Central
European
Study
Programme

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IP_314
International Management

WEEK 3 Entry Mode Strategies

Steps in the internalization of a firm
Multinational corporations (MNCs)
Risks that MNCs incur and their mitigation

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Outline

- <u>**Internationalization of a company**</u>
  - 4 stages
  - Eclectic (OLI) model
- **Case study on the Czech automotive industry**
- **Risks in international business**
  - Risk types
- **Strategies for avoiding and reducing the risks**
  - Diversification and hedging

Why internationalize?

- More profit opportunities.
- More customers to achieve economies of scale.
- Lower dependence on one market.
- Desire to offset global competitors.
- Offering international service to customers.

What are the barriers?

- High costs / lack of financial capital.
- Little knowledge of foreign cultures.
- Little understanding of needs of foreign customers.
- Little understanding of foreign legal system.
- Few managers with international expertise.
- Volatile country environment –> politics?

Major decisions in international management

- Deciding whether to go
- Deciding which markets to enter
- Deciding how to enter
- Deciding on the strategy, e.g. marketing program
- Deciding on the organization

Four stages of internationalization (Uppsala school model, 1970s)

- Stage 1: No regular export activities
- Stage 2: Export via independent agents
- Stage 3: Establish sales subsidiaries
- Stage 4: Establish production facilities abroad

Stage 1: No regular export activities

- The company is **purely domestic** and does not consider the alternative of going international.

- Today, small and medium-sized regional / local companies (SMEs).

Stage 2: Export via independent agents

- Having reached the **limits in its domestic market**, the company searches for foreign customers via **intermediaries**.

- Small and medium-sized companies across the country (SMEs).

Stage 3: Establish sales subsidiaries

- The **strategy** developed for the home market get **extended into foreign markets**.

- Smaller multinational companies (MNCs).

Stage 4: Establish production facilities abroad

- The focus of the company is **multinational**, or in strategic terms, multi-domestic. The company applies one of the four **international(ization) strategies**: *ethnocentric*, *polycentric*, *regional* or *global*.

- MNCs and transnational companies (TNCs).

Result: MNCs and TNCs

- "**Multinational company** – any company that engages in business functions beyond its domestic borders" /general notion/

John B. Cullen, K. Praveen Parboteeah
Multinational Management: A Strategic Approach, 5e, 2015

- **Multinational corporation** – next step of MNC, includes a holding company.

- **Transnational corporation** – global MNC, final stage of internationalization.

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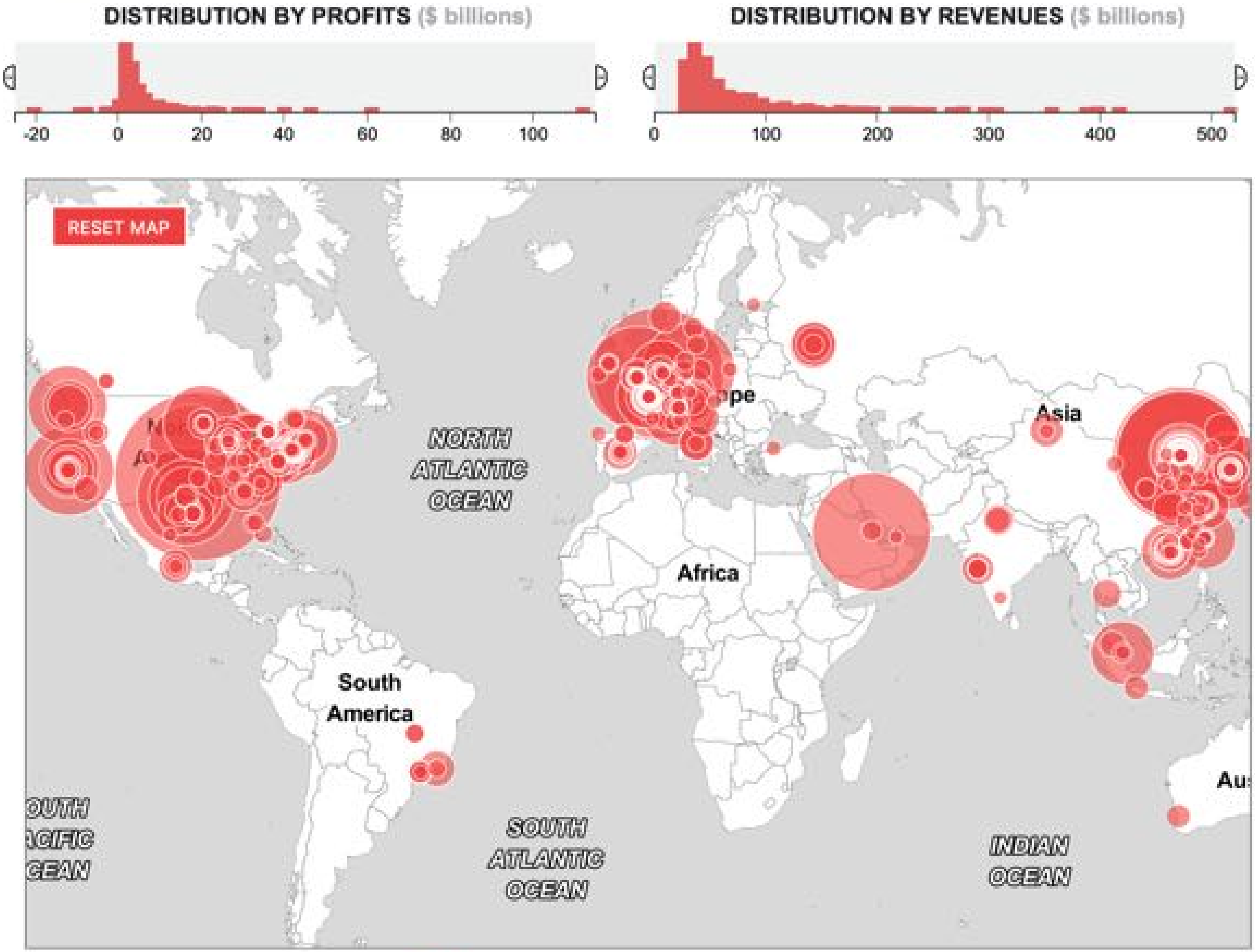
TNC (1)

Source: Fortune, 2019

RANK	NAME	REVENUES ($M)	REVENUE PERCENT CHANGE	PROFITS ($M)	ASSETS ($M)	PROFITS PERCENT CHANGE	EMPLOYEES	CHANGE IN RANK
1	Walmart	$514,405.00	2.8%	$6,670.00	$219,295.00	-32.4%	2,200,000	-
2	Sinopec Group	$414,649.90	26.8%	$5,845.00	$329,186.30	280.1%	619,151	1
3	Royal Dutch Shell	$396,556.00	27.2%	$23,352.00	$399,194.00	79.9%	81,000	2
4	China National Petroleum	$392,976.60	20.5%	$2,270.50	$601,899.90	-	1,382,401	-
5	State Grid	$387,056.00	10.9%	$8,174.80	$572,309.50	-14.3%	917,717	-3
6	Saudi Aramco	$355,905.00	35.3%	$110,974.50	$358,872.90	46.9%	76,418	-
7	BP	$303,738.00	24.2%	$9,383.00	$282,176.00	176.9%	73,000	1
8	Exxon Mobil	$290,212.00	18.8%	$20,840.00	$346,196.00	5.7%	71,000	1
9	Volkswagen	$278,341.50	7%	$14,322.50	$523,672.30	9.3%	664,496	-2
10	Toyota Motor	$272,612.00	2.8%	$16,982.00	$469,295.60	-24.6%	370,870	-4
11	Apple	$265,595.00	15.9%	$59,531.00	$365,725.00	23.1%	132,000	-
12	Berkshire Hathaway	$247,837.00	2.4%	$4,021.00	$707,794.00	-91.1%	389,000	-2
13	Amazon.com	$232,887.00	30.9%	$10,073.00	$162,648.00	232.1%	647,500	5
14	UnitedHealth Group	$226,247.00	12.5%	$11,986.00	$152,221.00	13.5%	300,000	1
15	Samsung Electronics	$221,579.40	4.5%	$39,895.20	$304,165.30	9.1%	309,630	-3

TNC (2)

Source: Fortune, 2019



501 HEADQUARTERS DISPLAYED

Map tiles by Stamen - Design by Nicolas Rapp for Fortune

Factors influencing internationalization today

- **Line of international business:**
  - Goods, services and their combinations (products)
- **Mode of entry into foreign markets:**
  - Indirect exporting, direct exporting, licensing, joint ventures, direct investment.
- **Choice of target markets:**
  - Based on PEST(LE), geographical location etc.
- **Organizational structure of the company:**
  - Export department, international division etc.
- **Human resources of the company:**
  - Experiences with international business etc.
- **Information and communication technologies.**

Five modes of entry into foreign markets

Capital non-intensive modes

- Indirect exporting
- Direct exporting
- Licensing

Capital intensive modes

- Joint ventures
- Direct investment

Commitment, Risk, Control, Profit Potential

OLI model – Eclectic paradigm

© John Harry Dunning, British Economist, 1979

Internationalization factors

- **(O) Ownership-specific advantages:**
  - Intellectual property (patents, production technology, trademarks, industrial designs), entrepreneurial skills, innovation capacity, returns to scale, market share etc.
- **(L) Location-specific advantages:**
  - Factors of production (raw materials, qualified workforce, low wages etc.), infrastructure, special taxes or tariffs, cultural proximity, stability of the target market.
- **(I) Internalization advantage:**
  - Advantages by own production rather than producing through a partnership arrangement: experiences with international business, organizational structure, quality control, HQ – subsidiary coordination.

OLI model – application

Mode	O	L	I
Capital entry mode	+	+	+
Exporting	+	-	+
Licensing	+	-	-

NB: The significance of each of these advantages and the combinations between them is likely to vary across industries / types of value-added activities, regions or countries and among firms.

Additional: Product life cycle model

© Raymond Vernon, Harvard University, 1966

Stage 1: Introduction /unique, luxury product/

- New product is introduced (in rich, i.e. developed countries) to meet *domestic needs* and is *first exported to similar countries*, the ones which have similar needs, preferences and incomes.

Stage 2: Growth /known but not commonplace product/

- A *copy product is produced abroad*, which motivates producers to *move production to other countries*, based on cost of production.

Stage 3: Maturity /usual, commonplace product/

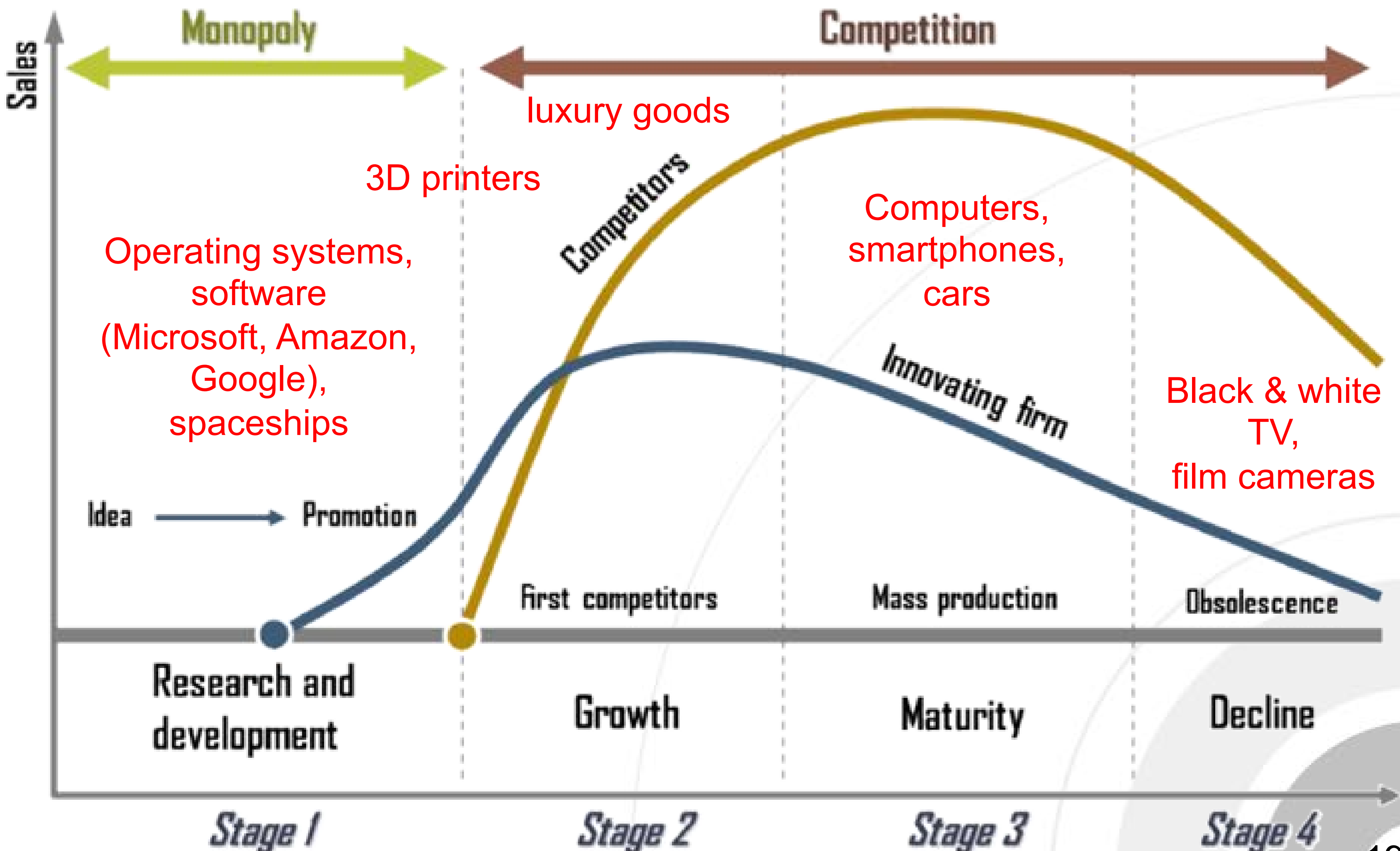
- The *industry contracts* and the *lowest cost producers*, especially in the developing world, become the main suppliers.

Stage 4: Decline /cheap everyday product/

- Poor countries, e.g. the least developed countries (LDCs), constitute the only markets for the product.

Source: Hofstra University

Product life cycle



Outline

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Case study on the Czech automotive industry

- **Download the study from this URL (Full Text/PDF):** https://cebr.vse.cz/pdfs/cbr/2015/03/04.pdf
- **Study the text (15–30 minutes).**
- **Discuss the example of each factory**: VW (Škoda Auto), Toyota and PSA (TPCA) and Hyundai (Hyundai). Why did their parent companies choose the Czech Republic? What was the entry mode?
- **Does the study portray a successful case of internationalization? If not, what was the problem?**
- **Did you find any statistics surprising?**

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The Four Types of Risks in IB

1. **Cross-cultural risk:** A situation or event when a cultural miscommunication puts *the result of a business operation at stake* or hampers the *functioning of a multinational company*.
2. **Country risk**: Potentially adverse effects on a multinational company's business operations and/or profitability by *developments in the PEST(LE)* of a country.
3. **Currency risk:** *Adverse unexpected fluctuations* in exchange rates or introduction of tighter *foreign exchange controls/limitations*.
4. **Commercial risk:** *Potential loss/failure from not well developed and/or executed business strategies*, tactics, or procedures in an multinational company or from *behavior of its business partner*.

Cross-Cultural Risk

- Differences in **language**, **lifestyles**, **attitudes**, **customs**, and **religion**, where a cultural miscommunication jeopardizes a culturally-valued mindset or behavior.
- **Cultural blunders** – hinder the effectiveness of foreign managers.
- **Language – critical dimension of culture – a window to people's values.**
- Language differences impede effective communication.
- Cultural differences may lead to **suboptimal business strategies**.

Example

“Daimler-Chrysler last week hung a big "for sale" sign on the Chrysler part of its corporate corpus. It seems likely now that the deal hailed nine years ago as the harbinger of a new age of transnational industrialism now will be regarded as just another failed mega-merger.

Whether the marriage of Daimler-Benz AG and Chrysler Corp. was a flawed idea based on phantom synergies, or whether it was a brilliant concept whose execution was horribly botched, will be debated within the auto industry and in business schools for years to come. It's likely that both are true: The synergies were overestimated and ***the clash of cultures made things much worse****.”*

DaimlerChrysler: The Divorce
By PAUL INGRASSIA
Updated Feb. 21, 2007 12:01 a.m. ET
http://www.wsj.com/articles/SB117203033453014589

Country (Political) Risk

- Every country is characterized by **diverse political and legal systems** that pose significant challenges for company strategy and performance, as managers must adhere to business laws and regulations.
- **Preferential subsidies**, **government incentives**, and **protection from competition** reduce business costs and influence strategic decision making.
- Governments encourage **domestic investment from foreign MNCs** by offering tax holidays and cash incentives to employ local workers.
- Political risk also includes social unrest, strikes, revolutions and other forms of **political instability**.

Source: Internet

Example

"Revolutions" in the Eastern European, Balkan and Middle East countries (Arab Spring) etc.
+ (Trade) wars + Sanctions.

Currency Risk

- **Currency risk –** arises from changes in the price of one currency relative to another → **complicates cross-border transactions → impacts firms with foreign currency obligations.**

- **If supplier's currency appreciates**; the company may need to hand over a larger amount of the currency to pay for the purchase.

- **If buyer's currency depreciates**; the company may receive a smaller payment amount in the currency (if sales price was expressed in the customer's currency).

- When currencies fluctuate significantly, **the value of the firm's assets, liabilities and/or operating income may be substantially reduced**.

Source: Bloomberg, Raobeco

Example

Commercial Risk

- **Less than optimal formulation and/or implementation** of strategies, tactics or procedures, e.g. **partnering selections**, market entry timing, pricing, product features, and promotional themes.

- **Failures in international markets are far more costly than domestic business blunders.**

Source: Internet

Example

Lehman Brothers created several new investment schemes in early 2000s, which collapsed during the crisis.

The three major Icelandic banks were involved in international operations with 'toxic assets', which led to huge losses in 2008.

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Risk management

- **Identifying the risks.**
- **Determining the acceptable level of risk for the company.**
- **Four methods of reducing risk:**
  - *Not doing anything* –> being optimist.
  - *Diversification* of assets, territories, currencies etc.
  - *Insurance* if available.
  - *Hedging* – purchasing financial instruments to tackle currency and financial risks.

Insurance

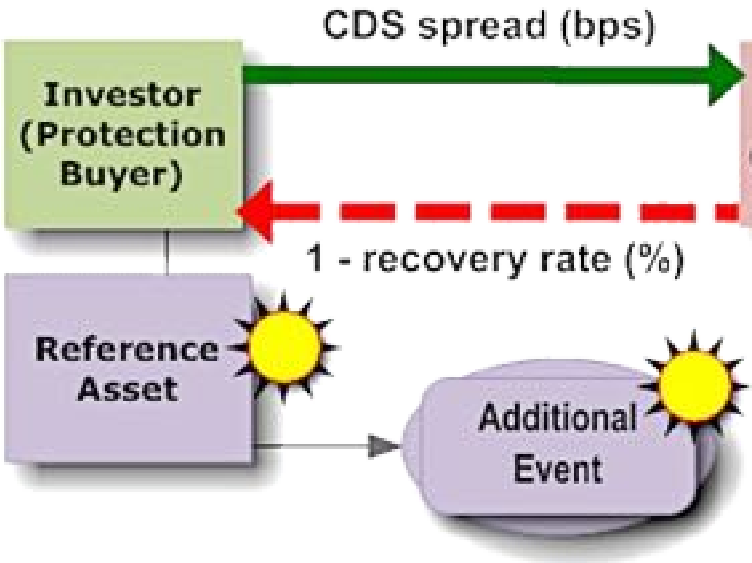
- **Standard/classical insurance – performed by insurance companies** (in Europe AXA, Allianz):
  - *Commercial risks*, e.g. *transport risk.*

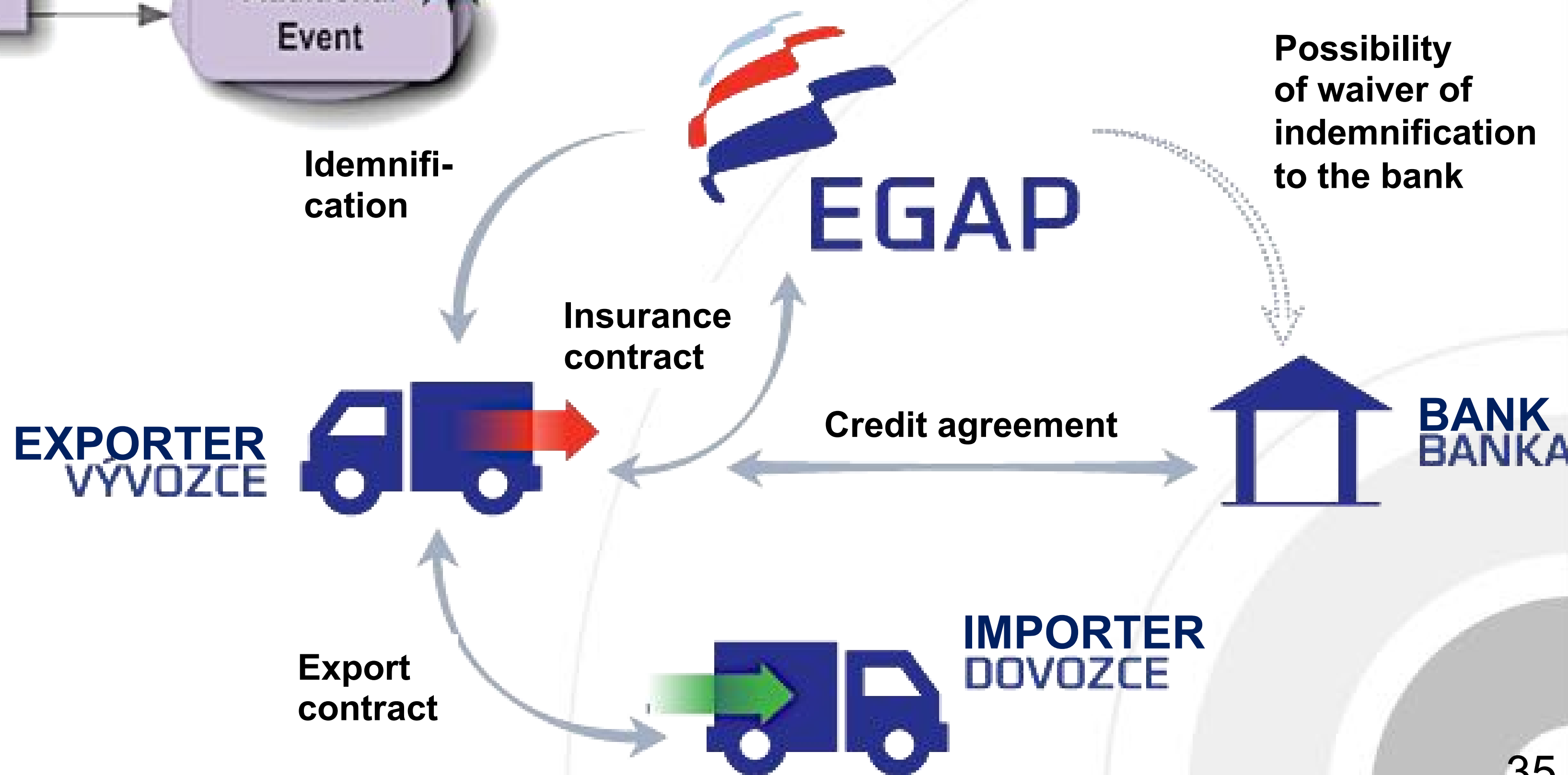
- **Over-the-counter insurance (OTC) – performed by insurance companies** (in the US – AIG) **and non-classical financial institutions:**
  - *Credit default swaps (CDS)* for investment into financial instruments, e.g. CDOs or government bonds.

- **With state support – state-owned institutions promoting export/investment** (in CZ – EGAP):
  - *Country risks*, e.g. non-payment of contract price due to partner's insolvency or force majeure

Example

Source: CreditLime, EGAP



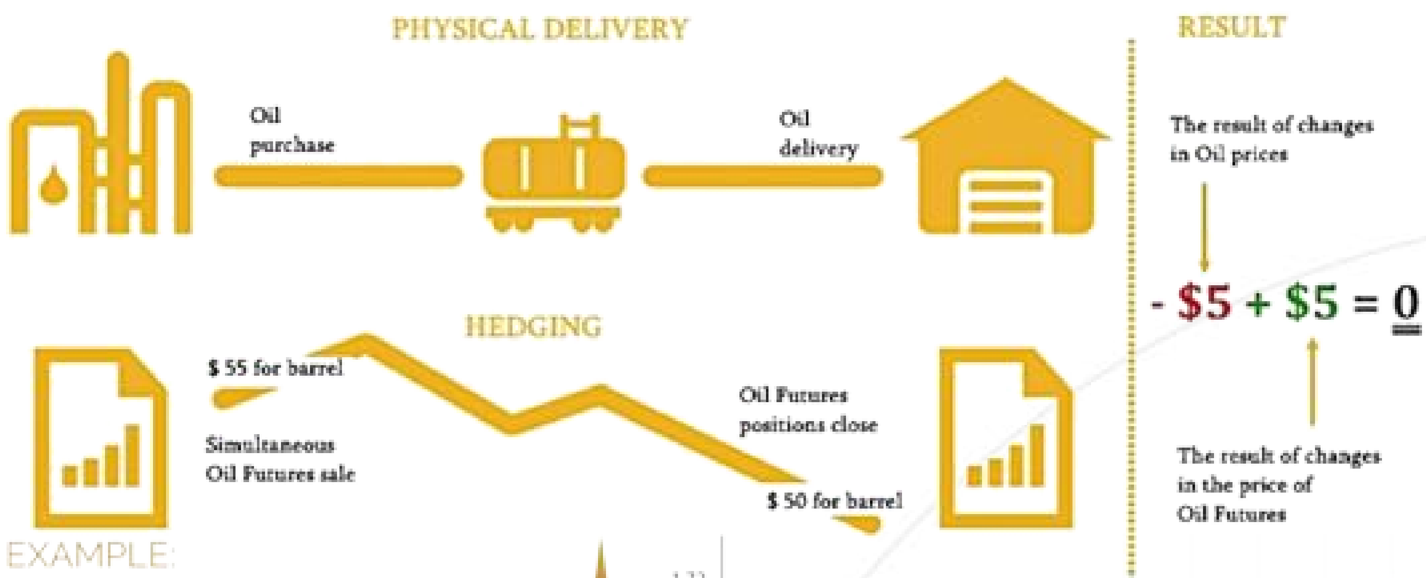


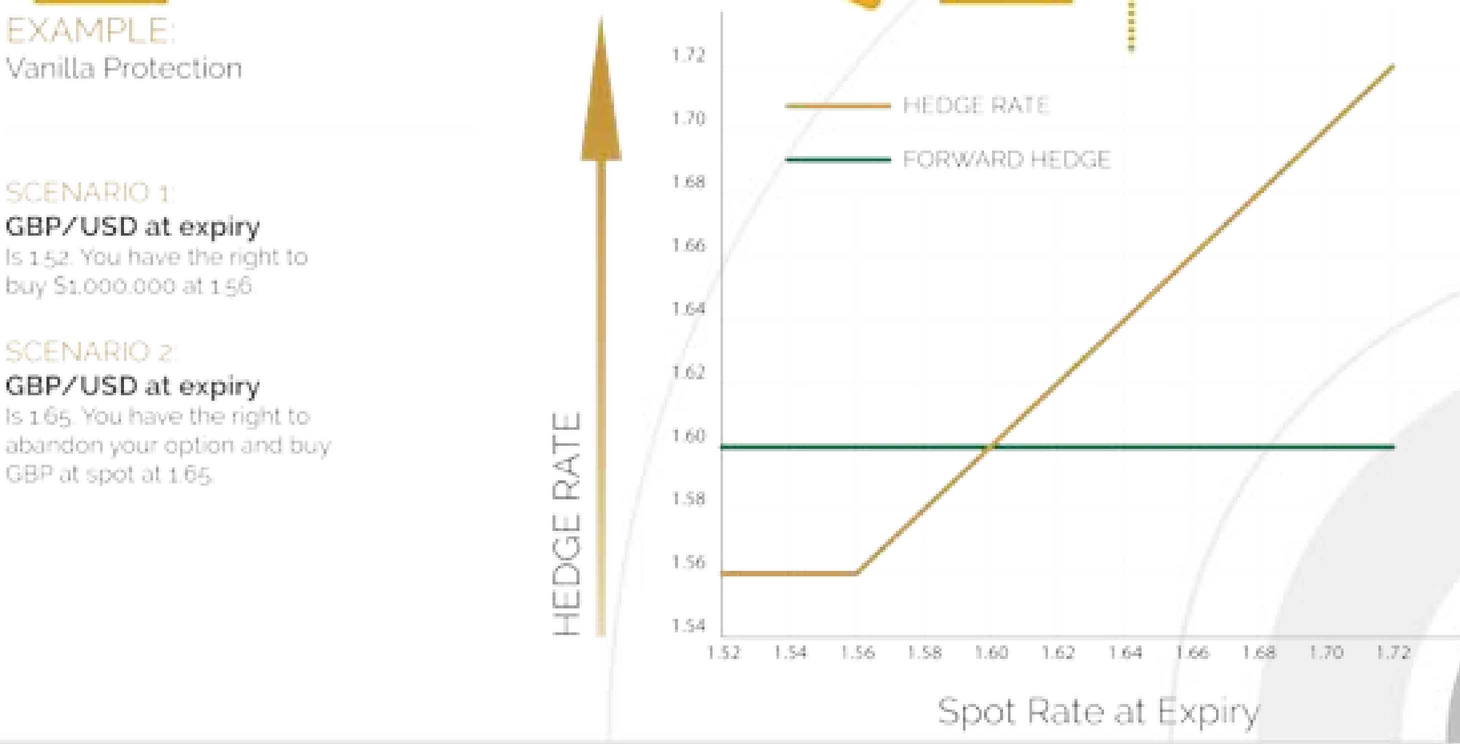
Hedging via financial instruments

- **Forward contract /over the counter/:**
  - a *non-standardized contract* between two parties to buy or to sell an asset *at a specified future time at a price agreed upon today*.
- **Futures contract /futures exchange/:**
  - a contractual agreement, generally made on the *trading floor of a futures exchange*, to buy or sell a particular commodity or financial instrument *at a pre-determined price in the future*.
- **Options contract /both/:**
  - an agreement between a buyer and seller that gives the purchaser of the option *the right to buy or sell* a particular asset *at a later date at an agreed upon price.* In case of *non-fulfillment*, the seller of the option receives a *premium.*
- **Swap contract /over the counter/:**
  - a contractual agreement through which two parties *exchange financial instruments* or *cash flows*.

Source: Renesource, South-West Foreign Exchange

Example





Thank you for your attention!

Questions?

The slides are available at
http://cesp.vse.cz/academics/materials/

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