and risks are shared, or licensing, where the licensee bears most of the costs and risks. But the risks of learning to do business in a new culture diminish if a company acquires an established host-country enterprise. Acquisitions, however, raise a whole set of additional problems, such as trying to marry divergent corporate cultures, and these may more than offset the benefits. (The problems associated with acquisitions are discussed in Chapter 10.)

8-6f Choosing an Entry Strategy

The advantages and disadvantages of the various entry modes are summarized in Table 8.1. Inevitably, there are tradeoffs in choosing one entry mode over another. For example, when considering entry into an unfamiliar country with a track record of nationalizing foreign-owned enterprises, a company might favor a joint venture with a local enterprise. Its rationale might be that the local partner will help it establish operations in an unfamiliar environment and speak out against nationalization should the possibility arise. But if the company's distinctive competency is based on proprietary technology, entering into a joint venture might mean risking loss of control over that technology to the joint venture partner, which would make this strategy unattractive. Despite such hazards, some generalizations can be offered about the optimal choice of entry mode.

Distinctive Competencies and Entry Mode When companies expand internationally to earn greater returns from their differentiated product offerings, entering markets where indigenous competitors lack comparable products, the companies are pursuing

Table 8.1 The Advantages and Disadvantages of Different Entry Modes

Entry Mode	Advantages	Disadvantages
Exporting	• Ability to realize location- and scale-based economies	• High transport costs • Trade barriers • Problems with local marketing agents
Licensing	• Low development costs and risks	• Inability to realize location- and scale-based economies • Inability to engage in global strategic coordination • Lack of control over technology
Franchising	• Low development costs and risks	• Inability to engage in global strategic coordination • Lack of control over quality
Joint ventures	• Access to local partner's knowledge • Shared development costs and risks • Political dependency	• Inability to engage in global strategic coordination • Inability to realize location- and scale-based economies • Lack of control over technology
Wholly-owned subsidiaries	• Protection of technology • Ability to engage in global strategic coordination • Ability to realize location- and scale-based economies	• High costs and risks

an international strategy. The optimal entry mode for such companies depends to some degree upon the nature of their distinctive competency. In particular, we need to distinguish between companies with a distinctive competency in technological know-how and those with a distinctive competency in management knowhow.

If a company's competitive advantage—its distinctive competency—derives from its control of proprietary technological knowhow (i.e., intellectual property), licensing and joint-venture arrangements should be avoided if possible to minimize the risk of losing control of that technology. Thus, if a high-tech company is considering setting up operations in a foreign country in order to profit from a distinctive competency in technological knowhow, it should probably do so through a wholly-owned subsidiary.

However, this should not be viewed as a hard-and-fast rule. For instance, a licensing or joint-venture arrangement might be structured in such a way as to reduce the risks that licensees or joint-venture partners will expropriate a company's technological knowhow. (We consider this kind of arrangement in more detail later in the chapter when we discuss the issue of structuring strategic alliances.) Or consider a situation where a company believes its technological advantage will be short lived and expects rapid imitation of its core technology by competitors. In this situation, the company might want to license its technology as quickly as possible to foreign companies in order to gain global acceptance of its technology before imitation occurs.[26] Such a strategy has some advantages. By licensing its technology to competitors, the company may deter them from developing their own, possibly superior, technology. It also may be able to establish its technology as the dominant design in the industry, ensuring a steady stream of royalty payments. Such situations aside, however, the attractions of licensing are probably outweighed by the risks of losing control of technology, and therefore licensing should be avoided.

The competitive advantage of many service companies such as McDonald's or Hilton Worldwide is based on management knowhow (i.e., process knowledge). For such companies, the risk of losing control of their management skills to franchisees or joint-venture partners is not that great. The reason is that the valuable asset of such companies is their brand name, and brand names are generally well protected by intellectual property laws pertaining to trademarks. Given this fact, many issues that arise in the case of technological knowhow do not arise in the case of management knowhow. As a result, many service companies favor a combination of franchising and subsidiaries to control franchisees within a particular country or region. The subsidiary may be wholly-owned or a joint venture. In most cases, however, service companies have found that entering into a joint venture with a local partner in order to set up a controlling subsidiary in a country or region works best because a joint venture is often politically more acceptable and brings a degree of local knowledge to the subsidiary.

Pressures for Cost Reduction and Entry Mode The greater the pressures for cost reductions, the more likely that a company will want to pursue some combination of exporting and wholly-owned subsidiaries. By manufacturing in the locations where factor conditions are optimal and then exporting to the rest of the world, a company may be able to realize substantial location economies and substantial scale economies. The company might then want to export the finished product to marketing subsidiaries based in various countries. Typically, these subsidiaries would be wholly-owned and have the responsibility for overseeing distribution in a particular country. Setting up wholly-owned marketing subsidiaries is preferable to a joint-venture arrangement or using a foreign marketing agent because it gives the company the tight control over marketing that might be required to coordinate a globally dispersed value chain. In addition, tight control over a local operation enables the company to use the profits generated in one market to improve its competitive position in another market. Hence companies pursuing global or transnational strategies prefer to establish wholly-owned subsidiaries.

8-7 GLOBAL STRATEGIC ALLIANCES

global strategic alliances
Cooperative agreements between companies from different countries that are actual or potential competitors.

Global strategic alliances are cooperative agreements between companies from different countries that are actual or potential competitors. Strategic alliances range from formal joint ventures in which two or more companies have an equity stake, to short-term contractual agreements in which two companies may agree to cooperate on a particular problem (such as developing a new product).