**Chapter Three**

**3.1 International Market Entry Modes**

When a firm is considering **entering a foreign market**, the question arises as to the best means of achieving it. There are basically **eight** ways to enter a foreign market: **exporting, turnkey projects, licensing, franchising, management contracts, joint venturing with a host-country firm, and setting up a wholly owned subsidiary in the host country**. Each entry mode has advantages and disadvantages. Managers need to consider these carefully when deciding which entry mode to use.

**Figure 3.1 Market Entry Strategies**

**Exporting**

* Direct exporting
* Indirect exporting

**Foreign Production**

* Turnkey projects
* Licensing
* Franchising
* Management contract
* Wholly owned subsidies

Entry analysis

* Profitability
* Assets
* Costs
* Sales
* Risk factors

**Ownership**

**Strategies**

* Alliances
* Joint venture

**Exist Strategy**

**Entry Strategy Decision**

1. **Exporting**

Most manufacturing firms begin their global **expansion as exporters and only later switch to another mode for serving a foreign market.** Here we focus on the advantages and disadvantages of exporting as an entry mode.

**Advantages:**

* Since most countries do not offer a large enough opportunity to justify local production, exporting allows a company to centrally manufacture its products and, therefore obtain economies of scale.
* Since exports represent incremental volume of an existing production operation located elsewhere, the marginal profitability of such exports tends to be high.
* It avoids the costs of establishing manufacturing operations in the host country, which are often substantial.
* Exporting also may help a firm achieve and exporting it to other national markets, the firm may be able to realize substantial scale of economiesfrom its global sales volume.

**Disadvantages:**

* Exporting from the firm’s home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad.
* High transport costs can make exporting uneconomical, particularly for bulk products.
* Tariff barriers can make it uneconomical. Similarly the threat of tariff barriers by the host-country government can make it very risky.
* When a firm delegates its marketing in each country where it does business to a local agent, the foreign agent may not do as good a job as the firm would if it managed its marketing itself. This problem is common for firms that are just beginning to export.
1. **Turnkey projects**

Firms that specialize in the **design, construction, and start-up** of turnkey plants are common in some industries. In a turnkey project, the contractor agrees to **handle every detail of the project for a foreign client including the training of operation personnel.** At completion of the contract, the **foreign client handled the “key” to a plan that is ready for full operation –hence** the term turnkey. This is actually a means of exporting process technology to other countries. Turnkey projects are most common in the chemical, pharmaceutical, petroleum refining, and metal refining industries, all of which use complex, expensive production-process technologies.

**Advantages:**

* They are a way of earning great economic returns from the asset. (The know-how required to assemble and run a technologically complex process, such as refining petroleum or steel, is a valuable asset.)
* It is particularly useful in cases where foreign direct investment (FDI) is limited by host-government regulations.
* It is useful to invest in a country were the political and economic environment is unstable such that a longer-term investment might expose the firm to unacceptable political and/or economic risks(e.g., the risk of nationalization or of economic collapse)

**Disadvantage**

* The firm that enters into a turnkey deal will have no long-term interest in the foreign country. This can be a disadvantage if that country subsequently proves to be a major market for the output of the process that has been exported.
* The firm that enters into a turnkey projects with a foreign enterprise may inadvertently create a competitor.
* If the firm’s 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 competition.
1. **Licensing**

Under licensing, a company assigns the **right to a patent** (which protects a product, technology, or process), or a **trade mark** (which protects product name) to another company for a fee or royalty. Using licensing as a method of market entry, a company can gain market presence **without an equity investment**. The foreign company or licensee, gains the right to commercially **exploit** the patent or trade mark either on exclusive or unrestricted basis.

A licensing agreement is an arrangement whereby a licensor grants the rights to intangible property to another entity(the licensee) for a specified period of time, and in return, the licensor receives a royalty fee from the licensee. Intangible property includes **patents, inventions, formulas, processes, designs, copyrights and trademarks.**

**Advantages:**

* The firm does not have to bear the development costs and risks associated with opening a foreign market. To reduce the need for a large amount of investment for fixed assets.
* Licensing is a very attractive option for firms lacking the capital to develop operations overseas.
* Licensing can be attractive when a firm is unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market.
* Licensing is also often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment.
* To operate oversea where, a company may not have the knowledge or the time to engage more actively in international marketing.

**Disadvantages**

* It limits the firm’s ability to realize experience curve and location economies by manufacturing its products in a centralize location.
* Competing in a global market may require a firm to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another. But licensing severely limits a firm’s ability to do this. A licensee is unlikely to allow a multinational firm to use its profits(beyond those due in the form of royalty payments) to support a different licensee operating in another country.
* A firm can quickly lose control over its technology (technological know-how) by licensing it.
* Insuring a uniform quality requires additional resources from the licenser that may reduce the profitability of the licensing activity.
1. **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 **franchisor** not only **sells intangible property to the franchisee** (normally a trademark), but also insists the **franchisee agree to abide by strict rules as to how it does business.**  The franchisor will also often assist the **franchisee** to run this business on an ongoing basis. As with licensing the franchisor typically receives a royalty payment that amounts to some percentage of the franchisee’s revenues. Whereas licensing is pursued primarily by manufacturing firms, franchising is employed primarily by service firms.

McDonald’s provides us with 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 extended to control over the menu, cooking methods, staffing policies, and the design and location of a restaurant. McDonald’s also organizes the supply chain for its franchisees and provided management training and financial assistance for franchisees.

**Advantages:**

* By using franchising strategy, a service firm can build a **global presence quickly and at a relatively low cost and risk.**
* The firm is **relieved of many of the costs and risks** of operating in a foreign market by itself. Instead, the franchisee typically assumes those costs and risks. This creates a good incentive for the franchisee to build up a profitable operation as quickly as possible.

**Disadvantage:**

* Franchising **inhibit the firm’s ability to take profits out of one country** to support competitive attacks in another.
* **Quality control** in franchising is mandatory. A more significant disadvantage of franchising comes from difficulty to quality control because of;
* geographical distance of the firm from its foreign franchisees and
* the sheer number of franchisees.

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. So consumers need to experience the same product quality wherever they are. So the result of poor quality in one foreign market can extend beyond lost sales in particular foreign market to a decline in the firm’s worldwide reputation.

1. **Management contracts**

An arrangement whereby a company operates a foreign firm for a client who retains the ownership is known as management contract. There are a number of variations but a broad distinction between foreign management and local ownership is a characteristic feature, and the management typically extends to all functions.

In the management contract the principal (the contractor) operates a complete management system. This method of conducting business has only gradually emerged. It can be said to carry the divorce between ownership and management that has been a feature of the business scene for many years, one stage further.

**Contractor**

**Contract**

**Client**

**Management**

**Ownership**

**Contract venture**

Fig 3.2illustrates the principle of the three-concerned relationship between contractor, client and contract venture.

*Fig 3.2 Relationships in Management contracts*

In a basic management contract the local(host country) company holds all the equity, but in practice the contractor often takes a small amount. The holding of equity makes it easier to negotiate the other terms; the contractor company does not feel so encouraged to provide for an increasing royalty in the event of success as it knows that it will share anyway. On the other hand, the holding of equity may bias the advice the contractor gives, especially when it’s not managing all the functions.

**Advantage:**

The reasons for developing management contracts as policies are similar to those; or licenses and franchises with a number of additions which include the following,

* Dissatisfaction with an existing licensing agreement where the licensee or franchisor does not show sufficient marketing, financial or other expertise to develop the business.
* The expropriation or nationalization of a subsidiary where the parent company’s commercial expertise is still required.
* The development of a consultancy or technical aid contract into a total management contract.
* When fees for management services may be easier to transfer, and subject to less tax than royalties or dividends.
* The case of under-employed-skills and resources are common factors in deciding to opt for management contracts.
* The contracts provide a useful contribution to a global strategy. They are particularly appropriate to the more difficult markets in the less developed countries.
* Management contracts can provide support to other business arrangements, tike technical agreements and joint ventures, and general support for existing markets where domestication or expropriation are likely. Minority equity holdings are also safeguarded in this way.
* For countries, this method brings the foreign expertise without the drawbacks of foreign ownership.

**Disadvantages:**

The disadvantages are similar to those for licenses and franchises.

* From the principal’s point of view, direct export or investment might have been more lucrative.
* From the point of view of some countries, contracts are still regarded as the intervention of a foreign authority- and the issue of foreign management remains delicate, however badly it may be needed.

**6. Joint Ventures**

A joint venture entails establishing a firm that is jointly owned by two or more otherwise independent firms. Establishing a joint venture with a foreign firm has long been a popular mode for entering a new market. The most typical joint venture is a 50/50 arrangement in which there are two parties, each of which holds a 50 percent ownership stake and contributes a team of managers to share operating control. Some firms however, have sought joint ventures in which they have a majority share and thus tighter control.

**Advantages:**

* A firm is able to benefit from a local partner’s knowledge of the host country’s competitive conditions, culture, language, political systems, and business systems.
* When the development costs and/or risks of opening a foreign market are high, a firm might gain by sharing these costs and/or risks with a local partner.
* Local partners’ minimize the influence of political/legal factors of the host country.
* Joint ventures are sometimes necessary to enter countries where the economy is largely under
* state control. In such countries, foreign investors are only allowed to take minority positions in conjunction with local firms.

**Disadvantages:**

* A firm that enters into a joint venture risks giving control of its technology to its partner.
* A joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience curve or location economies.
* It does not give a firm the tight control over a foreign subsidiary that it might need for engaging coordinated global attacks against its rivals.
* Shared ownership arrangement can lead to, conflicts and battles for control between the investing firms if their goals and objectives change over time, or if they take different views as to what the strategy of the venture should be.

**7. Strategic Alliances**

It is a business relationship established by two or more companies to cooperate out of mutual need and to share risk in achieving a common objective. It is a situation when each partner brings a particular skill or resource (usually they are complementary) and by joining forces, each expects to profit from the other’s experience. In alliance, two entire firms pool their resources directly in a collaboration that goes beyond the limits of a joint venture. Although a new entity may be formed, it is not a requirement. Typically, alliances involve distribution access, technology transfers, or production technology, with each partner contributing a different element to the venture.

The alliance can be

* technology-based alliance
* product-based alliance
* Distribution-based alliance.

Strategic alliance implies that

* there is a common objective
* alone partner’s weakness is offset by the other’s strength;
* reaching the objective alone would be too costly, take too much time, or be too risky; and
* together their respective strength make possible what otherwise would be unattainable.

***Reasons for going into strategic alliances include***

* To gain access to new technologies and acquire the skills necessary to achieve their objectives more efficiently, at a lower cost, or with less risk than if they acted along.
* To enter ”blocked” markets
* To reduce required investment
* To gain access to a brand name or customer group
* To achieve more global coverage, etc.

***Problems/ Disadvantage***

* Partners may disagree on further investment
* Different expectations of return
* Inability to change with changing market conditions
* Cultural communications barriers
* Difficulties in integrating the two companies’ accounting and information systems

**8. Wholly Owned Subsidiaries**

In a wholly owned subsidiary, the firm owns 100 percent of the subsidiary. Establishing a wholly owned subsidiary in a foreign market can be done in two ways. The firm can either setup a new operation in that country or it can acquire an established firm or use that firm to promote its products in the country’s market.

**Advantages:**

* When a firm’s competitive advantage is based on technological competence, a wholly owned subsidiary will often be the preferred entry mode, since it reduces the risk of losing control over that competence.
* A wholly owned subsidiary gives a firm the kind of tight control over operations in different countries that are necessary for engaging in global strategic coordination(i.e., using profits from one country to support competitive attacks in another).
* A wholly owned subsidiary may be required if a firm is trying to realize location and experience curve economies (as firms pursuing global and transnational strategies try to do).

**Disadvantages:**

* Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market.
* Firms doing this must bear the full costs and risks of setting up overseas operations.

**3.2 Selecting an Entry Mode**

As the preceding discussion demonstrated, there are advantages and disadvantages associated with all the entry modes. Due to these advantages and disadvantages, trade-offs are inevitable when selecting an entry mode. For example, when considering entry into an unfamiliar country with a track record for nationalizing foreign enterprises, a firm 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 will speak out against nationalization should the possibility arise. However, if the firm’s core competence is based on proprietary technology, entering a joint venture might risk losing control of that technology to the joint-venture partner in which case the strategy may seem very unattractive. Despite the existence of such trade-offs, it is possible to make some generalizations about the, optimal choice of entry mode.

**3.3 Criteria for selecting a market entry mode**

Selection of market entry mode has an important bearing on strategy, and can later prove to be a severe constraint on future intended international expansion unless due care and attention has been exercised in terms of any contractual arrangement. The criteria to be considered include:

1. ***Speed of market entry desired:*** If speed is required, building up a wholly owned subsidiary is too slow and so acquisition and licensing or exporting will be the likely ways to ensure quick effective distribution in the foreign market.
2. ***Costs to include direct and indirect costs:*** Subjectivity which is ever present may force a wrong decision. Commitment to establishing a market presence does not mean blindness to facts. Possible savings may be outweighed by indirect costs such as freight, strikes, or disruptions to output, lack of continuity with the power supply, or irregularity in the supply of raw materials. Against this the cost of doing nothing has to be considered; this may be higher than the attendant risks of moving into a relatively unknown market.
3. ***Flexibility require –*** The laws of a country exist to protect that country’s nationals. There is as yet no such thing as international law. In disputes between two countries the domestic law of a neutral third country is often called on, so that domestic law then becomes used for a purpose for which it was never designed; international disputes.
4. ***Risk factors -* including** political risk and economic as well as competitive risk. In a dynamic market, time is of the essence. No product remains ‘new’ forever. Getting the product to market is important but so, too, is avoiding the creation of a competitor, a common criticism of licensing. Risk may be diminished by minimizing the investment stake in the company by accepting a local joint-venture partner.
5. ***Investment payback period –*** Sorter-term payback may be realized from licensing and franchising deals, whereas joint ventures or wholly owned subsidiaries will tie up capital for a number of years.
6. ***Long-term profit objectives* –** the growth expected in that market for the years ahead. Here, the question of distribution channel policy is very important. A wholly owned foreign subsidiary may build up its own technical service department alongside a small but growing sales team.