Chapter 2 - Expanding Abroad- Motives, Modes and Timing

Introduction

In this chapter, we will discuss the various motives that organizations have for geographical diversification, as well as the considerations that go into choosing the modes for going abroad. Some brief discussion will also be given to the determinants of the speed of overseas expansion.

The decision to locate particular value chain activities in specific countries ultimately reflects management’s view that the foreign location in question offers certain advantages compared to the locations where those activities are currently carried out; however, what matters are the new locations’ advantages that exist at the margin. That is, while it might be advantageous, for example, to do a certain amount of manufacturing in one or more new foreign locations, it might not be advantageous to relocate all current manufacturing activity from current locations to the new foreign locations. For one thing, it would be very expensive to shut down existing facilities and build new facilities that have the same capacity as the old ones. For another, concentrating the organization’s facilities entirely in a new location exposes the organization to political and related risks which, if they materialized, might seriously disrupt the organization’s ability to produce and deliver product to customers. In short, the location of value chain activities outside the home country is typically, albeit certainly not always, undertaken in an incremental manner. Likewise, exporting to foreign markets is usually incremental to sales that are made in the home country.

While specific foreign locations may offer certain advantages with respect to various value chain activities, the organization must have the financial and managerial resources to be able to diversify (or expand) efficiently into new geographic locations. As discussed in the preceding chapter, it is ordinarily impossible as a practical business matter for an organization to profitably clone its home country value chain activities elsewhere. Circumstances typically dictate that some modifications be made to reflect locational features and circumstances. This implies that international business organizations must ordinarily have access to substantial financial resources in order to absorb the financial costs associated with identifying and implementing localization initiatives. Hence, it is unsurprising that large companies are more intensively involved in international business activities than small and medium-sized enterprises (SMEs). Large companies also have the in-house managerial expertise to develop and implement international expansion strategies, or else they can afford to hire knowledgeable experts to fill internal company gaps. This is not to say that SMEs cannot engage profitably in international

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1 There are examples of so-called “born global” companies. These are companies that carry-out value chain activities outside the home country from their inception. See Tanev (2012) and Kudina, Yip and Barkema (2001). Tallman and Yip (2001) and Barkema and Drogendijk (2007) note that internationalization increasingly involves expansion in several countries at the same time, rather than in a one-by-one sequence.

2 The issue of where and how to diversify geographically is also related to how quickly to diversify internationally. For example, if one location is much more favorable to enter than another location, it is also likely to be more attractive to expand into more quickly than the other location. We discuss some issues related to slower versus faster international expansion later in the chapter.
business. Rather, it is to say that they will ordinarily find international business less profitable than large companies. Furthermore, while large companies can afford to establish and operate affiliated foreign businesses, SMEs must ordinarily carry out international business activities using less expensive and simpler business modes.

International business activities can in principle be carried out using a number of different organizational forms or modes. For example, an organization can market its products abroad by exporting those products. It can acquire inputs from outside the home country by importing those inputs. Furthermore, it can undertake exporting and importing activities directly, or it can hire agents such as brokers or trading companies to do the exporting and importing. In some cases, the agents might be paid a fee; in other cases, the agents might pay a fee to take ownership of the goods in question and then export the goods. In cases when the organization does not want to export goods abroad or produce those goods in foreign market, it might license a product’s brand name to a foreign company and let the latter produce and market the product. Or it might license some other form of intellectual property such as a patent or an industrial design to a foreign company and essentially collect royalties related to the foreign company’s usage of the intellectual property. Franchising, and service and management contracts are other contractual modes of international business.

Exporting and importing, as well as licensing, franchising and management agreements are relatively low cost initiatives to expand internationally. They are also business modes that can be implemented relatively quickly. More expensive and complex modes of doing international business encompass joint ventures and foreign affiliates. A joint venture is a business arrangement in which two or more companies ordinarily share ownership of the venture and, therefore, also share the revenues and profits in some agreed-upon manner. Foreign direct investment (FDI) identifies a mode of international business in which companies operate business establishments or enterprises outside their home countries. The distinction between joint ventures and foreign direct investments is not a bright line. Both involve the organization being active in managing value chain activities outside the home country. Typically, FDI involves establishing and operating a foreign affiliate in which the parent has management control rather than sharing control with a foreign partner, as is typically the case with joint ventures. The conventionally accepted ownership benchmark for distinguishing FDI from other forms of foreign investment is 10 percent of the capital invested in the foreign enterprise; however, it is more typically the case that multinational companies (MNCs) own 100 percent of the equity in their foreign affiliates.

Foreign affiliates can be either Greenfield or brownfield. The former are newly established businesses, while the latter are established businesses that are acquired by the foreign investor. One primary advantage of a brownfield investment is that it allows an organization to enter a foreign market relatively quickly, since there is already an operating business in place. A Greenfield investment obliges the foreign investor to hire new employees, find and lease space for the various value chain activities,

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3 The sharing of revenues and profits need not be in strict proportion to the ownership shares. There are also non-equity joint ventures in which the participants do not furnish financial capital as part of the agreement.
4 The affiliates are therefore characterized as “wholly owned”. See Globerman (2013) for a discussion of the FDI phenomenon.
identify and establish ongoing relationships with suppliers and distributors and so forth. Hence, brownfield investments are ordinarily a less risky way for companies to enter foreign markets. On the other hand, because they are quicker and less risky ways to expand abroad than Greenfield investments, foreign investors will typically need to pay a so-called takeover premium in order to acquire established businesses.5

Figure 1 identifies the main modes of international business and summarizes their main features in terms of the relevant extent of foreign ownership the mode typically involves, the resource commitments or, equivalently, the scale of investment and management input required, and the speed at which initial entry into a foreign market is feasible using the mode. In general, there is a positive relationship between the extent of ownership of the international business involved, the resource commitments entailed, and the time it takes to establish the business activity abroad. These features will be discussed in more detail later in this chapter. For now, we note that the advantages and disadvantages of each specific mode of international business will depend upon the motives for going abroad, as well as where the relevant value chain activities are located. We therefore turn to consider the motives for undertaking international business and to assess how those motives affect the choice of international business mode.

Figure 1
Major International Business Modes

<table>
<thead>
<tr>
<th>Mode</th>
<th>Extent of Ownership</th>
<th>Resource Commitments</th>
<th>Speed of Entry</th>
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</thead>
<tbody>
<tr>
<td>Exports/Imports</td>
<td>low</td>
<td>relatively low</td>
<td>fast</td>
</tr>
<tr>
<td>Contractual Licensing Franchising Service &amp; Management Agreements</td>
<td>low</td>
<td>relatively low</td>
<td>relatively fast</td>
</tr>
<tr>
<td>Joint Venture</td>
<td>moderate</td>
<td>moderate</td>
<td>moderately fast</td>
</tr>
<tr>
<td>FDI Greenfield</td>
<td>high</td>
<td>large</td>
<td>relatively slow</td>
</tr>
<tr>
<td>FDI Brownfield</td>
<td>high</td>
<td>large</td>
<td>relatively fast</td>
</tr>
</tbody>
</table>

5 For a discussion of the advantages and disadvantages of Greenfield versus brownfield foreign direct investments, see Hennart and Slanger (2008).
Motives for International Business

As noted in Chapter 1, there are four main motives for organizations to diversify into foreign markets: 1) Market-seeking; 2. Resource-seeking; 3. Efficiency-seeking; 4. Strategic asset-seeking. \(^6\)

Market-Seeking

An important motive for international geographic diversification of value chain activities is to sell the organization’s products at profitable prices in new (to the organization) markets. The attractiveness of new geographic markets will depend upon how well the organization’s products and capabilities match the key attributes of specific foreign markets, as well as the economic outlook for those markets. In broad terms, companies will be more interested in seeking out markets for which relatively modest efforts are needed to localize the organization’s products, other things constant. While the precise characteristics of a location that make it favorable or unfavorable for geographic expansion will depend heavily upon the strengths and weaknesses of the organization, as well as its products, as will be discussed shortly, certain attributes of foreign locations generally make them desirable as locations in which to sell products. In particular, foreign markets that are expected to enjoy rapid economic growth and that are characterized by relatively strong and stable exchange rates, adequate protection of property rights, such as patents and trademarks, rule of law, transparent and limited government regulations, and weak competition, among other attributes, are relatively attractive markets for most organizations.\(^7\)

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\(^6\) For the original identification of these motives, see Dunning (1993; 1998). It should be noted that Dunning discussed these motives in the context of foreign direct investment, although they conceptually apply to international diversification initiatives, more generally.

\(^7\) Location attributes that make them generally more attractive specifically for market-seeking international expansion are summarized in Figure 2.
Target Customers

The brief discussion of Datsun’s plans to sell in emerging markets illustrates the point that attractive markets to seek out are those that have relatively large numbers of “target customers.” In Datsun’s case, target customers are first-time car buyers upgrading from motorcycles or used cars. There are large numbers of such customers in emerging markets relative to rich, developed countries. Hence, companies seeking international markets must understand who their target customers are and how well those customers are represented in different countries and regions. Often the target customers in foreign markets are similar to target customers in the home market, although the basic product is typically localized to better fit local market conditions. For example, the Indian conglomerate Mahindra & Mahindra sells tractors, among other things. In India, where it is the dominant supplier of tractors, Mahindra’s tractor products tend to be smaller than tractors sold by U.S. rivals, such as Deere, reflecting the smaller-sized farms in India compared to farms in the United States. In its efforts to expand into the U.S. market, Mahindra is sticking to small tractors— not powerful enough for big farms,
but fine for what a company spokesperson calls the company’s target demographic: “gentlemen farmers”, or baby boomers buying small farms and ranches. To be sure, farmers in India have less income than gentlemen farmers in the United States, so Mahindra makes its tractors more luxurious for American customers by adding features such as automatic transmission, air-conditioning, cruise control and sunroofs to its U.S. models.

**Growth of Real Incomes**

The larger the target customer segment in a country and the faster the expected growth of the target segment, the more attractive that country is from a market-seeking perspective. For many products, the relevant customer segments can be expected to grow more rapidly if the overall economy grows more rapidly, since disposable income is required to buy any and all products. However, sales of some products will be more responsive to increases in national income levels than will other products. The relevant notion in this regard is the product’s income elasticity of demand, which is defined as the percentage change in the quantity demanded of a product divided by the percentage change in the real incomes of consumers. Thus, if a product has an income elasticity of 2, it means that a 10% increase in the inflation-adjusted incomes of consumers can be expected to result in a 20% increase in the quantity demanded of the product. A country whose income level is increasing fairly rapidly is therefore a particularly attractive geographic market for companies that sell products with high income elasticities, other things constant. It should be noted, however, that income elasticities are not necessarily identical across countries, even for the same products. For example, in a number of Western countries such as the United States, the income elasticity of demand for health care is greater than one; however, the income elasticity of demand for health care in Taiwan is apparently around 0.4.⁸

**Exchange Rate Behavior**

The behavior of a country’s exchange rate also influences its attractiveness to market-seeking foreign companies. As discussed in Chapter 1, exchange rates identify the prices at which currencies exchange for other currencies, with the U.S. dollar being the typical “measuring rod” against which other currencies’ market values are measured. When companies sell their products in foreign countries, they are generally paid in the domestic currencies of those countries. For example, on August 28, 2013, the Canadian dollar exchanged at a rate of CDN$1.00 = U.S. $.9533. Hence, if a U.S.-based company earned CDN$1.00 in revenues on that day and exchanged the Canadian revenues for U.S. dollars that same day, it would have earned 95.33 U.S. cents. On January 1, 2013, the exchange rate was CDN $1.00 = U.S. $.9928. So if the U.S. Company in question decided on January 1, 2013 to start selling its products in Canada beginning at the end of August, the amount of U.S. dollars it would effectively receive once it started making sales in Canada is less than the amount it might have anticipated receiving given the exchange rate on January 1, 2013. As we shall discuss in a later chapter, there are techniques that companies can use to “lock in” exchange rate values for transactions that are anticipated to occur in future periods; however, there are costs associated with “hedging” against changes in exchange rates. Hence, countries whose exchange rates are relatively stable against other currencies represent markets

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⁸ See T. Yu and Y. Hong (2007)
for which the costs of hedging, or the risks of not hedging, are relatively low. This makes them more attractive for market-seeking international businesses, other things constant.

The Rand’s Problems Hurt the South African Economy

A weak and unstable currency typically reflects a poorly performing economy. However, it can also contribute to poor economic performance which, in turn, makes an economy even less attractive to market-seeking foreign companies. South Africa is an example. By the end of May, 2013, the South African Rand fell to an exchange rate or 10.0 Rand to the U.S. dollar. This represented an 18% decline in the value of the Rand just since the beginning of 2013. One of the consequences of the decline in the Rand is that imports became much more expensive, especially imports denominated in U.S. dollars, so the cost of living for South African workers shot up. The higher cost of living led workers to demand higher wages that employers were reluctant to grant given weak foreign markets for South African exports. The outcome was an economy-cripling wave of labor strikes which shut down much of the country’s mining sector, a major source of the country’s employment and income.

Political and Regulatory Infrastructure

One of the major problems that companies doing international business confront, particularly in emerging markets, is an unpredictable or non-transparent legal system. Such systems are often characterized by a lack of due process, as well as the absence of an independent (from government) judiciary. In some instances, foreign government officials expect to be formal or informal partners in international business ventures, or, at the least, expect to profit from those ventures. In other cases, the intellectual property of international businesses is effectively stolen by local companies through product piracy or by using a well-known brand name or trademark without the permission of the copyright holder. When intellectual property protection is not effectively enforced by foreign governments, international companies often have to resort to costly initiatives to protect their patents, trademarks, and industrial designs which reduces the profitability of carrying out value chain activities in foreign markets. More generally, companies based in developed economies with relatively transparent legal and regulatory systems that follow principles of “natural justice,” and that are accountable to independent and impartial courts of law will find it more costly and difficult to do business in developing countries where the political and regulatory systems can be substantially different.9

9 See Kaufmann (2010) for a brief overview of the characteristics of a nation’s legal and regulatory system that are regularly monitored and reported by The World Bank. These World Bank’s Worldwide Governance Indicators will be discussed in more detail in a later chapter. For an empirical study documenting how national legal and regulatory systems influence the attractiveness of countries to foreign investors, see Globerman and Shapiro (2002).
The governance practices of national and local governments and regulators can be particularly important attributes of foreign markets when international companies choose to sell products in those markets through foreign affiliates. In choosing this international business mode, companies must ordinarily make large investments in physical assets that are difficult to liquidate at compensatory prices if host country governments act punitively toward the foreign affiliates. Indeed, an ongoing challenge for multinational companies is to ensure that the sunk cost investments they make in foreign countries do not effectively become hostages to punitive regulatory and taxation policies of host governments. This sometimes obliges multinational companies to take in local partners to ensure favorable ongoing relationships with host governments, to use local debt to finance the activities of the foreign affiliates, or to implement other actions that would not necessarily be profitable in the home country or in foreign countries with legal and regulatory regimes similar to that of the home country.

**Competition**

All other things constant, foreign markets in which there is relatively limited competition for an international company’s products are more attractive from a market-seeking perspective. Competition

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**IKEA in Russia**

IKEA is a well-known department store chain based in Sweden that has enjoyed great international success primarily by selling affordable, yet high quality furniture. It is also one of the few retail chains based in Europe or North America to expand into Russia. Indeed, by the end of 2008, IKEA was one of the country’s largest foreign investors outside of the oil and gas sector; however, IKEA’s Swedish owners complained publicly about the corruption of local Russian officials who allegedly demanded bribes from the company in order to make it possible for the company to open and operate stores in Russian cities. Indeed, in 2009, IKEA announced that it was halting all investment projects in Russia given the rampant corruption of local government officials and executives of state-owned companies with which IKEA needed to do business. It was therefore an embarrassment to IKEA’s headquarters’ management when it announced in 2010 that it was firing two high-level expat executives in Russia for either approving or acquiescing to the payment of bribes by its contractor in St. Petersburg to officials of Lenenergo, the city’s utility company. In exchange for the bribes, IKEA would have one of its St. Petersburg mega-malls hooked up to the local power grid for the first time since its 2006 opening. The fact that IKEA executives in Russia participated in a bribery arrangement undercut the public position against government corruption in Russia taken by headquarters’ management. It highlights the difficulties that an international company faces in ensuring that its local executives or representatives do not engage in behavior in specific countries that, while consistent with local business practices, is inconsistent with the ethical positions the company has staked in other international markets.

will be ordinarily more intense the more firms a company confronts as rivals in a given location. However, as Porter (2008) discusses, potential profitability is affected by more than the number of direct rivals a company competes against in a geographic market. Specifically, Porter’s Five Forces also include as determinants of the attractiveness of a market these other factors: 1, Potential entry; 2. Substitutes; 3. Market power of suppliers; 4. Market power of buyers.10

Potential entry references the ease with which new competitors can enter a market. Presumably entry will be attractive if existing sellers are earning profit rates that are higher than warranted by the associated risks involved in doing business in that market. If markets are relatively easy to enter, profit rates will return quickly to competitive levels if they are above those levels for whatever reason. While economic conditions can make entry more or less difficult, laws and regulations are frequently a barrier to entry, particularly for foreign-owned firms. In particular, countries often use anti-dumping laws to discourage low-priced imports from entering their markets. In other cases, national health and safety regulations restrict specific foreign products from being legally sold in a country. In still other cases, national foreign ownership laws make it illegal for foreign-owned businesses to be established in certain industries. The implication is that while potential profits can be relatively attractive in countries that restrict competition, foreign-owned firms are often the target of those restrictions.

All products face competition from substitutes to a greater or lesser extent. For example, sellers of soda beverages face competition from sellers of bottled water. Obviously, the more substitutes available for a product in a location, the less attractive that location is from the perspective of profitability, other things constant. Technology is often a determinant of the ease with which buyers can substitute one product for another. For example, the widespread availability of broadband capacity in a location allows consumers of video programming to download that programming over the Internet, rather than being constrained to watch it using other distribution media such as cable television. Since technology differs across countries, it is certainly possible that there might be more substitutes for a company’s products in one country than in another.

Finally, if there are only a few large buyers of a company’s product in a given location, an international company is likely to find that location a less attractive place to sell its products. This is because the buyers have the incentive and ability to bargain hard for low prices or other advantages that reduce the profit margins on the products. In fact, the number of large buyers of products can vary across countries, particularly when the government participates in the market as a buyer. As an example, in many developed countries, government health ministries are large buyers of prescription drugs and medical devices. They use their buying power to drive hard bargains on prices with multinational pharmaceutical companies.11

10 While Porter typically discusses his Five Forces of profitability in the context of the industry in which a company competes, it can also be applied to the geographic markets in which the company sells its products.
11 The symmetrical notion is that if there are a few sellers of inputs required by an international company doing business in a specific location, those sellers will demand relatively high prices for those inputs, thereby making it less profitable for the company to do business in that location. However, in the context of market-seeking
Diversification

Seeking new international markets for a company’s products is sometimes justified on the grounds that it helps make a company’s revenues and profits more stable. The basic idea is the same as that behind diversifying financial portfolios. Specifically, if business conditions are not perfectly synchronized across countries, the variance in a company’s sales revenue and profitability is likely to decline as the company increases the number of countries in which it sells its products. In the limit, if the business cycles of two countries are mirror images, then if the market for a firm’s products declines in one of the countries, it will expand in the other country and vice-versa. What this implies is that a country will be more attractive from a market-seeking perspective if it has a substantially different economic structure compared to a company’s home country, since that makes it less likely that business conditions will be synchronized in that firm’s foreign and domestic markets. The *quid pro quo*, however, is that substantial differences in economic characteristics and business conditions will oblige the international company to do more localization of its marketing with resulting higher costs. Furthermore, shareholders of international companies can benefit from geographical diversification of their portfolios by investing in mutual funds or Exchange Traded Funds (ETFs) that invest across companies in many different countries.\(^{12}\) That is, shareholders might be able to benefit from geographical diversification of their asset holdings through their portfolio investments, which would partially or totally negate any risk-diversification benefits provided by the geographic diversification undertaken by companies in which they are invested.

Distance

Yet another relevant determinant of the attractiveness of a location for market-seeking international companies is distance. Ordinarily, distance has a physical connotation. The requirement to ship goods a long physical distance contributes to higher transportation costs and, as a consequence, to lower profits. Physically distant markets will be particularly unattractive as export targets for bulky and heavy goods, such as cement; however, cultural distance can also be a relevant determinant of where international organizations seek out markets, particularly when those organizations choose to serve markets by establishing foreign affiliates. We shall say much more about cultural distance throughout the book. At this point, we note that the ongoing business linkages between countries that were formerly in a colonial relationship, such as France and North Africa, reflect a cultural familiarity that businesses in the colonizing country developed with the colonized societies, as well as a shared language and legal system typically imposed by the colonizing country on its colonies.

Other Motives for International Diversification

Besides market-seeking, other motives for international diversification mentioned earlier in the chapter include resource-seeking, efficiency-seeking and strategic asset-seeking. These are somewhat

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\(^{12}\) Doukas and Kan (2006) argue that geographical diversification might lower risks to bondholders of a company, even though shareholders are actually disadvantaged.
related concepts, as they are all concerned with an effort to lower costs incurred along the various stages of the company’s value-chain.

Resource-seeking international diversification is motivated by the availability of lower priced or higher quality natural resources located outside an organization’s home country. It might also be motivated in some cases by a desire to diversify the geographical sources of supply for required natural resources given the risks to the organization of political or weather-related disruptions to supply coming from a single location. Efficiency-seeking international diversification is most often focused on lowering the costs of labor-intensive value chain activities by directly or indirectly using lower-cost labor located in foreign markets. Organizations can directly lower labor costs by establishing their own facilities in foreign markets. They can indirectly lower labor costs by outsourcing the value chain activity, typically production, to domestic companies located in countries with an abundance of low or modestly skilled labor. Finally, strategic asset-seeking international diversification is driven by an organization’s need to acquire technology, managerial expertise and other “knowledge-related assets” that are presumably more abundant in foreign markets than in the organization’s home country, or to enable the organization to be better informed about the technological opportunities and threats surrounding its business. In the case of strategic asset-seeking geographic diversification, organizations typically establish a physical presence in foreign locations, since the assets being acquired are usually intangible and, therefore, difficult to import or otherwise acquire on an “arms-length” basis.13

Figure 3

Location Attributes That Encourage Resource-Seeking, Efficiency Seeking and Strategic Asset-Seeking Geographic Diversification

- Different factor endowments
- Transportation costs
- Technology clusters
- Low tax rates
- Good physical/communications infrastructure
- Strong property rights protection

13 Location attributes that encourage resource-seeking, efficiency-seeking or strategic asset-seeking geographic diversification are summarized in Figure 3.
Factor Endowment Differences

Geographical diversification to lower costs or, equivalently, to improve the efficiency of an organization presumes that overseas locations are abundant in the inputs that the organization is seeking relative to the home country. Another way of saying this is that the costs of different inputs are lower in certain foreign markets than they are in the home country. In the limit, specific inputs may not be available at all in the home country. For example, there are no economical deposits of precious metals such as gold and silver in Japan, so Japanese manufacturers that use those metals as inputs in making computer products or medical devices, for example, must acquire those inputs from outside their home country. As another example, Chinese companies over the past few years have embarked on a major effort to acquire natural resources such as iron ore, and oil and gas from foreign countries ranging from Canada to Sudan. While there are apparently plentiful oil and gas deposits in China, they are relatively costly to extract compared to costs in other countries.\(^\text{14}\)

While cross-country differences in factor endowments are relatively obvious when it comes to natural resources and relatively unskilled labor, those differences are somewhat less obvious when they involve knowledge-related assets. After all, knowledge can take many forms, and it is also intrinsically difficult to price. Nevertheless, the phenomenon of “clustering” highlights how geographically concentrated specialized knowledge can be. For example, most of the global expertise in biotechnology is located in universities and medical centers in a handful of cities in North America and Western Europe. As another example, the bulk of new financial products are developed by firms that are located in New York City and London. In the case of biotechnology, financial services and many other business activities, specialized education and other skills are required, and the appropriately educated workers and supporting skills are concentrated in a relatively few geographic locations.

Comparative Advantage

The well-known economic concept of comparative advantage is directly linked to the notion of factor endowments. Specifically, a country will be said to have a comparative advantage in an activity if it is cheaper to carry out that activity in the country in question than in other countries compared to the relative costs of carrying out other activities. In turn, a country’s comparative advantage will typically be in business activities that rely upon one or more factors of production that are relatively abundant in that country.

A simple illustration of the concept of comparative advantage is provided in Table 1. The simple example focuses on two countries (the United States and China) and two products (corn and cell phones). Table 1 shows the number of hours of labor required to produce a bushel of corn and an ultrasound machine each country. Specifically, it is assumed to take 2 hours of labor to produce a bushel of corn in the United States versus 4 hours of labor in China. It is assumed to take 16 hours of labor to produce an ultrasound machine in the United States versus 20 hours of labor in China. In this (purely) illustrative example, the United States has a comparative advantage in producing corn, while

\(^{14}\) In some cases, China acquires raw materials through imports from foreign suppliers. In other cases, Chinese companies have made direct investments in foreign countries and acquire the inputs from their foreign affiliates.
China has a comparative advantage in producing ultrasound machines. The reason is that corn can be produced in the United States using half the labor required in China, whereas producing ultrasound machines in the United States requires four-fifths the amount of labor as is required in China.\textsuperscript{15} The implication is that corn should be relatively cheap compared to ultrasound machines in the United States, while it should be relatively expensive compared to ultrasound machines in China. If the two countries were free to trade with each other, the United States would focus on producing corn and China would focus on producing ultrasound machines. Corn would be exported from the United States to China, while ultrasound machines would be exported from China to the United States. In this way, the total output of corn and ultrasound machines would be maximized across the two countries. The implication is that corn-producing organizations would locate in the U.S., while organizations producing ultrasound machines would locate in China.

<table>
<thead>
<tr>
<th></th>
<th>Hours of Labor Required Per Unit of Output</th>
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<tbody>
<tr>
<td></td>
<td>Corn</td>
</tr>
<tr>
<td>U.S.</td>
<td>2</td>
</tr>
<tr>
<td>China</td>
<td>4</td>
</tr>
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The relative cost advantage U.S. farmers enjoy in corn production presumably reflects a relative abundance of fertile land and water in the United States compared to China. The relative cost advantage Chinese companies enjoy in making ultrasound machines presumably reflects China’s abundance of low and moderately skilled assembly workers. While these assumptions are realistic, the illustration of the principle of comparative advantage in Table 1 is highly simplified. For example, it assumes that an hour of labor in the United States earns the same wage in both industries and similarly for China. It also assumes that all value chain activities associated with producing corn will be carried out in the United States, while all activities involved in producing ultrasound machines will be carried out in China. In fact, it is likely that there will be even more geographic specialization. For example, the research into designing ultrasound machines, and producing the chips and software to run the machines will likely be done in the United States, while China will specialize in assembling the machines. Despite these and other simplifications, the principle of comparative advantage is an empirically robust explanation of why specific business activities tend to be located in some countries or regions, but not in others.

Laws, Regulations and Taxes

Of course, comparative advantage is not a complete explanation of why international organizations engage in resource-seeking, efficiency-seeking or knowledge-seeking geographic

\textsuperscript{15} Note that it takes less labor in the United States to produce each product. One would say that the United States has an absolute cost advantage in each product; however, what matters for locating value chain activities is comparative advantage.
diversification. In many cases, companies may be required by foreign governments either to buy inputs from local producers or to carry out specific value chain activities in their countries in exchange for being allowed to sell their products in those countries. Other relevant location considerations include tariffs and non-tariff barriers imposed by foreign governments. Tariffs are essentially taxes on imports, while non-tariff barriers encompass a wide range of initiatives that directly or indirectly increase the cost of imports. In the presence of tariff and non-tariff barriers, it might be less costly to carry out value chain activities, including production, in foreign countries rather than in the home country, and then exporting from the home country, even when relative factor endowments by themselves favor production in the home country. Along similar lines, transportation costs influence location decisions for value chain activities. All other things constant, if a product (raw, semi-finished or final) has high transportation costs relative to its market value, it is more likely to have its production located in proximity to consumers. In some cases, physical distance is the most important determinant of transportation costs. In other cases, a lack of good seaports and airports might limit the viability of serving specific foreign markets through exports from other locations.

Tax rates are an additional consideration in the decisions made by international organizations about where to locate specific value chain activities. There has been a good deal of controversy surrounding the practical importance of international tax rate differences as they affect decisions by multinational companies about where to locate value chain activities. Certainly many national governments believe that multinational companies place a high strategic priority on minimizing their international tax burdens. It is beyond the scope of this chapter to address the controversies in any detail. In broad terms, there are those who argue that other factors discussed earlier in this chapter are far more important influences on location decisions than are differences in corporate income tax rates and other taxes. This is particularly true to the extent that government revenues collected through taxes are used to finance improvements in physical infrastructure, environmental remediation, public safety, better public schools and the like, since these amenities will make a location more attractive to international managers and other skilled employees, and therefore a more economical location for multinational companies to site value-chain activities. Conversely, other experts argue that the impact of tax rate differences has become greater over time as other barriers to expanding abroad have declined, and as companies have become more adept at managing and coordinating geographically dispersed value chain activities.

While the impact of international tax differences on location choice likely differs depending upon whether firms are engaged in resource, efficiency or knowledge-seeking geographical diversification, the empirical evidence, on balance, suggests that higher tax rates in host countries are associated with less investment in those countries by multinational companies, and this association is apparent for both indirect taxes (e.g. value-added taxes) and corporate income taxes. At the same time,

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16 As an example, in 2012, British lawmakers accused major multinational companies, including Google, Starbucks and Amazon of aggressive tax avoidance. Lawmakers accused Starbucks’ British affiliate of paying excessive royalties to its Dutch affiliate to take advantage of the company’s special tax status in the Netherlands where Starbucks has its European headquarters. The lawmakers were incredulous that Starbucks could honestly report having lost money in all but one of the 15 years it has operated in the United Kingdom.
empirical evidence also shows that higher quality government-provided services such as public education, roads and other transportation facilities, public safety, protection of the environment and food and water supplies, and like initiatives attract foreign investment. The inference one might draw is that governments that provide public services efficiently, thereby holding down tax rates, will be particularly attractive to multinational companies looking to expand value-chain activities abroad.

The Imperative to Localize

Regardless of whether an organization’s motive for geographic diversification is resource-seeking, efficiency-seeking or strategic asset-seeking, the organization will undoubtedly find it advantageous, indeed, perhaps even legally necessary, to localize the value chain activities being sited abroad. For example, the relative prices of inputs such as labor, physical capital and energy will differ across locations. Hence, warehouse facilities in Viet Nam will use more labor relative to computer-controlled equipment than will warehouse facilities in Canada. Regulations governing the ability of employees to lay-off workers for economic reasons, or to avoid contributing to benefit programs such as pensions, will vary across countries which will affect employers’ incentives to hire full-time versus part-time employees. As another example, multinational companies will use more debt relative to equity in affiliates located in countries with high tax rates. This is because interest paid on debt can be deducted from earnings before taxes, whereas dividend payments are not tax-deductible. Hence, debt is a progressively less costly method of financing an organization as that organization’s corporate tax rate increases.

17 For comprehensive reviews of empirical studies linking taxation and government services to location attractiveness in an international context, see Desai, Foley and Hines (2006) and Globerman and Chen (2010).
Choosing the Mode of International Business

As discussed earlier in the chapter, there are different modes (or governance structures) that are used to carry out international business activities. The main alternative modes are summarized in Figure One. The issue to be considered here is why an international organization would favor one mode over another. For example, why would an organization choose to establish wholly owned foreign affiliates which require large up-front expenditures and are complicated to manage, particularly in countries that are economically, politically or culturally different from the organization’s home country, rather than utilize a contractual mode such as licensing or franchising which involves much lower
upfront investments and no direct management? The obvious conceptual answer is that the expected benefits of operating in foreign markets using wholly owned affiliates exceeds the associated costs and by a margin that is greater than for other possible modes. But this begs the question: what are the benefits of ownership when engaging in international business?

Benefits of Ownership

The main advantage of ownership is that it ordinarily also conveys managerial control. The owners of a company can in principle choose the senior managers of the company and appoint the Directors. The owners can set the incentive systems for managers so that the latter will act in the interests of the owners. Most importantly, the owners are the residual claimants on the profit stream resulting from the organization’s international activities. There is no concern that a foreign partner or licensee will act in an opportunistic fashion to divert profits to itself and away from the organization in question, as would be the case, for example, if the organization licensed the use of a new proprietary technology but could not identify or prevent the foreign licensee from using the technology outside of the scope of activities initially agreed upon. In this regard, an ongoing concern expressed by management experts about U.S. firms forming joint ventures with Chinese firms to carry out value chain activities in China is that the Chinese partners will use the technological and managerial expertise acquired through the joint ventures to compete against those U.S. firms in other markets.

In theories of foreign direct investment, the advantages of control through ownership are particularly significant when the multinational company’s main assets are intellectual property in the form of new technology or managerial know-how. It is extremely difficult to contract with an independently owned foreign company to rent or lease intellectual property, since the commercial value of the property is difficult to establish before it is deployed. Furthermore, it is difficult for a multinational company (MNC) to write and enforce a contingent contract with a foreign company that sets out exactly how much compensation will be paid as the intellectual property is actually used. How does either party know whether larger or smaller than expected profits reflect the actual value of the know-how versus factors outside the control of either party, e.g. general economic conditions? How does the MNC identify whether the foreign partner is misrepresenting the benefits of the know-how, say by crediting sales that result from using the new technology to other product lines or business ventures? In short, the profitable usage of certain types of skills and expertise often requires that the owner of those skills and expertise internalize their usage within the company.

Costs of Ownership

But then, why isn’t FDI the only observable mode of international business? After all, virtually every organization that engages in international business has some type of know-how that underlies, at
least in part, its ability to compete in global markets. The conceptual explanation is that while there is always some benefit to managerial control, there can be more than offsetting costs depending upon the specific circumstances surrounding the business activity in question. This is particularly likely to be so, for example, if the MNC sees only the possibility of doing a small amount of business in a location, in which case the overhead costs of establishing a foreign affiliate may be greater than the administrative advantages of managerial control. This point is underscored by the data presented in Table 2 which lists the 20 largest transnational companies in 2011. These are companies with hundreds of billions of dollars of assets and which earn a majority of their sales revenue outside their home countries. Clearly, very large companies that earn the majority of their sales revenue in foreign locations are more likely than smaller companies to find it economical to establish and operate foreign affiliates as the preferred mode for doing international business.

### Table 2

Biggest Transnational Companies

(By Foreign Assets – 2011, $bn)

<table>
<thead>
<tr>
<th>Company</th>
<th>Home Country</th>
<th>Foreign Assets</th>
<th>Foreign Sales as % of Total</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Electric</td>
<td>USA</td>
<td>480</td>
<td>52.6</td>
<td>Conglomerate</td>
</tr>
<tr>
<td>Royal Dutch Shell</td>
<td>Netherlands/Britain</td>
<td>300</td>
<td>60.1</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>BP</td>
<td>Britain</td>
<td>285</td>
<td>79.8</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>Exxon Mobil</td>
<td>USA</td>
<td>195</td>
<td>73.0</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>Toyota</td>
<td>Japan</td>
<td>190</td>
<td>60.8</td>
<td>Autos</td>
</tr>
<tr>
<td>Total</td>
<td>France</td>
<td>180</td>
<td>76.9</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>GDF Suez</td>
<td>France</td>
<td>170</td>
<td>65.6</td>
<td>Energy utility</td>
</tr>
<tr>
<td>Vodafone</td>
<td>Britain</td>
<td>160</td>
<td>88.3</td>
<td>Telecom</td>
</tr>
<tr>
<td>Enel</td>
<td>Italy</td>
<td>150</td>
<td>60.5</td>
<td>Energy utility</td>
</tr>
<tr>
<td>Telefonica</td>
<td>Spain</td>
<td>145</td>
<td>72.1</td>
<td>Telecom</td>
</tr>
<tr>
<td>Chevron</td>
<td>U.S.</td>
<td>145</td>
<td>59.0</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>E.On</td>
<td>Germany</td>
<td>138</td>
<td>57.9</td>
<td>Energy utility</td>
</tr>
<tr>
<td>Eni</td>
<td>Italy</td>
<td>130</td>
<td>69.2</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>ArcelorMittal</td>
<td>Luxembourg</td>
<td>127</td>
<td>99.7</td>
<td>Steel and mining</td>
</tr>
<tr>
<td>Nestle</td>
<td>Switzerland</td>
<td>125</td>
<td>97.8</td>
<td>Food</td>
</tr>
<tr>
<td>Volkswagen</td>
<td>Germany</td>
<td>123</td>
<td>78.3</td>
<td>Autos</td>
</tr>
<tr>
<td>Siemens</td>
<td>Germany</td>
<td>120</td>
<td>85.3</td>
<td>Electronics</td>
</tr>
<tr>
<td>Anheuser InBev</td>
<td>Belgium</td>
<td>117</td>
<td>89.5</td>
<td>Beverages</td>
</tr>
<tr>
<td>Honda</td>
<td>Japan</td>
<td>115</td>
<td>77.7</td>
<td>Autos</td>
</tr>
<tr>
<td>Deutsche Telekom</td>
<td>Germany</td>
<td>113</td>
<td>55.1</td>
<td>Telecom</td>
</tr>
</tbody>
</table>

Source: The Economist

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18 The term “transnational” is a synonym for “multinational” in this context. The companies listed in Table 2 have foreign affiliates in many different countries around the world.
Summary of Benefits and Costs of Ownership

Rugman and Verbeke (2003) summarize the advantages and disadvantages of ownership of value chain activities located in foreign locations. As noted above, one potential benefit is that ownership is likely to reduce bargaining conflicts that might arise between parties to transactions, especially when intangible and, therefore, difficult to price assets such as knowledge are being transferred. Since there is often uncertainty about the future commercial value of new products and processes being created in cooperating organizations, it is difficult for independently owned firms to cultivate the trust needed to share knowledge assets, since each has an incentive to appropriate new knowledge for their exclusive use once it is created, and each party is aware of this incentive. This trust problem is mitigated (at least in principle) when the cooperating organizations share the same profit-function. Yet another broad benefit of common ownership is that headquarters management is better able to implement differences in pricing and other initiatives across locations when demand and other economic conditions differ across those locations.

The disadvantages of ownership are related to the increased costs associated with managing a larger organization whose value chain activities are physically distant from headquarters and that operate in different environments from the home country. For example, there are costs associated with the need for a high volume of accounting and control information compared to the costs associated with coordinating transactions in the market-place with independently owned companies. There are also additional costs associated with staffing management in affiliates and ensuring that those managers have ongoing incentives to act in the interests of the global organization. Yet another potential disadvantage that is not mentioned by Rugman and Verbeke is that some foreign governments, as well as suppliers and consumers, may distrust foreign-owned companies or worry about a loss of political or cultural sovereignty if “too much” of their domestic economy is owned by foreign investors. This phenomenon increases political and social risk faced by multinational companies.19

19 Obviously, if host country governments limit or prohibit foreign ownership in specific activities, the tradeoff between the advantages and disadvantages of ownership is moot. A summary of the advantages and disadvantages of ownership of business activities located outside the home country is provided in Figure 4. Figure 5 identifies some factors favoring ownership/control versus contractual or other modes of international business.
Advantages and Disadvantages of Ownership

Advantages

- Managerial control
- Residual claimant to profits
- Reduced risk of misappropriation of key technology/expertise
- Faster decision-making

Disadvantages

- Relatively large financial commitment
- Increased costs associated with accounting and MIS systems
- Increased costs of staffing
- Political and social risks

Factors Favoring Ownership

- Large firm size
- Similarities between home and host countries
- Technological intensity of the industry
- Favorable foreign-ownership laws and regulations in host countries
Flexibility

In a related vein, even large companies may be uncertain about whether specific business opportunities outside the home country are temporary or whether they are likely to be longer-lasting. Before undertaking large, and possibly sunk cost investments to enter a market, management might deem it prudent to expand geographically using a more flexible and less risky mode. For example, it might choose to enter a market by taking in a joint venture partner that would share the initial capital expenses, as well as the operating costs of expansion in that market. If the view of management is that it would be best, in the long-run and if the market opportunities proved to be long-lasting, to operate in the market in question through a wholly owned affiliate, it might consider proposing an option agreement with the joint venture partner. The agreement might, for example, allow management to acquire the joint venture partner’s ownership share by some date in the future and at a pre-agreed upon price or valuation procedure. Clearly the option has financial value for management, since it limits the upfront costs and risks of geographical diversification, while allowing full ownership of the business activity in question if things work out as hoped in the relevant location. Therefore management will need to compensate the joint venture partner in some satisfactory way, since the partner is presumably sacrificing the option of continuing as an owner of the business if things work out well financially for the joint venture.20

More generally, whenever there is uncertainty surrounding the environment in which international diversification is being contemplated, there is value in moving deliberately to initiate or expand international business activities. Equivalently, there is an advantage to initiating or expanding those activities using modes that conserve on sunk costs, but that allow the organization to make relatively large financial and organizational commitments to the activities in the future as critical uncertainties are resolved. Hence, it is not surprising to find that a company such as Starbucks expanded in the U.S. and Canada using company-owned stores, but it used joint ventures with large, foreign-owned companies to enter markets, such as Japan, China and India. These latter markets are physically and culturally relatively distant from the company’s North American market, and therefore posed much greater risks that market-seeking expansion would be unprofitable. Starbucks use of joint ventures in “distant” markets therefore reflects both the need for location-specific marketing and related expertise (to be discussed below), as well as a desire to limit sunk cost investments in new markets until it has greater confidence that it can operate profitably and on a relatively large scale in those markets.

International business modes that allow organizations to expand or contract their international business activities in a relatively flexible manner offer what international business experts call real option value to those organizations.21 Comparable to the earlier observation that holders of options

20 The value of the option to buy out the joint venture partner will reflect the standard determinants of option values as identified in the famous Black-Scholes option pricing model. The details of this model are beyond the scope of this book; however, the interested reader might consult Luerhman (1998) for a simple introduction to the Black-Scholes model.

21 For a broad discussion of how companies have employed real option strategies when undertaking business activities in the Asia-Pacific region, see Tong and Li (2008).
should expect to pay for the value that options create, so too are there costs associated with using relatively flexible international business modes. For example, in the case of Starbucks joint ventures, Starbucks must share some of the profits with its joint venture partner. Furthermore, the company runs an ongoing risk that there will be strategic or other disagreements with its partners that slow Starbucks expansion or, worse, compromise the efficient operation of its branded stores in the relevant foreign locations. As with all business decisions which require a benefit-cost analysis, management must weigh the benefits of achieving greater flexibility against the associated costs.

Acquiring Complementary Inputs

Carrying out one or more value chain activities efficiently in a foreign location generally requires that a host of complementary skills and assets be brought together and managed effectively. Many of the requisite assets and skills may be idiosyncratic to the foreign locations in which the value-chain activities are to be carried out. For example, international companies seeking to sell their products in foreign markets require distribution channels, e.g. warehouses to store inventories and retail outlets in which to sell their products. Those market-seeking international companies might consider building their own warehouses and retail outlets, e.g. Greenfield investments, in order to facilitate their market-seeking international diversification. However, they are likely to lack as much knowledge as they would like to have about where to site the warehouses and retail outlets, particularly if they have had little or no experience in similar locations. Alternatively, they might seek to acquire existing locally owned companies that already have warehouse and retail distribution facilities in place, e.g. brownfield investments; however, the locally owned companies usually own other assets related to their warehouses and retail outlets for which the international companies in question may have little use. For example, the potential acquisition targets may own bottling or food manufacturing facilities that are not required by the international companies. In such cases, acquisition of entire locally owned companies would be unnecessarily expensive. In these circumstances, international companies often implement strategic alliances in which complementary assets of the international company and locally owned organizations are pooled to carry out specific value-chain activities. Often the alliance involves joint ownership of the alliance by the parties, if the sharing of assets is substantial and expected to last a relatively long time. In other cases, the pooling of assets involves contractual agreements. This is more likely to be the case when the complementary assets are very specialized and the cooperation is designed to accomplish a specific task or is not expected to last very long.

Definition of Strategic Alliances: Agreements among firms in which each commits to achieve a common set of objectives through sharing specific skills or assets. Equity ownership by the cooperating firms may or may not be involved.


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22 Obviously, the less useful assets of the acquired company might be sold off, but this could involve potentially large capital losses for the acquiring firm, as well as take up substantial amounts of management’s time that would be better focused on expanding the organization’s business activities in the location in question.
IBM Shops for Lab Partners

A striking example of a multinational company looking outside its home country for knowledge assets is provided by IBM. For decades, IBM (and many other U.S. companies) treated the work done in their labs as top secret. However, in recent years, companies such as IBM (and other companies in the information and computer technology business) have begun tapping into talent outside the company for specialized bits of science and technology. Indeed, IBM has made collaboration with outsiders an essential piece of its research strategy. The company literally searches throughout the world for what it calls “collaboratories” which match up its researchers with foreign experts from governments, universities and companies. By the fall of 2009, IBM had established collaboratories in Saudi Arabia, Switzerland, China, Ireland, Taiwan and India. In explaining the rationale for the alliances, IBM’s Director of Research explained that the collaborations exposed IBM to science challenges and ideas that it might not otherwise encounter. To be sure, IBM has its own labs employing its own personnel in a number of countries outside the United States. However, expanding its research scope through joint venture collaborations reduces the amount of money that IBM needs to spend on “bricks and mortar”, as well as on full-time researchers.

Each joint venture is expected to be staffed with between 10 and 100 scientists targeting technologies that can be delivered in a relatively short time. IBM sifts through hundreds of potential partnerships to pick the ones that are the best fit. In doing so, it considers a wide range of factors including available scientific and engineering talent and host government stability and corruption. Then the company and its partners negotiate contracts that spell out responsibilities and that protect each party’s interests. IBM wants to co-own the intellectual property created or have exclusive rights to it, although that arrangement is not always agreeable to university partners. IBM aims for a minimum of 50% funding by its partners. Also, the work is meant to focus on areas of research that IBM considers critical to its future. By participating in joint ventures with IBM, countries have the potential to build new industries, and universities can attract the best faculty and students. IBM often gains commercial connections in foreign countries through the collaboratories which help the company sell its computer services in those countries. In such cases, the knowledge-asset seeking component of IBM’s strategy might augment its market-seeking initiatives.¹

Note: The facts of this case are drawn from Steve Hamm, “Big Blue’s Global Lab”, Business Week, September 7, 2009, pp. 041-045.
Successful Collaboration in Alliances and Among Affiliates

There is no guarantee that common ownership will make for a successful “partnership” between corporate headquarters and its wholly owned foreign affiliates. Nor does shared ownership or mutually agreed upon contracts guarantee the success of joint ventures or other strategic alliances. Even if organizations choose the most efficient modes \textit{ex ante}, the results can be unsatisfactory \textit{ex post} if the chosen modes are not operated efficiently. There has been much written about how to make strategic alliances work successfully, although the track record is that the majority of those alliances fail to achieve the objectives of the alliance partners. It is beyond the scope of this chapter to discuss in detail the determinants of success and failure in strategic alliances, including joint ventures. Certainly, one factor that seems to matter is shared goals for the alliance, as well as the familiarity and comfort that the foreign partners share in terms of the operating procedures that each follows. This familiarity and comfort is, in turn, likely to be related to cultural similarities between the organizations involved in the alliance. Other factors include the experience that the partners have had with other international alliances, as well as with international business more generally, the degree to which each partner supplies relatively unique assets and expertise to the alliance, and a relatively well defined set of responsibilities and tasks that each partner is assigned.\textsuperscript{23} The responsibilities and tasks should, in turn, reflect the attributes of the location in which each alliance partner carries out the main value chain activities encompassing the alliance, as well as the specific skills and expertise possessed by each of the partners.

Increasingly, foreign direct investment is motivated by strategic asset seeking, particularly knowledge-related assets.\textsuperscript{24} In such cases, two-way knowledge flows between the parent company headquarters and its foreign affiliates, as well as among the foreign affiliates, are important features of the interaction that takes place across the units of the multinational company. A hierarchical relationship between the parent company and its foreign affiliates would likely thwart or at least weaken the effectiveness of the investment initiatives undertaken by the MNC. As with international alliances, the various affiliates of the MNC likely have specific skills and expertise that, in turn, are related, at least in part, to where the affiliates are located. For example, a multinational drug company might have an affiliate in Cambridge, England that is particularly well placed to draw upon the biotechnological expertise at Cambridge University, as well as upon biotechnology scientists and engineers in companies and research institutes that are relatively abundant in that location. At the same time, it might have an affiliate in Silicon Valley that is well located to draw upon the software engineering expertise that is resident in that region of the world.

As Rugman and Verbeke (2003) note, autonomous strategic behavior on the part of foreign affiliates should not only be accepted by headquarters, but should be encouraged, even if it deviates from mainstream thinking in the firm. A discipline that might be imposed by headquarters management on managers of its affiliates is linking reductions in the level of control over foreign affiliates to the track

\textsuperscript{23} For a discussion of the evidence on the determinants of international alliance outcomes, see B.Nielsen (2007).
\textsuperscript{24} See Dunning (1998) and Cantwell (2009) for discussions of the growing importance of this motive for foreign direct investment and how it enhances the relevance of location as a determinant of an organization’s profitability.
record of success of those affiliates. Other controls can also be introduced including the use of competitive internal transfer prices for components, services and the like made available to affiliates by headquarters. That is, affiliates should expect to pay the same amount for goods and services provided by headquarters as would an independently owned firm. This would help ensure that the affiliates are being efficient in the use of inputs supplied by or paid for by headquarters.

The key notion here, as with successful alliances among independently owned firms is that new knowledge creation and innovative activity depends upon physical proximity, and that specific skills and technologies tend to be clustered in particular locations. As a consequence, the traditional “model” whereby R&D and other innovative activities are concentrated at corporate headquarters, while foreign affiliates are mainly responsible for adapting innovations developed at headquarters to local market conditions, is inappropriate for a world in which highly specialized knowledge is increasingly important to business success and where relevant specialized knowledge exists outside the home country. As knowledge becomes an ever-more important strategic asset, multinational affiliates increasingly resemble a network of knowledge centers that complement each other. The objective is to maximize synergies across the network by choosing the appropriate locations to access the knowledge-assets needed by the firm, and by implementing the appropriate modes to govern the relevant activities.

**Timing**

As noted earlier in this chapter, organizations must also determine the speed at which they will commit resources to expand in individual foreign markets. There is a basic tradeoff that all firms face. On the one hand, slower expansion allows firms to learn about the specific foreign market before undertaking large sunk-cost investments in that market. The additional information and experience should help the international organization better assess the long-run attractiveness of the location in question, as well as identify how to be successful doing business in that location. On the other hand, a slow expansion into a foreign location can result in rivals establishing dominant positions in that geographic market making the costs of successful expansion in the future even higher.

What is relevant to note in this context is that locational attributes will affect the net advantages of faster versus slower expansion in a country or region. In particular, relatively rapid expansion in a location makes more sense when future economic, political and cultural conditions in that location are relatively predictable, since the strategic benefits of “learning by waiting” will be commensurately smaller. The attractiveness of the location to market-seekers, resource-seekers, efficiency-seekers or strategic asset-seekers is also relevant. More attractive locations will draw in competitors sooner, thereby making slow expansion risky for an organization. Obviously, some organizations are better positioned to expand more quickly in foreign markets than others. For example, large firms have more resources to undertake risky expansion, while firms that have reputations for being trustworthy partners will find it easier to partner with host country organizations, thereby facilitating faster expansion.

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25 See Birkinshaw and Hood (2001) for a discussion of how headquarters’ management can promote innovation on the part of their foreign affiliates.

26 This tradeoff, along with specific influences on the tradeoff is discussed in Petersen and Pedersen (1999).
main point here is that any individual organization is unlikely to expand at the same rate in each foreign location in which it carries out business activities.

Summary

Creating and growing an international business ultimately involves making ongoing decisions about where to locate activities comprising the organization’s value chain, as well as choosing the modes that will be used to govern the operations of the value chain activities, wherever those activities are located. In theory, these decisions are interrelated ones that are driven by the organizations’ objective to maximize the value of the physical and human assets of the global company. Decisions about where to locate activities are related to decisions about how to organize and manage the activities, because the attributes of specific locations that make them attractive for carrying-out specific value chain activities also condition the attractiveness of different modes for governing those activities.

What should be emphasized is that location and mode choices are constantly being revised, as the resource needs and capabilities of the organization change over time, and as location attributes and the advantages and disadvantages of alternative international business modes also change over time. For example, some observers argue that the intensity of competition in recent years has driven many MNCs, especially those in high-technology industries, to access new products and capabilities in other companies. This has resulted not only in those MNCs engaging in more international mergers and acquisitions, but also in their increased use of joint ventures and other types of strategic alliances (Tallman and Yip, 2001).

The choice between ownership versus alliance is ultimately predicated on a constellation of factors that determine the advantages and disadvantages of managerial control of the underlying value chain activities, where control, in turn, is related to the degree of ownership of those activities. As Buckley and Casson (2009) point out, balancing the advantages and disadvantages of ownership is the underlying tension that sets the boundaries for any organization and not just international businesses, although assessing the advantages and disadvantages is a much more complex calculation in the context of international business. The added complexity is related to the localization theme discussed in Chapter 1. Specifically, differences across countries and regions create an imperative to determine where it is most efficient and profitable to locate specific value chains while avoiding siting them elsewhere. Location differences also change the net benefits calculations for the most efficient modes to use in carrying out specific value chain activities. They also condition the speed at which it is profitable to expand business activities in alternative locations. Hence, one is likely to observe the same international organization using different governance modes in different locations, while also expanding (or contracting) business activities at different speeds in those locations.
References

Books and articles


**Videos**

Discussion Questions

1. In September 2013, Microsoft announced that it would acquire the Finnish Company Nokia’s telephone business. This announcement came three years after working with Nokia in an alliance in which Nokia manufactured the mobile hand sets and Microsoft supplied the operating system for the handsets. As a shareholder of Microsoft, what advantages do you think Microsoft will gain from acquiring Nokia? What are the disadvantages? Why do you think Microsoft chose not to acquire Nokia three years earlier when it decided to partner with Nokia to develop smartphones based on Microsoft’s operating system?

2. In September 2011, Toyota announced that it had started a series of basic research projects with a number of U.S. universities to better understand key safety issues facing the automobile industry, such as reducing driver distraction, cutting teen accidents and protecting pedestrians in crashes. The announced program will cost the company $50 million dollars over 5 years. Toyota set up a center it named the Collaborative Safety Research Center to work with outside institutes in North America. Joining with universities represents a shift in the way that Toyota conducts its research. Previously, most of the company’s work was proprietary. The new studies will be published and made available to other auto makers. The research drive into safety and the company’s promise to share its findings with other auto makers follow the quality and safety troubles that Toyota suffered in 2010, when poorly designed floor mats were found to cause some Toyota models to speed up on their own by pinning down the vehicles’ gas pedals. Do you think that Toyota might have chosen the alliance relationship with universities even if it hadn’t been investigated and fined by U.S. regulators for safety violations? Specifically, what advantages do you think the company gains from engaging in safety research through partnerships with U.S. universities with research findings available to the public? What are the disadvantages?

3. Honda Motor Co. recently announced that it planned to sell electric – gasoline hybrid cars in China and would likely start producing hybrid cars in China in a few years if it meets its sales targets in that country. Most imported hybrid cars in China are expensive for consumers because of hefty duties and taxes. As a consequence, Honda currently sells only 200 to 300 hybrids a year in China. Nevertheless, Honda expects to be able to sell roughly 50,000 hybrid cars within the next three years if it succeeds in making its hybrid technology acceptable to consumers. The sales effort might get a big push from stringent new Chinese fuel-economy standards expected to be phased in over the coming years. However, Beijing has yet to detail the requirements. Honda and other Japanese auto makers enjoyed a boost in sales in the U.S. when new fuel-efficiency standards were introduced in that country. Initially the company would start with knock-down production, which involves assembling vehicles from already-made parts, while bringing components such as batteries and motors from Japan. But over time, Honda would begin buying or making parts locally, especially batteries and motors that are heavy and, therefore, expensive to import from Japan. In what way is Honda’s plan an example of a real options’ approach to geographical diversification?

4. In the article by D. Yiu and S. Makino (2002), the authors draw a fairly sharp distinction between transactions cost-based explanations of choice of international business mode and institutional-based theories of mode choice. Specifically, they argue that the former focuses on “efficiency” as the primary determinant of the choice of governance structure, whereas the latter focuses on “legitimacy” as the
primary determinant. Do you think there is a meaningful distinction between the two from the perspective of international business managers? Asked differently, do you think the two criteria would lead to different choices about governance structure in any given circumstance or would they lead to the same choice? Explain your answer.

5. Starbucks CEO Howard Schultz announced in April 2010 that China would usurp Japan as Starbucks biggest market outside North America in announcing the company’s plans to open thousands of stores in China over time. But Schultz said that Starbucks would plan its China growth carefully. The Company opened its first store in China in 1999; yet by mid-2010 it had only 376 stores on China’s mainland, compared with 878 in Japan, a market it entered in 1996. Why do you think Starbucks expanded more rapidly in Japan than in China? With the benefit of hindsight, do you think Starbucks should have expanded faster in China than it did and perhaps slower in Japan?