Chinese Economy and International Exposure

Lecture 4 International Operations of Chinese multinationals

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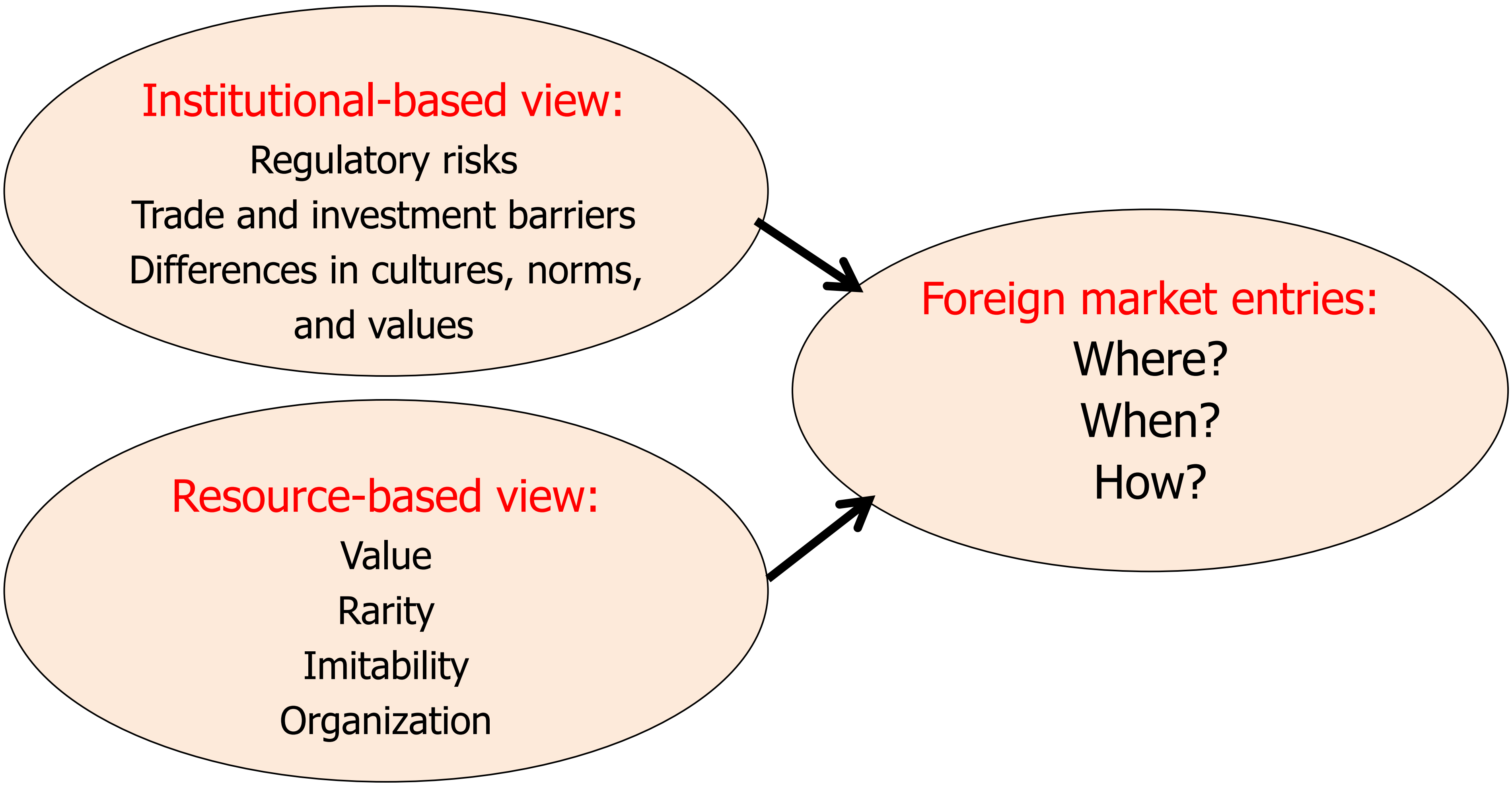
Questions

- Why do firms enter certain countries but not others?
- How do firms overcome their liability of foreignness?
- Why do some firms succeed and others fail?

Case: Pearl River Piano enters foreign markets

- Incumbents:
  - Bosendorffer (Vienna, Austria)
  - Steinway (New York, USA)
  - Grotrian-Steinweg (Braunschweig, Germany)
  - Yamaha(Yokohama, Japan)
    - The largest piano maker in the world in 1990s.
    - In 2008, Yamaha acquired Bosendorffer for a stronger positioning in the premium segment
- Pearl River:
  - Was founded in 1956 in Guangzhou
  - Focused on domestic market, top selling brand in China
  - In 2002, overtook Yamaha to become the largest piano producer in the world, making about 100,000 pianos every year.
- How did it achieve that through FDI as an aspirational product “made in China”?

Institutions, resources, and foreign market entries



Where to enter?

- Two sets of consideration drive the location of foreign entries:
  - Strategic goals;
  - Cultural and institutional distances

(1) Location-specific advantages and strategic goals

- Location-specific advantages: the benefits a firm reaps from features specific to a particular place.
- Location-specific advantages may come from
  - Natural geographical advantage: e.g. Rotterdam seaport and Dubai airport
  - Agglomeration: clustering of economic activities
    - Knowledge spillover, or the diffusion of knowledge from one firm to others among closely located firms that attempt to hire individuals from competitors.
    - Industry demand that creates a skilled labor force whose members may work for different firms without moving out of the region.
    - Industry demand that facilitates a pool of specialized suppliers and buyers also located in the region.

Matching strategic goals with locations

Strategic goals	Location-specific advantages
Market seeking	Abundance of strong market demand and customers willing to pay.
Natural resource seeking	Possession of natural resources and related transport and communication infrastructure
Efficiency seeking	Economies of scale and abundance of low-cost factors, such as labor and suppliers, transport and communication infrastructure
Strategic-asset seeking	Abundance of innovative individuals, enterprises, universities and industrial clusters

(1) Location-specific advantages and strategic goals

- Location-specific advantages may grow, change, and/or decline, prompting a firm to relocate.
- If policy makers fail to maintain the institutional attractiveness and if companies overcrowd and bid up factor costs such as land and talents, some firms may move out of certain locations previously considered advantageous.

(2) Cultural/institutional distances and foreign entry locations

- Institutional distance: the extent of similarity and dissimilarity between the regulatory, normative, and cognitive institutions of two countries.
- Cultural distance is a subset of institutional distance.

(2) Cultural/institutional distances and foreign entry locations

- Two schools of thought have emerged in overcoming these distances:
  - Stage model: firms will enter culturally similar countries during their first stage of internationalization and will then gain more confidence to enter culturally distant countries in later stages.
    - Business between countries that share a language is three times greater than between countries without a common language.
    - Firms from common-law countries are more likely to be interested in other common-law countries.
    - Colony-colonizer links boost trade significantly.
  - It’s more important to consider strategic goals rather than culture and institutions.

When to enter?

- Entry timing: whether there are compelling reason to be an early or late entrant in a particular country.
- First-mover advantage: Benefit that accrues to firms that enter the market first and that later entrants do not enjoy.
- Late-mover advantage: Benefit that accrues to firms that enter the market later and that early entrants do not enjoy.

First-mover advantages	Examples
Proprietary, technological leadership	Apple's iPod, iPad, and iPhone
Preemption of scarce resources	Japanese MNEs have cherry picked leading local suppliers and distributors in Southeast Asia
Establishment of entry barriers for late entrants	Poland's F-16 fighter jet contract
Avoidance of clash with dominant firms at home	Sony, Honda, and Epson went to the US market ahead of their Japanese rivals
Relationships with key shareholders such as governments	Citigroup, JP Morgan Chase, and Metallurgical Corporation of China entered Afghanistan
Late-mover advantages	**Examples**
Opportunity to free ride on first mover investments	Cola wars in China
Resolution of technological and market uncertainties	BMW, GM, and Toyota have patience to wait until the Nissan leaf resolves uncertainties about the electric car
First mover's difficulty to adapt to market changes	

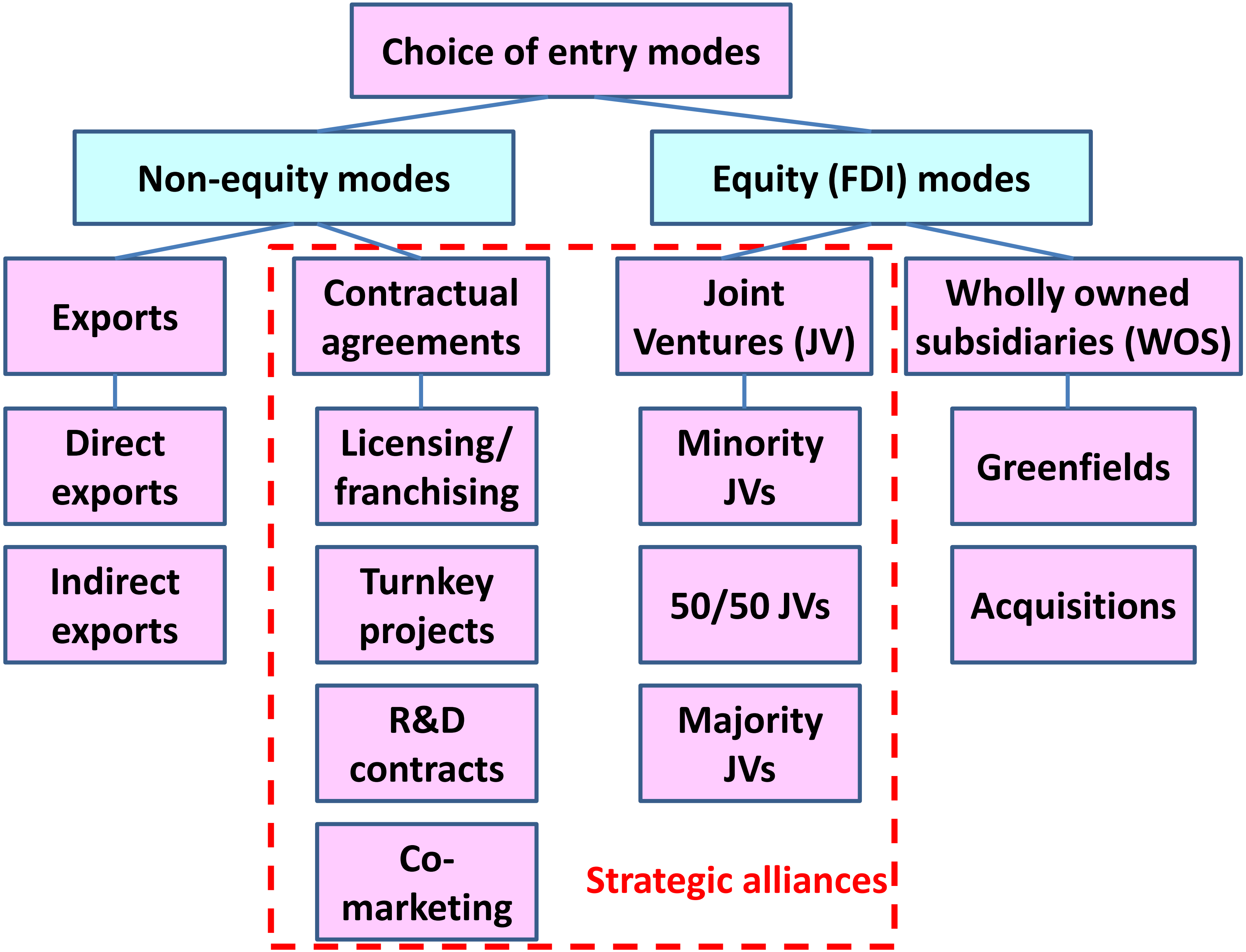
When to enter?

- First movers may have an opportunity to win, their pioneering status is not a guarantee of success.
  - The three first movers into the Chinese automobile industry in 1980s: Volkswagen, Chrysler, and Peugeot
  - The three late movers in 1990s: GM, Honda, and Hyundai
- Entry timing cannot be viewed in isolation, and it has an impact on performance through interaction with other strategic variables.

How to enter?

- Modes of entry:
  - the first step on equity vs. non-equity modes
  - the second step on making actual selections
- Scale of entry: commitment and experience

Modes of entry: A comprehensive model



Step 1: equity vs. non-equity modes

- Non-equity mode: a mode of entry that does not involve owning equity in local firm.
  - A smaller commitment to overseas markets;
  - Often the cornerstone of smaller firms' international strategy
- Equity mode: a mode of entry that involves taking full or partial equity ownership in a local firm.
  - A larger, harder-to-reverse commitments;
  - Often complement entry modes for larger firms.
- The distinction between equity and non-equity modes is what defines a MNE.
- Firms competing especially on the basis of technology, brand names or other intangible assets are likely to use equity modes.
  - Tacit knowledge transfer

Step 2a: choices among non-equity modes

Entry modes	Advantages	Disadvantages
1. Non-equity modes: Exports		
Direct exports	◆ Economies of scale in production concentrated in home country ◆ better control over distribution	◆High transportation costs for bulky products ◆Marketing distance from customers ◆Trade barriers and protectionism
Indirect exports (exporting through domestically based export intermediaries)	◆Concentration of resources on production ◆No need to directly handle export processes	◆Less control over distribution (relative to direct exports) ◆Inability to learn how to compete overseas

Non-equity modes: Contractual agreements

- Licensing/franchising: the licensor/franchisor sells the rights to intellectual property such as patents and know-how to the licensee/franchisee for a loyalty fee.
- Turnkey projects: clients pay contractors to design and construct new facilities and train personnel. At project completion, contractors hand clients the proverbial key to facilities ready for operations.
- Build-operate-transfer (BOT): build a long-term presence by building and then operating a facility for a period pf time before transferring operations to a domestic agency or firm.
- R&D contracts: outsourcing agreements in R&D between firms.
- Co-marketing: efforts among a number of firms to jointly market their products and services.

Step 2a: choices among non-equity modes

Entry modes	Advantages	Disadvantages
2. Non-equity modes: Contractual agreements		
Licensing /Franchising	◆ Low development costs ◆ Low risk in overseas expansion	◆Little control over technology and marketing ◆May create competitors ◆Inability to engage in global coordination
Turnkey projects	◆Ability to earn returns from process technology in countries where FDI is restricted	◆May create efficient competitors ◆Lack of long-term presence
Research and development (R&D) contracts	◆Ability to tap into the best locations for certain innovations at low cost	◆Difficult to negotiate and enforce contracts ◆May nurture innovative competitors ◆May lose core innovation capabilities
Co-marketing	◆Ability to reach more customers	◆Limited coordination

Step 2b: choices among equity modes

Degree of equity control	Internal (organic)	External (acquisitive)
High	Wholly owned greenfield	Full acquisition
Low	Newly created joint venture	Partial acquisition

Resource growth

Step 2b: choices among equity modes

- The resource dimension: make-or-buy decision.
- Greenfield:
  - refers to building new factories and offices from scratch;
  - is preferred by MNEs with competitive advantages grounded in the firm's organizational structure and culture.
- Acquisition:
  - is the most important mode in terms of volume, representing approximately 70% of worldwide FDI flows.

Step 2b: choices among equity modes

Entry modes	Advantages	Disadvantages
3. Equity modes: Wholly owned subsidiaries (WOS)		
Greenfield	◆Design operations to fit the parent ◆Completely equity and operational control ◆ Protection of know-how ◆Ability to coordinate globally	◆Potential political problems and risks ◆High development costs ◆Add new capacity to industry ◆Slow entry speed (relative to acquisitions) and long pay-back periods
Full acquisition	◆Same as greenfield (above) ◆Do not add new capacity ◆Fast entry speed	◆Political sensitivity ◆High up-front capital needs ◆Post-acquisition integration problems

Step 2b: choices among equity modes

- The control dimension:
- Joint venture (JV):
  - refers to a new corporate entity created and jointly owned by two or more parent companies.
  - Minority JV (less than 50% equity), 50/50 JV (equal equity), Majority JV (more than 50% equity).
- JVs are appropriate when three conditions are met:
  - The new business unit depends on resource contributions from two or more firms;
  - High transaction cost inhibit the markets for these resources or for the expected outputs;
  - It’s not feasible for the entire parent firms to be integrated into one firm.

Step 2b: choices among equity modes

- The control dimension:
- Joint venture (JV):
  - Many JVs operate only for a limited lifetime;
  - some JVs are designed for a specific purpose, and are discontinued once this purpose has been achieved.

Step 2b: choices among equity modes

- The control dimension:
- Partial acquisitions:
  - refers to acquisition of an equity stake in another firm.
  - occur in particular:
    - If a seller is unwilling to sell the business in full; or
    - If the previous owner are still needed to run the operation;
    - When MNEs buy out entrepreneurial firms.

Step 2b: choices among equity modes

Entry modes	Advantages	Disadvantages
4. Equity modes: Partially owned subsidiaries		
Joint ventures	◆ Sharing costs, risks, and profits ◆ Access to partners' knowledge and assets ◆ Politically acceptable	◆ Divergent goals and interests of partners ◆ Limited equity and operational control ◆ Difficult to coordinate globally
Partial acquisition	◆ Access to operations that the previous owner is reluctant to give up ◆ Previous owners' continued commitment	◆ Need to restructure and integrate, yet with limited control

Acquisition dynamics

- A single acquisition is often insufficient to create the operation that the foreign investor needs to achieve its objectives.
- Acquisitions are often followed by extensive restructuring and additional investments or divestments.
- Brownfield acquisition: acquisition where subsequent investment overlays the acquired organization
- Multiple acquisition: a strategy based on acquiring and integrating multiple businesses
- Staged acquisition: acquisition where ownership transfer takes place over stages.

Acquisition dynamics

Types	Purpose (example)	Risks
Conventional acquisition	Take over a company that has complementary resources and capabilities	●Not overpaying ●Post-acquisition integration
Brownfield acquisition	Obtain specific asset controlled by another firm, but upgrade it to fit the global operation	●Very high capital investment ●Complex post-acquisition upgrading and integration
Multiple acquisition	Build a strong market share in a previously highly fragmented market	●Very high capital investment ●Integration of multiple local units, as well as integrating them with the global operation
Staged acquisition	Take over a firm whose sellers are unwilling to let go, or where their continued commitment is important	●Integration process with initially limited control ●Uncertainty over long-term ownership structure

Institutions and foreign entry strategies

Types of constraints	Impact of entry mode (examples)	Impact on location (examples)
Certain operations or transactions are not permitted	Establish JVs where WOSs are not permitted	Locate where planning permissions are easier to obtain
Need for local knowledge	Establish JVs to access local knowledge	Locate in agglomerations of foreign investors that help attaining local knowledge
Higher transaction costs due to costly contract enforcement	Avoid complex arm's-length contracts with unfamiliar partners	Locate in areas where local uncertainty is lower
Higher transaction costs due to lack of financial intermediaries	Avoid full or partial acquisitions of local firms	-
Higher tariffs or other trade barriers	-	Locate production in the target market

Scale of entry: commitment and experience

- Scale of entry: the amount of resources committed to entering a foreign market.
- Small firms facing resource constraints typically enter with a small operation that they gradually expand, as suggested by the stage model;
- Resource-rich companies face a strategic choice between a large up-front investment, or with a small foothold operation.

Scale of entry: commitment and experience

- Large-scale entries
  - can help assure local customers and suppliers while detering potential entrants
  - but may limit strategic flexibility elsewhere; and
  - have huge losses if these large scale bets turn out to be wrong
- Small-scale entries
  - are less costly, and focus on learning by doing while limiting the downside risk
  - but may lead to difficulties in building market share and capturing first-mover advantage