The reading on the Entry Mode:

Once a firm decides to enter a foreign market, the question arises as to the best mode

of entry. Firms can use six different modes to enter foreign markets: exporting, turnkey

projects, licensing, franchising, establishing joint ventures with a host-country

firm, or setting up a new wholly owned subsidiary in the host country. Each entry

mode has advantages and disadvantages. Managers need to consider these carefully

when deciding which to use. 11

**EXPORTING** Many manufacturing firms begin their global expansion as exporters

and only later switch to another mode for serving a foreign market. We take a close

look at the mechanics of exporting in the next chapter. Here we focus on the advantages

and disadvantages of exporting as an entry mode.

Advantages **Exporting**has two distinct advantages. First, it avoids the often substantial

costs of establishing manufacturing operations in the host country. Second,

exporting may help a firm achieve experience curve and location economies (see

Chapter 11). By manufacturing the product in a centralized location and exporting it

to other national markets, the firm may realize substantial scale economies from its

global sales volume. This is how Sony came to dominate the global TV market, how

Matsushita came to dominate the VCR market, how many Japanese automakers made

inroads into the U.S. market, and how South Korean firms such as Samsung gained

market share in computer memory chips.

Disadvantages Exporting has a number of drawbacks. First, exporting from the

firm’s home base may not be appropriate if lower-cost locations for manufacturing the

product can be found abroad (i.e., if the firm can realize location economies by moving

production elsewhere). Thus, particularly for firms pursuing global or transnational

strategies, it may be preferable to manufacture where the mix of factor

conditions is most favorable from a value creation perspective and to export to the rest

of the world from that location. This is not so much an argument against exporting as

an argument against exporting from the firm’s home country. Many U.S. electronics

firms have moved some of their manufacturing to the Far East because of the availability

of low-cost, highly skilled labor there. They then export from that location to

the rest of the world, including the United States.

A second drawback to exporting is that high transport costs can make exporting

uneconomical, particularly for bulk products. One way of getting around this is to

**LEARNING OBJECTIVE 2**

Compare and contrast the

different modes that firms

use to enter foreign

markets.

**Exporting**

Sale of products

produced in one country

to residents of another

country.

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manufacture bulk products regionally. This strategy

enables the firm to realize some economies from

large-scale production and at the same time to limit

its transport costs. For example, many multinational

chemical firms manufacture their products regionally,

serving several countries from one facility.

Another drawback is that tariff barriers can

make exporting uneconomical. Similarly, the threat

of tariff barriers by the host-country government

can make it very risky. A fourth drawback to exporting

arises when a firm delegates its marketing,

sales, and service in each country where it does

business to another company. This is a common

approach for manufacturing firms that are just beginning

to expand internationally. The other company

may be a local agent, or it may be another

multinational with extensive international distribution

operations. Local agents often carry the products

of competing firms and so have divided loyalties. In such cases, the local agent

may not do as good a job as the firm would if it managed its marketing itself. Similar

problems can occur when another multinational takes on distribution.

The way around such problems is to set up wholly owned subsidiaries in foreign

nations to handle local marketing, sales, and service. By doing this, the firm can exercise

tight control over marketing and sales in the country while reaping the cost advantages

of manufacturing the product in a single location, or a few choice locations.

**TURNKEY PROJECTS** Firms that specialize in the design, construction, and

start-up of turnkey plants are common in some industries. In a **turnkey project,** the

contractor agrees to handle every detail of the project for a foreign client, including

the training of operating personnel. At completion of the contract, the foreign client is

handed the “key” to a plant that is ready for full operation—hence, the term *turnkey.*

This is a means of exporting process technology to other countries. Turnkey projects

are most common in the chemical, pharmaceutical, petroleum refining, and metal refining

industries, all of which use complex, expensive production technologies.

Advantages The know-how required to assemble and run a technologically complex

process, such as refining petroleum or steel, is a valuable asset. Turnkey projects

are a way of earning great economic returns from that asset. The strategy is particularly

useful where FDI is limited by host-government regulations. For example, the

governments of many oil-rich countries have set out to build their own petroleum

refining industries, so they restrict FDI in their oil and refining sectors. But because

many of these countries lack petroleum-refining technology, they gain it by entering

into turnkey projects with foreign firms that have the technology. Such deals are often

attractive to the selling firm because without them, they would have no way to earn a

return on their valuable know-how in that country. A turnkey strategy can also be less

risky than conventional FDI. In a country with unstable political and economic environments,

a longer-term investment might expose the firm to unacceptable political

and/or economic risks (e.g., the risk of nationalization or of economic collapse).

Disadvantages Three main drawbacks are associated with a turnkey strategy.

First, the firm that enters into a turnkey deal will have no long-term interest in the

foreign country. This can be a disadvantage if that country subsequently proves to be

**Another** Perspective

**Saudi Arabia to Export Phosphate**

In an effort to curb its reliance on oil as the country’s primary

export commodity, the kingdom of Saudi Arabia has taken

steps to develop and market a number of its other natural

resources, including phosphate, gold, and bauxite, the main

source of aluminum. Phosphate is important in the manufacture

of many commercial fertilizers. As the world population

continues to grow, the global food crisis deepens, leading

economists to emphasize the need to optimize crop yields.

Thus, fertilizer stands to become an important commodity.

According to the Saudi Ports Authority, plans are under way

to export phosphates from the port of Ras al-Zour. (“Saudis

to Start Exporting Phosphates in Dec—Paper,” *Reuters.com,*

January 27, 2010, www.reuters.com)

**Turnkey Project**

A project in which a

firm agrees to set up an

operating plant for a

foreign client and hand

over the “key” when the

plant is fully operational.

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a major market for the output of the process that has been exported. One way around

this is to take a minority equity interest in the operation. Second, the firm that enters

into a turnkey project with a foreign enterprise may inadvertently create a competitor.

For example, many of the Western firms that sold oil-refining technology to firms in

Saudi Arabia, Kuwait, and other Gulf states now find themselves competing with these

firms in the world oil market. Third, if the firm’s process technology is a source of

competitive advantage, then selling this technology through a turnkey project is also

selling competitive advantage to potential and/or actual competitors.

**LICENSING** A **licensing agreement** is an arrangement whereby a licensor grants

the rights to intangible property to another entity (the licensee) for a specified period,

and in return, the licensor receives a royalty fee from the licensee. 12 Intangible property

includes patents, inventions, formulas, processes, designs, copyrights, and trademarks.

For example, to enter the Japanese market, Xerox, inventor of the photocopier, established

a joint venture with Fuji Photo that is known as Fuji–Xerox. Xerox then licensed

its xerographic know-how to Fuji–Xerox. In return, Fuji–Xerox paid Xerox a royalty fee

equal to 5 percent of the net sales revenue that Fuji–Xerox earned from the sales of

photocopiers based on Xerox’s patented know-how. In the Fuji–Xerox case, the license

was originally granted for 10 years, and it has been renegotiated and extended several

times since. The licensing agreement between Xerox and Fuji–Xerox also limited Fuji–

Xerox’s direct sales to the Asian Pacific region (although Fuji–Xerox does supply Xerox

with photocopiers that are sold in North America under the Xerox label). 13

Advantages In the typical international licensing deal, the licensee puts up most

of the capital necessary to get the overseas operation going. Thus, a primary advantage

of licensing is that the firm does not have to bear the development costs and risks associated

with opening a foreign market. Licensing is very attractive for firms lacking

the capital to develop operations overseas. In addition, licensing can be attractive

when a firm is unwilling to commit substantial financial resources to an unfamiliar or

politically volatile foreign market. Licensing is also often used when a firm wishes to

participate in a foreign market but is prohibited from doing so by barriers to investment.

This was one of the original reasons for the formation of the Fuji–Xerox joint

venture in 1962. Xerox wanted to participate in the Japanese market but was prohibited

from setting up a wholly owned subsidiary by the Japanese government. So Xerox

set up the joint venture with Fuji and then licensed its know-how to the joint venture.

Finally, licensing is frequently used when a firm possesses some intangible property

that might have business applications, but it does not want to develop those applications

itself. For example, Bell Laboratories at AT&I originally invented the transistor

circuit in the 1950s, but AT&I decided it did not want to produce transistors, so it

licensed the technology to a number of other companies, such as Texas Instruments.

Similarly, Coca-Cola has licensed its famous trademark to clothing manufacturers,

which have incorporated the design into clothing.

Disadvantages Licensing has three serious drawbacks. First, it does not give a

firm the tight control over manufacturing, marketing, and strategy that is required for

realizing experience curve and location economies. Licensing typically involves each

licensee setting up its own production operations. This severely limits the firm’s ability

to realize experience curve and location economies by producing its product in a centralized

location. When these economies are important, licensing may not be the best

way to expand overseas.

Second, competing in a global market may require a firm to coordinate strategic

moves across countries by using profits earned in one country to support competitive

**Licensing**

Occurs when a firm (the

licensor) licenses the

rights to produce its

product, its production

processes, or its brand

name or trademark to

another firm (the

licensee); in return, the

licensor collects a royalty

fee from the licensee.

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attacks in another. By its very nature, licensing limits a

firm’s ability to do this. A licensee is unlikely to allow

a multinational firm to use its profits (beyond those

due in the form of royalty payments) to support a different

licensee operating in another country.

A third problem with licensing is one that we

encountered in Chapter 7 when we reviewed the

economic theory of FDI. This is the risk associated

with licensing technological know-how to foreign

companies. Technological know-how constitutes the

basis of many multinational firms’ competitive advantage.

Most firms wish to maintain control over

how their know-how is used, and a firm can quickly

lose control over its technology by licensing it. Many

firms have made the mistake of thinking they could

maintain control over their know-how within the

framework of a licensing agreement. RCA Corporation,

for example, once licensed its color TV technology to Japanese firms including

Matsushita and Sony. The Japanese firms quickly assimilated the technology,

improved on it, and used it to enter the U.S. market, taking substantial market share

away from RCA.

There are ways of reducing this risk. One way is by entering into a cross-licensing

agreement with a foreign firm. Under a cross-licensing agreement, a firm might

license some valuable intangible property to a foreign partner, but in addition to a

royalty payment, the firm might also request that the foreign partner license some of

its valuable know-how to the firm. Such agreements are believed to reduce the risks

associated with licensing technological know-how, since the licensee realizes that if it

violates the licensing contract (by using the knowledge obtained to compete directly

with the licensor), the licensor can do the same to it. Cross-licensing agreements

enable firms to hold each other hostage, which reduces the probability that they will

behave opportunistically toward each other. 14 Such cross-licensing agreements are

increasingly common in high-technology industries. For example, the U.S. biotechnology

firm Amgen licensed one of its key drugs, Nuprogene, to Kirin, the Japanese

pharmaceutical company. The license gives Kirin the right to sell Nuprogene in Japan.

In return, Amgen receives a royalty payment and, through a licensing agreement,

gained the right to sell some of Kirin’s products in the United States.

Another way of reducing the risk associated with licensing is to follow the Fuji–Xerox

model and link an agreement to license know-how with the formation of a joint venture

in which the licensor and licensee take important equity stakes. Such an approach

aligns the interests of licensor and licensee because both have a stake in ensuring that

the venture is successful. Thus, the risk that Fuji Photo might appropriate Xerox’s

technological know-how and then compete directly against Xerox in the global photocopier

market was reduced by the establishment of a joint venture in which both

Xerox and Fuji Photo had an important stake.

**FRANCHISING** Franchising is similar to licensing, although franchising tends

to involve longer-term commitments than licensing. **Franchising** is basically a specialized

form of licensing in which the franchiser not only sells intangible property (normally

a trademark) to the franchisee, but also insists that the franchisee agree to abide

by strict rules as to how it does business. The franchiser will also often assist the franchisee

to run the business on an ongoing basis. As with licensing, the franchiser typically

receives a royalty payment, which amounts to some percentage of the franchisee’s

At the completion of the contract, the foreign client is handed the “key”

to a plant that is ready for full operation.

**Franchising**

A specialized form of

licensing in which the

franchiser sells

intangible property to the

franchisee and insists on

rules to conduct the

business.

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revenues. Whereas licensing is pursued primarily by manufacturing firms, franchising

is employed primarily by service firms. 15 McDonald’s is a good example of a firm that

has grown by using a franchising strategy. McDonald’s strict rules as to how franchisees

should operate a restaurant extend to control over the menu, cooking methods,

staffing policies, and design and location. McDonald’s also organizes the supply chain

for its franchisees and provides management training and financial assistance. 16

Advantages The advantages of franchising as an entry mode are very similar to

those of licensing. The firm is relieved of many of the costs and risks of opening a

foreign market on its own. Instead, the franchisee typically assumes those costs and

risks. This creates a good incentive for the franchisee to build a profitable operation as

quickly as possible. Thus, using a franchising strategy, a service firm can build a global

presence quickly and at a relatively low cost and risk, as McDonald’s has.

Disadvantages The disadvantages are less pronounced than in the case of licensing.

Since franchising is often used by service companies, there is no reason to consider

the need for coordination of manufacturing to achieve experience curve and

location economies. But franchising may inhibit the firm’s ability to take profits out of

one country to support competitive attacks in another. A more significant disadvantage

of franchising is quality control. The foundation of franchising arrangements is

that the firm’s brand name conveys a message to consumers about the quality of the

firm’s product. Thus, a business traveler checking in at a Four Seasons hotel in Hong

Kong can reasonably expect the same quality of room, food, and service that she would

receive in New York. The Four Seasons name is supposed to guarantee consistent

product quality. This presents a problem in that foreign franchisees may not be as

concerned about quality as they are supposed to be, and the result of poor quality can

extend beyond lost sales in a particular foreign market to a decline in the firm’s worldwide

reputation. For example, if the business traveler has a bad experience at the Four

Seasons in Hong Kong, she may never go to another Four Seasons hotel and may urge

her colleagues to do likewise. The geographical distance of the firm from its foreign

franchisees can make poor quality difficult to detect. In addition, the sheer numbers of

franchisees—in the case of McDonald’s, tens of thousands—can make quality control

difficult. Due to these factors, quality problems may persist.

One way around this disadvantage is to set up a subsidiary in each country in which

the firm expands. The subsidiary might be wholly owned by the company or a joint

venture with a foreign company. The subsidiary assumes the rights and obligations to

establish franchises throughout the particular country or region. McDonald’s, for

example, establishes a master franchisee in many countries. Typically, this master franchisee

is a joint venture between McDonald’s and a local firm. The proximity and the

smaller number of franchises to oversee reduce the quality control challenge. In addition,

because the subsidiary (or master franchisee) is at least partly owned by the firm,

the firm can place its own managers in the subsidiary to help ensure that it is doing a

good job of monitoring the franchises. This organizational arrangement has proven

very satisfactory for McDonald’s, KFC, and others.

**JOINT VENTURES** A **joint venture** entails establishing a firm that is jointly

owned by two or more otherwise independent firms. Fuji–Xerox, for example, was set

up as a joint venture between Xerox and Fuji Photo. Establishing a joint venture with

a foreign firm has long been a popular mode for entering a new market. As we saw in

the opening case, General Motors used a joint-venture strategy to enter the Chinese

automobile market. The most typical joint venture is a 50/50 venture, in which each of

the two parties holds a 50 percent ownership stake and contributes a team of managers

**Joint Venture**

Establishing a firm that is

jointly owned by two or

more otherwise

independent firms.

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to share operating control. This was the case with the Fuji–Xerox joint venture until

2001; it is now a 25/75 venture with Xerox holding 25 percent. The GM SAIC venture

in China was a 50/50 venture until 2010, when it became a 51/49 venture, with

SAIC holding the 51 percent stake. Some firms, however, have sought joint ventures

in which they have a majority share and thus tighter control. 17

Advantages Joint ventures have a number of advantages. First, a firm benefits

from a local partner’s knowledge of the host country’s competitive conditions, culture,

language, political systems, and business systems (this was one reason GM entered

into a joint venture with SAIC in China; see the opening case). Thus, for many U.S.

firms, joint ventures have involved the U.S. company providing technological knowhow

and products and the local partner providing the marketing expertise and the local

knowledge necessary for competing in that country. Second, when the development

costs and/or risks of opening a foreign market are high, a firm might gain by sharing

these costs and or risks with a local partner. Third, in many countries, political considerations

make joint ventures the only feasible entry mode (again, as was the case with

GM’s joint venture with SAIC). Research suggests joint ventures with local partners

face a low risk of being subject to nationalization or other forms of adverse government

interference. 18 This appears to be because local equity partners, who may have

some influence on host-government policy, have a vested interest in speaking out

against nationalization or government interference.

Disadvantages Despite these advantages, joint ventures have major disadvantages.

First, as with licensing, a firm that enters into a joint venture risks giving control

of its technology to its partner. Thus, a proposed joint venture in 2002 between Boeing

and Mitsubishi Heavy Industries to build a new wide-body jet (the 787), raised fears

that Boeing might unwittingly give away its commercial airline technology to the

Japanese. However, joint-venture agreements can be constructed to minimize this risk.

One option is to hold majority ownership in the venture. This allows the dominant

partner to exercise greater control over its technology. But it can be difficult to find a

foreign partner willing to settle for minority ownership. Another option is to “wall

off ” from a partner technology that is central to the core competence of the firm,

while sharing other technology.

A second disadvantage is that a joint venture does not give a firm the tight control

over subsidiaries that it might need to realize experience curve or location economies.

Nor does it give a firm the tight control over a foreign subsidiary that it might need

for engaging in coordinated global attacks against its rivals. Consider the entry of

Texas Instruments (TI) into the Japanese semiconductor market. When TI established

semiconductor facilities in Japan, it did so for the dual purpose of checking Japanese

manufacturers’ market share and limiting their cash available for invading TI’s global

market. In other words, TI was engaging in global strategic coordination. To implement

this strategy, TI’s subsidiary in Japan had to be prepared to take instructions

from corporate headquarters regarding competitive strategy. The strategy also required

the Japanese subsidiary to run at a loss if necessary. Few if any potential jointventure

partners would have been willing to accept such conditions, since it would

have necessitated a willingness to accept a negative return on investment. Indeed,

many joint ventures establish a degree of autonomy that would make such direct control

over strategic decisions all but impossible to establish. 19Thus, to implement this

strategy, TI set up a wholly owned subsidiary in Japan.

A third disadvantage with joint ventures is that the shared ownership arrangement

can lead to conflicts and battles for control between the investing firms if their goals

and objectives change or if they take different views as to what the strategy should be.

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This was apparently not a problem with the Fuji–Xerox joint venture. According to

Yotaro Kobayashi, currently the chairman of Fuji–Xerox, a primary reason is that both

Xerox and Fuji Photo adopted an arm’s-length relationship with Fuji–Xerox, giving

the venture’s management considerable freedom to determine its own strategy. 20

However, much research indicates that conflicts of interest over strategy and goals

often arise in joint ventures. These conflicts tend to be greater when the venture is

between firms of different nationalities, and they often end in the dissolution of the

venture. 21 Such conflicts tend to be triggered by shifts in the relative bargaining power

of venture partners. For example, in the case of ventures between a foreign firm and a

local firm, as a foreign partner’s knowledge about local market conditions increases, it

depends less on the expertise of a local partner. This increases the bargaining power of

the foreign partner and ultimately leads to conflicts over control of the venture’s strategy

and goals. 22 Some firms have sought to limit such problems by entering into joint

ventures in which one partner has a controlling interest.

**WHOLLY OWNED SUBSIDIARIES** In a **wholly owned subsidiary,** the

firm owns 100 percent of the stock. Establishing a wholly owned subsidiary in a foreign

market can be done two ways. The firm either can set up a new operation in that

country, often referred to as a greenfield venture, or it can acquire an established firm

in the host nation and use that firm to promote its products. 23For example, ING’s

strategy for entering the U.S. insurance market was to acquire established U.S. enterprises,

rather than try to build an operation from the ground floor.

Advantages There are several clear advantages of wholly owned subsidiaries.

First, when a firm’s competitive advantage is based on technological competence, a

wholly owned subsidiary will often be the preferred entry mode because it reduces the

risk of losing control over that competence. (See Chapter 7 for more details.) Many

high-tech firms prefer this entry mode for overseas expansion (e.g., firms in the semiconductor,

electronics, and pharmaceutical industries). Second, a wholly owned subsidiary

gives a firm tight control over operations in different countries. This is necessary

for engaging in global strategic coordination (i.e., using profits from one country to

support competitive attacks in another).

Third, a wholly owned subsidiary may be required if a firm is trying to realize location

and experience curve economies (as firms pursuing global and transnational strategies

try to do). As we saw in Chapter 11, when cost pressures are intense, it may pay

a firm to configure its value chain in such a way that the value added at each stage is

maximized. Thus, a national subsidiary may specialize in manufacturing only part of

the product line or certain components of the end product, exchanging parts and

products with other subsidiaries in the firm’s global system. Establishing such a global

production system requires a high degree of control over the operations of each affiliate.

The various operations must be prepared to accept centrally determined decisions

as to how they will produce, how much they will produce, and how their output will be

priced for transfer to the next operation. Because licensees or joint-venture partners

are unlikely to accept such a subservient role, establishing wholly owned subsidiaries may

be necessary. Finally, establishing a wholly owed subsidiary gives the firm a 100 percent

share in the profits generated in a foreign market.

Disadvantages Establishing a wholly owned subsidiary is generally the most

costly method of serving a foreign market from a capital investment standpoint.

Firms doing this must bear the full capital costs and risks of setting up overseas operations.

The risks associated with learning to do business in a new culture are less if

the firm acquires an established host-country enterprise. However, acquisitions raise

in a Global Marketplace

additional problems, including those associated with trying to marry divergent corporate

cultures. These problems may more than offset any benefits derived by acquiring

an established operation. Because the choice between greenfield ventures

and acquisitions is such an important one, we shall discuss it in more detail later in

the chapter.

Selecting an Entry Mode

As the preceding discussion demonstrated, all the entry modes have advantages and

disadvantages, as summarized in Table 12.1. Thus, trade-offs are inevitable when

selecting an entry mode. For example, when considering entry into an unfamiliar

country with a track record for discriminating against foreign-owned enterprises

when awarding government contracts, a firm might favor a joint venture with a local

enterprise. Its rationale might be that the local partner will help it establish operations

in an unfamiliar environment and will help the company win government contracts.

However, if the firm’s core competence is based on proprietary technology,

entering a joint venture might risk losing control of that technology to the jointventure

partner, in which case the strategy may seem unattractive. Despite the existence

of such trade-offs, it is possible to make some generalizations about the optimal

choice of entry mode. 24

**LEARNING OBJECTIVE 3**

Identify the factors that

influence a firm’s choice of

entry mode.

**Entry**