Chapter 2

Internationalisation process
Reasons firms internationalise

The firm

- Diversification
- Economies of scale
- Government incentives
- Market growth
- Joint venture opportunities
- Saturated domestic market

An international market
Internationalisation methods (1)

- Export based
  - Direct exporting
  - Indirect exporting
- Non-equity based
  - Licensing
  - Franchising
- Equity based
  - Joint ventures
  - Foreign direct investment (fdi)
  - Consortia, Keiretsus and Chaebols.
Internationalisation methods (2)

- Indirect exporting (through intermediaries)
- Direct exporting
- Licensing and franchising
- Joint ventures
- Direct investment and foreign manufacture

Minimum risk, minimum reward → Maximum risk, maximum reward
Export-based internationalisation (1)

• *Indirect exporting*: firm operates through intermediaries
  – Export house
  – Confirming house
  – Buying house
  – ‘piggybacking’; benefits to ‘rider’ and ‘carrier’
• *Advantages*: less cost, quicker
• *Disadvantages*: information/experience is ‘second hand’.
Export-based internationalisation (2)

• **Direct exporting**: firm engages directly with overseas markets.

• **Advantages**:
  – Allows the exporter to closely monitor developments and competition in the host market
  – Promotes interaction between producer and end-user
  – Involves long-term commitments, such as providing after-sales services to encourage repeat purchases.

• **Disadvantages**: higher resource cost (more expensive), takes time to establish etc.
Export Processing Zones (EPZs)

- Provide incentives for direct exporting activities: e.g. Lower or zero taxes on profits and/or imported components, government subsidies, better infrastructures, less restrictive regulations, etc.
- Widely used by countries to encourage inward fdi specifically targeted towards increasing direct exports.
Non-equity based internationalisation

- Licensing
- Patents
- Franchising
- Management contracting, etc.
Licensing

- Permission granted by the proprietary owner to a foreign concern (the licensee) in the form of a contract that would otherwise be legally forbidden (e.g. Under patent protection).
- **Licensors** benefit by access to overseas markets (via licensees) with little or no investment or ‘local knowledge’.
- **Licensees** benefit by access to technologies or products (brands) otherwise unavailable.
Franchising

- *Franchisee* purchases the right to undertake business activity using the *franchiser’s* name or trademark rather than any patented technology.

- *First-generation franchising*: franchiser grants considerable autonomy to franchisee.

- *Second-generation franchising*: franchiser grants little or no autonomy to franchisee.
Franchiser: advantages/disadvantages

- **Advantages for the franchiser:** overseas expansion can be much less expensive and any local adaptations can (with agreement) be made by those well acquainted with cultural issues in that country.

- **Disadvantages for the franchiser:** possible conflict with the franchisee for not following regulations and agreements as well as a threat that the franchisee may opt to ‘go it alone’ in the future and thus become a direct competitor.
Franchisee: advantages/disadvantages

• **Advantages for the franchisee**
  – Buy into an existing brand and receive support from the franchiser in terms of marketing, training and starting up.
  – When customers walk into a McDonald’s restaurant, they know exactly what to expect.

• **Disadvantages for the franchisee**
  – Restrictions on what they can and can’t do. E.g. McDonald’s have very strict regulations concerning marketing, pricing, training etc.
  – A franchisee cannot simply change the staff uniform, alter prices or vary opening hours as the company operates a standardised approach to doing business.
Other contractual modes of internationalisation

- Management contracting
- Technical service agreements
- Contract-based partnerships.
Equity-based methods of internationalisation

- Joint ventures
- Alliances
- Consortia: e.g. Keiretsu (Japan), Chaebols (Korea).
Joint ventures

• Create a new identity in which both the initiating partners take active roles in formulating strategy and making decisions.

• Advantages
  – Share and lower the costs of high-risk, technology-intensive development projects
  – Gain economies of scale and scope in value-adding activities that can only be justified on a global basis
  – Secure access to a partner’s technology, its accumulated learning, proprietary processes or protected market position
  – Create a basis for more effective future competition in the sector.
Specialised joint ventures

- Each partner brings a specific and different competency – e.g. one produces, the other markets/distributes.
- Advantages: share risks, learn about each partner’s knowledge/skills and marketing/distribution methods, etc.
- Disadvantages: partner learns from you and may now compete in your core competency; high co-ordination costs; etc.
Shared value-added joint ventures

• Both partners contribute to the same function, i.e. bring a similar competency.

• Advantages: benefit from increased economies of scale (size), economies of scope (product mix), economies of experience.

• Disadvantages: partner finds it easier to learn and copy when familiar with same functional area; higher exit costs size increases in production/administration have already taken place.
Critical success factors for joint ventures

• Take time to assess the partners.
• Understand that collaboration is a distinct form of competition.
• Learn from partners while limiting unintended information flows.
• Establish specific rules and requirements for joint venture performance at the outset.
Alliances (1)

• Collaborative relationship which is much less structured than a joint venture or acquisition.
• Four ‘I’s’ determine whether to have an alliance rather than a joint venture or acquisition
  – Infeasibility
  – Information asymmetry
  – Investment in options
  – Indigestibility.
Figure 2.1  The four ‘Is’ of collaboration

Source: Based on Reuer (1999)
Infeasibility and information asymmetry

• Alliance preferred when:
  – ‘infeasibility’ exists for acquisitions/JVs, e.g. legal restrictions prevent them, but not alliances.
  – ‘information asymmetry’ exists for acquisitions/JVs, e.g. difficult to carry out the due diligence needed for them, but not alliances.
Investment in options and indigestibility

- Alliances preferred when:
  - ‘Investment in call options’ is likely to be attractive given the high degree of uncertainty that exists for an acquisition or JV.
  - ‘Indigestibility’ is strongly associated with the proposed acquisition or JV being assimilated within the existing organisational structures.
Consortia (1)

• These involve the bringing together of different companies to pool resources into an integrative organisational design.

• Some overlap with ‘alliances’ but consortia usually occur across many firms and sectors.
Consortia (2)

- **Keiretsu**: Japanese consortia where 20/25 different companies integrate through interlocking directorates, common bank holdings, close personal ties, etc.

- **Chaebols**: South Korean consortia and have similarities with Japanese keiretsu.
Foreign direct investment (fdi)

• International investment in ‘real’ items, e.g. land, buildings, equipment, organisation

• Can take various forms:
  – ‘Greenfield investment’, whereby an entirely new foreign operation is established
  – Merger with, or acquisition of an existing organisation

• Advantages/disadvantages of mergers acquisitions – explored further in Ch. 7.
Why invest abroad?

• Supply factors
  – Production costs
  – Distribution costs
  – Availability of natural resources
  – Access to key technology
  – Incentive schemes to reduce costs.
## Production costs
Differences in relative unit labour cost

<table>
<thead>
<tr>
<th>Country</th>
<th>Total labour costs ($ per hour)</th>
<th>Total labour costs ($ per hour Index: UK = 100)</th>
<th>Labour productivity (Index UK = 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>2.6</td>
<td>21.8</td>
<td>35.2</td>
</tr>
<tr>
<td>Korea</td>
<td>13.6</td>
<td>20.9</td>
<td>48.4</td>
</tr>
<tr>
<td>France</td>
<td>24.6</td>
<td>95.7</td>
<td>118.1</td>
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<tr>
<td>UK</td>
<td>25.7</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Japan</td>
<td>21.8</td>
<td>84.8</td>
<td>82.4</td>
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<tr>
<td>US</td>
<td>23.7</td>
<td>92.2</td>
<td>116.2</td>
</tr>
<tr>
<td>Germany</td>
<td>33.0</td>
<td>128.4</td>
<td>109.7</td>
</tr>
</tbody>
</table>
# Production costs
## Differences in tax rates

<table>
<thead>
<tr>
<th>Economy</th>
<th>Individual tax rate (%)</th>
<th>Corporate tax rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong (China)</td>
<td>16</td>
<td>17.5</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Latvia</td>
<td>25</td>
<td>15</td>
</tr>
<tr>
<td>Romania</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>13</td>
<td>24</td>
</tr>
<tr>
<td>Slovakia</td>
<td>19</td>
<td>19</td>
</tr>
</tbody>
</table>
Other supply factors and fdi

- **Distribution costs**: e.g. greater the bulk/weight of product, more important it is to invest in producing/assembling close to the final market to reduce transport costs.

- **Availability of natural resources**: e.g. oil, natural gas, mineral deposits, etc. stimulate foreign investment.

- **Access to key technology**: e.g. investing in overseas expertise, as in Science Parks, etc.
Why invest abroad?

• Demand factors
  – Market-oriented multinationals
  – Saturation of home market
  – Demand from business customers now abroad
  – Avoidance of trade barriers
  – Demand from overseas governments for inward fdi (incentive schemes)
  – Strategic issues: e.g. matching rivals; seeking more ‘local’ responsiveness.
Market-oriented multinationals

Figure 2.2 Evolution of a market-orientated multinational

Source: Adapted from Healey (2007)
Other demand factors

- *Saturation of home market*: e.g. Beer drinking is much smaller percentage of Chinese/Indian than EU markets.

- *Demand from business customers now abroad*: e.g. Japanese component suppliers moving to EU to support Japanese car companies moving to EU.
‘Political’ reasons for fdi

- **Avoidance of trade barriers**: e.g. Producing inside EU avoids the Common External Tariff on imported industrial products.
- **Economic development incentives**: e.g. Government provision of low or zero taxes, subsidised infrastructure, lighter regulation, etc.
Other demand-related reasons for FDI

- Motivation of the organisation
  - Market seeking
  - Efficiency seeking
  - Resource seeking
- ‘Bandwagon’ effect: following rivals FDI
- International product life cycle: see below!
Theories of internationalisation

- Ownership – specific advantages
- Location – specific advantages
- Internalisation
- Eclectic theory
- Sequential theory
- Simultaneous theory
- Network theory
- International product life cycle (IPLC).
Ownership-specific advantages

• Here the focus is on the assets owned by the firm which might give it a competitive edge vis-à-vis other firms operating in overseas markets.

• Such ownership-specific advantages might include superior technology, a well-known brand name, economies of scale or scope, managerial or organisational skills, etc.
Location-specific advantages

These theories have mainly sought to answer the ‘where’ question involving MNE activity outside the home country as well as the ‘why’.

The availability and price of natural and human resources in overseas territories, of transport and communications infrastructure, market-size characteristics and other locational attributes are the focus of attempts by these theories to explain the internationalisation process.
Internalisation

• Here the focus is on the costs of entering into a transaction, e.g. the costs of negotiating, monitoring and enforcing a contract.

• The firm decides whether it is cheaper to own and operate a plant or establishment overseas or to contract with a foreign firm to operate on its behalf through a franchise, licensing or supply agreement.

• Foreign direct investment is more likely to occur (i.e. the process to be internalised) when the costs of negotiating, monitoring and enforcing a contract with a second firm are high.
Eclectic theory

• John Dunning (1993) concluded that companies will only become involved in overseas investment and production (fdi) when the following conditions are all satisfied:
  – Companies possess an ‘ownership-specific’ advantage over firms in the host country
  – It must be more profitable for the multinational to exploit its ownership-specific advantages in an overseas market than in its domestic market. In other words, there must additionally exist ‘location-specific’ factors which favour overseas production
  – These advantages are best exploited by the firm itself, rather than by selling them to foreign firms.
Sequential theory (1)

- Sometimes called the ‘Uppsala model’ as Johanson and Widersheim-Paul examined the internationalisation of Swedish firms.
- They found a regular process of gradual change involving the firm moving *sequentially* through four discrete stages:
  - Intermittent exports
  - Exports via agents
  - Overseas sales via knowledge agreements with local firms, for example by licensing or franchising
  - Foreign direct investment in the overseas market.
Sequential theory (2)

• This particular sequence is sometimes called the *establishment chain*, the argument being that each of these stages marks a progressive increase in the resource commitment by the firm to the overseas markets involved.

• There is also a suggestion that as firms move through these sequential stages, the knowledge and information base expands and the ‘psychic distance’ between themselves and the overseas markets involved contracts, making progression to the next stage that much easier.
Simultaneous theory

- Suggests that customers’ tastes around the world are becoming progressively homogeneous, e.g. the success of such global products as Coca-Cola or Sony Walkman.
- The economies of scale and scope available for standardised products in such global markets are so substantial that a gradual, sequential approach to internationalisation is no longer practicable.
- Proponents point to studies which suggest that the global awareness of brands has fallen dramatically over time, with less than two years now needed for making consumers worldwide aware of high profile brand images.
- Critics, however, suggest that sophisticated customers demand greater customisation.
Network theory (1)

- Internationalisation builds on existing relationships or creates new relationships, with the focus shifting from the organisational or economic to the social.
- It is *people* who make the decisions and take the actions.
Network theory (2)

• Networks can be considered at three levels.
  – *Macro* – external environment is seen as a set of diverse interests, powers and characteristics. To enter new markets a firm may have to break old relationships or add new ones.
  – *Inter-organisational* – firms may well be competitors in one market, collaborators in another.
  – *Intra-organisational* – relationships within the organisation may well influence the decision-making process; e.g. decisions may be taken in overseas subsidiaries that influence the international involvement of the parent MNE.
## Barriers to internationalisation

<table>
<thead>
<tr>
<th>Rank</th>
<th>Classification of barrier</th>
<th>Description of barrier</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Capabilities</td>
<td>Inadequate quantity of and/or untrained personnel for internationalisation</td>
</tr>
<tr>
<td>2</td>
<td>Finance</td>
<td>Shortage of working capital to finance exports</td>
</tr>
<tr>
<td>3</td>
<td>Access</td>
<td>Limited information to locate/analyse markets</td>
</tr>
<tr>
<td>4</td>
<td>Access</td>
<td>Identifying foreign business opportunities</td>
</tr>
<tr>
<td>5</td>
<td>Capabilities</td>
<td>Lack of managerial time to deal with internationalisation</td>
</tr>
<tr>
<td>6</td>
<td>Capabilities</td>
<td>Inability to contact potential overseas customers</td>
</tr>
<tr>
<td>7</td>
<td>Capabilities</td>
<td>Developing new products for foreign markets</td>
</tr>
<tr>
<td>8</td>
<td>Business environment</td>
<td>Unfamiliar foreign business practices</td>
</tr>
<tr>
<td>9</td>
<td>Capabilities</td>
<td>Meeting export product quality/standards/specification</td>
</tr>
<tr>
<td>10</td>
<td>Access</td>
<td>Unfamiliar exporting procedures/paperwork</td>
</tr>
</tbody>
</table>