Chapter 4

Methods of Entry into Foreign Markets

The first venture of most firms in the international arena is usually more the result of serendipity than of careful planning and thoughtful strategic thinking. The first few sales abroad emerge from a chance contact made at a trade show, an unexpected fax sent after a prospect viewed a domestic sales brochure, or a sales inquiry resulting from an ad in a trade magazine. After a few of these haphazard transactions, the firm then realizes that there may be a substantial market—at least large enough to warrant further consideration—for its products outside their original domestic market, and management starts considering selling on a more systematic basis abroad. The pitfalls usually start at this point. Firms rarely assess correctly the market's characteristics, its potential and, particularly, the advantages and disadvantages of a given method of entry, and instead base their entry strategy on a chance encounter at a trade show with a foreign agent or a distributor, or enter a joint venture with a partner met through casual business acquaintances. Unfortunately, some of those decisions end up being inappropriate: Countless headaches can be avoided if the correct strategy is determined early on, using as many pieces of information as possible.

4.1 Entry Strategy Factors

There are many factors that will influence a company's entry strategy into a foreign market. Some of these factors are related to the characteristics of the market that the firm is targeting, and others are related to the characteristics of the product and of the exporter.

Specifically, the exporter should analyze carefully the following determinant factors:

- **The size of the market:** While there is no easy rule, the method of entry is different for a market in which combined sales amount to €10,000,000 (US $12,500,000) per year and a market that exhibits sales in billions of euros.
- **The growth of the market:** A stable market, growing at a moderate rate, will call for a different entry strategy than one in which there is a substantial potential for growth.
- **The potential market share of the exporter:** A market in which the exporter can become a major player will call for a different strategy than one in which the exporter has no chance to be much more than a niche player.
- **The type of product:** Products with technology and a need for after-sale service and parts will require a different entry strategy than a disposable consumer good.

- **The market strategy of the firm:** Although selfevident, a firm whose strategy is to provide a top-o the-line product will have a different entry strategy than a firm that has chosen to be the lowest co provider.
- **The willingness of the firm to get involved:** Firms that actively want to develop foreign marke should have a different entry strategy than firms that believe that their domestic market is the primary concern and consider foreign sales as "bothersome."
- **The characteristics of the country considered:** The level of development, the infrastructure of th country, the business sophistication of potential trade partners, the overall climate under which bus ness is conducted, the culture of the market, and the culture of customers should all be considered i the decision of an entry strategy.
- **The time horizon considered:** Products that have a short life cycle, or products that are likely t generate a lot of "me-too" competitors, demand a different entry strategy than products that ar patent-protected, or are likely to have a long life cycle or engender a long line of complementar products.

Only after all of these factors are evaluated is it possible for a firm to decide appropriately whic market entry strategy to pursue. Overall, great caution should be exercised in decisions regarding entr strategies: Among all the decisions made by marketers regarding the marketing mix, the distributio decision is the one with the longest time horizon, and the least likely to be quickly adjusted. Not tha product, promotion, and price can be easily adjusted, but a distribution change can be quite an undertak ing, leading to ill feelings and trauma, and therefore the need for a correct initial decision is yet mor critical.

The alternative entry strategies available to a casual exporter will be presented first, followed by thos alternatives available to an active exporter, and then the strategies available to a company willing t manufacture abroad.

4.2 Indirect Exporting

Some firms are unwilling exporters in that they prefer to concentrate on their domestic markets and handl any foreign inquiry as a "difficult sale." As such, they do not like to handle them. Under this banner o "Indirect Exporting," several alternatives are possible, from the lowest level of involvement to some ver moderate interest.

4.2.1 Export Trading Company (ETC)

In the case where a company is unwilling to undertake any of the activities of marketing abroad, the use o an Export Trading Company is the simplest solution. An Export Trading Company (ETC) is an interme diary that will purchase the goods in the exporting country and resell them to a customer in a foreig country.

The dominant ETCs are very large firms, with local offices in numerous countries. The trading companies operate in the following fashion: They take title to the goods in the exporting country, making this transaction a domestic transaction for the "exporter," and transfer title to the "importer" in the importing country, making that transaction a domestic transaction as well. As far as either of the parties dealing with the trading company is concerned, the product is seemingly handled by a domestic company. its foreign origin is not a concern for the buyer, and its sale abroad is not an issue for the seller.

Trading companies were first created in the Netherlands, France, and Britain for trade with India and Indochina. As these trade routes disappeared, new trading companies were founded in Spain and Portugal for commerce with South America; eventually these trade routes also disappeared in the late nineteenth

century. In the twentieth century, trading companies were resurrected in Japan to handle Japan's exporting efforts after World War II. These so-called *sogo shosha* have come to mightily dominate the export trading business: Mitsubishi, Mitsui, Itochu, Marubeni, and Sumitomo. All have sales in the trillions of yen, and trade in all sorts of goods. Mitsui claims to be involved from "noodles to missiles." Because of their presence in all countries of the world, these trading companies have acquired a wealth of information on potential sellers and buyers and they leverage this knowledge into sales. They contact sellers when they are aware of a buyer in some foreign country, and contact buyers when they become aware of a particularly motivated seller. In addition, these trading companies have come to offer a complete "package" of international logistical services; they ship, insure, and finance international trade, and, in some cases, sophisticated traders rely on their services for complex transactions rather than handle them themselves.[1] Their expertise in handling international transactions is unmatched.

Other ETCs are in existence, but they tend to specialize in one geographical area or one product line. However, they still offer the breadth of services that a *sogo shosha* can make available to an exporter; in particular, they take title to the goods in the exporting country. In the United States, since the passage of the Export Trading Companies Act in 1982, a number of firms have been created, all operating on this smaller scale; however, their number is growing and so is their share of the export volume of the United States.[2]

The use of an ETC makes great sense for the novice exporter or the company unwilling or unable to dabble in the complexities of an occasional international transaction. However, should the company decide to become more involved in the long run, choosing an ETC is a poor strategy as the customers abroad are not the customers of the exporter but of the ETC, and may not be known to the exporter. It is unlikely that the ETC will relinquish this information readily if it is no longer profiting from its efforts at developing the market for the exporter's products; it is equally unlikely that the exporter could benefit from the goodwill created by the ETC with its foreign customers as well.

4.2.2 Export Management Corporation (EMC)

Despite the similarity in name, an Export Management Corporation (EMC) is an altogether different type of intermediary. An EMC is typically located in the exporting country and is operating as an export-oriented manufacturer's representative (agent) for the exporter (i.e., it does not take title to the goods but earns a commission on the sale).

Most EMCs are small firms, typically with fewer than fifteen employees. The firms rarely have an office abroad, although they do have contacts with a large number of potential importers, and regularly send employees—or, more likely, the owner of the agency—abroad to visit customers and actively attend trade shows and other promotional activities. EMCs tend to restrict their sales efforts to potential customers in one country and often specialize in selling one line of products in that country. Most of them represent more than one manufacturer abroad, usually in complementary lines.

Because an EMC acts as an agent, the exporter is slightly more involved in the foreign sale than with an ETC; for example, the exporter is responsible for shipping the goods, invoicing the importer, and collecting from him. The degree to which the EMC helps the exporter depends on the relationship they have established with each other and the level of sophistication of the exporter. In general, an EMC helps a lot rather than a little: It acts as the export department of the seller, handling every detail of the transaction, from freight forwarding to insurance and from invoicing to collection. The compensation of the EMC therefore varies in function of its involvement: It either earns a higher commission for handling all of the details of the sale or earns a commission on the sale and fixed fees for the remainder of its efforts. The range of alternative arrangements is such that it is difficult to generalize.[3]

The use of an EMC makes great sense for the novice exporter; by working with an EMC, and by at lea partially managing its foreign accounts, a firm gains substantial insights, which would become quite val able should the company decide to become further involved in export sales. In practice, though, because tl EMC is a small firm and has valuable contacts abroad, it is often absorbed—at least partially—and tran formed into the export department of the exporter. This allows the firm to capitalize on the talent of tl personnel of the EMC and the goodwill it generated abroad.

4.2.3 Piggy-Backing

A third alternative choice exists for a reluctant exporter: it is called "Piggy-Backing" and can refer to one two possible situations:

1. A customer of a firm enters a foreign market by setting up a manufacturing facility. The custom tells its suppliers that they will need to supply parts for assembly and spare parts for custom service. The suppliers therefore end up selling their product abroad, "piggy-backing" on the strate of an existing customer. In some cases, the suppliers develop their own independent sales in th market. This piggy-backing also happens with franchised businesses, which require that the equi ment of the franchises they establish overseas are equipped with exactly the same machinery ar utilize the same supplies worldwide.
2. A successful exporter involves one of its suppliers—or a company that makes a complementa product—in the markets that this exporter has developed. This form of piggy-backing is sometim referred to as collaborative exporting: Nevertheless, there is certainly an imbalance in the ability the two partners, with one particularly competent, the other a novice.

Piggy-backing can sometimes be seen as a passive arrangement (triggered by another firm), at whic point it is difficult to call it a strategy. Nevertheless, should the opportunity present itself, it makes perfe sense for a company to seize it and acquire some knowledge about selling abroad (see Figure 4-1). piggy-backing is initiated by a firm eager to develop its own sales in foreign markets, it is quite a appropriate strategy as the experience gained from the experienced exporter can eventually develop into solid export strategy with the use of agents, distributors, or even sales subsidiaries.

4.3 Active Exporting

Once a firm realizes that it wants to exploit the possibilities that sales abroad can bring, and decides t become involved in its exporting activities, a number of alternatives open up. Under this banner "Active Exporting," several alternatives are possible, differing not only in the level of involvement of th exporter, but also in the strategies pursued by the exporter.

4.3.1 Agent

An agent is usually a small firm or an individual located in the importing country, which acts as manufacturer's representative for the exporter. Therefore an agent does not take title to the goods it sel but earns a commission on the sales it makes. In its relationship with an agent, the exporter is also know as the **principal**. An agent often has several principals, and generally sells a group of complementar products rather than products that compete directly with one another. The agent will handle all of th sales functions for the exporter, from the initial prospecting for customers to the close. The agent usually given varying support by the exporter: Some exporters only provide the bare minimum of a sal brochure and a price list, while the more experienced exporters provide training on the product's chara teristics, analysis on the competitors' products, information on the sales and service philosophy of th

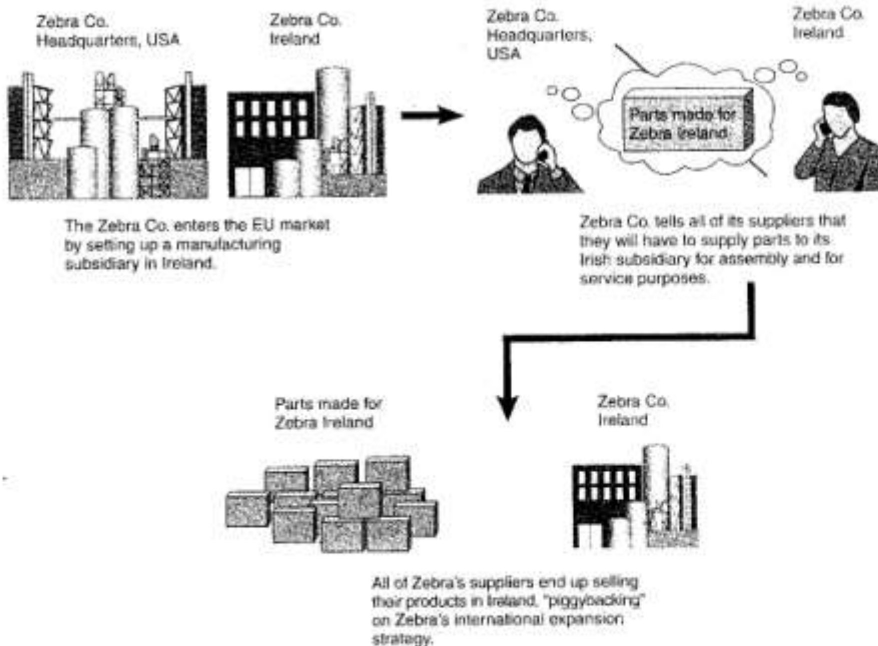

Figure 4-1 *Piggy-Backing*

company, sales support in the form of samples, catalogs (translated or adapted), trade advertising, and financial support to attend trade shows, technical visits by corporate engineers, participation in sales incentive programs, and so on.

Agents, as a whole, like to keep control over their schedule and over their sales approach, but the exporter's support of their efforts is critical to their success and to the extent to which they expend a lot of effort selling the exporter's product. In particular, requests for quotes and *pro-forma* invoices should be handled quite promptly and negotiations on price and delivery done diligently, so as to not delay the agent's sales efforts; time differences sometimes exacerbate the perception of a lack of responsiveness on the part of the exporter.

Sometimes, there is the suggestion that, given a set of guidelines, the agent could be trusted to reach decisions and negotiate with the customer on critical aspects of the sale: price, delivery, terms of trade (see Chapter 6), terms of sale (see Chapter 7), and collection. However, it is critical that all such negotiations be handled by the principal, with the agent acting as an intermediary between the exporter and the importer. If the agent is allowed to negotiate directly with the importer, then the agent is considered by a large number of countries' governments as a **binding agent**, and the exporter is considered to have a permanent establishment in the country of import, with significant taxation implications, specifically taxation of the profits realized on sales in that country. After the sale is concluded between the agent and the importer, all of the other aspects of the transaction, from *pro-forma* invoice to the actual collection, are handled directly and solely by the exporter. Finally, the agent does not get paid until after the exporter has been paid by the importer.

The choice of an agent should obviously be made on a large number of criteria: its ability to represent the exporter and its product accurately, its ability to sell, its contacts, its knowledge of the industry that

the exporter wants to target, the compatibility of its objectives with those of the exporter, and so on. Moreover, the choice of an agent is a long-term commitment; although the contract is often based on one-year increments, the effective duration of a relationship between an exporter and its agents is much longer.

There are several alternative routes to "finding" agents in foreign countries; among the most commonly used methods are trade shows, trade missions, the commercial attache's of the exporter's country's consulates, and contacts with other successful exporters.

The use of an agent is generally driven by several factors,[4] one or more of which can be enough to trigger this strategic decision:

1. When the firm estimates that its potential sales in that market are small (perhaps no more than 5 or 10 percent of its domestic sales), with moderate or no growth potential
2. When the product is not a stock item, but a product specifically designed and made for a particular customer
3. When the product is a very expensive item, such as operating machinery
4. When the company expects a short product life cycle
5. When the product does not require frequent after-sale service
6. When the exporter is unlikely to ever become one of the dominant players in the market and will remain a niche player
7. When the company is reasonably well equipped to handle export sales
8. When the company is not pursuing a "top-of-the-line" strategy, and does not attempt to collect premium prices
9. When the company wants to keep a reasonable amount of control over its prices and delivery policies.

4.3.2 Distributor

A distributor is usually a firm located in the importing country—or, rarely, in a neighboring country—that buys the goods from the exporter. A distributor therefore takes title to the goods it sells and earns a profit on the sales it makes. What characterizes a relationship with a distributor is that there are two sets of invoices: one set of international invoices between the exporter and the distributor, who is also the importer; and a set of domestic invoices between the distributor and its customers, who see these transactions as domestic sales of a foreign product. A distributor is therefore carrying inventory of the exporter's goods, and it also often carries inventory of spare parts and provides after-sale service. A distributor will carry complementary products but also may carry products that compete directly with those of the exporter.

A distributor is taking much more risk in its relationship with the exporter than does an agent and experiences much higher costs. The distributor carries the traditional risks associated with inventory and invests a considerable sum of money in the inventory; should the goods not sell well, the distributor is saddled with the unsold or obsolete goods. In addition, it is traditional for a distributor to participate in the costs of advertising, trade show attendance, and so on. In exchange, the distributor has much more freedom in setting prices, negotiating terms with customers and in managing all matters not directly related to the exporter's trademarks or copyrights. However, there is a large number of exporting firms that attempt to limit these freedoms, specifically on price, in order to maintain as standard a strategy as possible from country to country, and to eliminate or reduce "parallel imports" (see Section 4.5).

A distributor should also be considered a long-term partner. Because it makes a substantial investment in inventory and in the training of its employees, the distributor considers itself involved for a long period of time, and great care should be taken in finding the right partner. The choice of a distributor should be made on a large number of criteria: its ability to represent the exporter and its product accurately, its

ability to invest in the exporter's products, to sell them, and to provide after-sale service, as well as its employees, their contacts, its knowledge of the industry, the compatibility of its objectives with those of the exporter, and so on.

There are several alternative routes to "finding" distributors in foreign countries; among the most commonly used methods are trade shows, trade missions, the commercial attache's of the exporter's country's consulates, and contacts with other successful exporters.

The use of a distributor is generally driven by several factors,[5] one or more of which can be enough to trigger this strategic decision:

1. When the firm estimates that the market is substantial (perhaps 20 or 25 percent of its domestic sales) or when it estimates that there is substantial growth potential
2. When the product is a stock item, and generally not tailored to the needs of a specific customer
3. When the product is a rather moderately priced item
4. When the company expects a fairly long product life cycle
5. When the product requires (frequent) after-sale service and/or maintenance parts
6. When the company estimates it will not become much more than a minor player in the market
7. When the company prefers to handle export sales with only one customer
8. When the company is not pursuing a prestige pricing strategy with premium prices and service
9. When the company is comfortable relinquishing control of its price and delivery terms.

4.3.3 Additional Issues in the Agent-Distributorship Decision

There are two other issues to consider when determining whether an agent or a distributor would be the most appropriate strategy: Both of them are legal in nature. First, some countries will not allow agents at all, or will not allow agents to represent foreign manufacturers, or will mandate a physical after-sale service presence on the country's soil, all requirements that mandate the use of a distributor.

The second issue is more complicated: Most governments make a substantive differentiation in the way agents and distributors are considered by their judicial system. Most often, because agents tend to be individuals or very small firms, many countries have decided to place them under the protection of labor law, the code of laws that deals with the relationships between employers and employees (see Section 5.3.1). In many countries, notably European countries, labor law tends to be very restrictive in terms of what an employer can and cannot impose on an employee and, in those countries in which labor law applies to agents, what an exporter can and cannot require of an agent. For example, even though the principal-agent contract may call for a termination notice of thirty days and no compensation, labor law can call for a six-month notice and six-month loss-of-income compensation and the terms of the contract are overruled. There are similar restrictions on the number of hours worked, the payment of taxes, the legal requirements of certifications, licenses, and so on.

In contrast, distributors, because they tend to be larger and are assumed to be more sophisticated, are covered in almost all countries by contract law. Contract law is much less restrictive and courts tend to render judgments based upon the terms of the contract; the only restrictions are limited to contracts that are obviously biased or coerced, a situation very unlikely to be observed if one of the International Chamber of Commerce model contracts or an equivalent is used.

4.3.4 Marketing Subsidiary

Finally, a firm may decide, rather than to employ an agent or a distributor (over neither of which it has much control), to create its own sales or marketing subsidiary in a foreign country. A marketing subsidiary is a foreign office, staffed by employees of the exporting firm, who will sell its goods in the foreign market.

A subsidiary is incorporated in the foreign market, so it is the importer of record as far as the foreign government is concerned, and the "export" takes place between two legal entities that are part of the same company, at a transfer price. Although transfer prices can sometimes create problems in the process of clearing Customs, the process is very smooth altogether, as the traditional concerns of payment, terms of sale, and terms of trade are eliminated. All sales made by the foreign subsidiary to its customers are domestic sales and therefore are simpler to manage.

The costs of a marketing subsidiary are higher, and a good portion of them are fixed: A building must be rented, an inventory built, and employees hired and trained before measurable sales can offset these expenses. This is in stark contrast with sales through an agent, which are essentially variable cost sales (the commission is only paid if the agent sells) or sales through a distributor, where that distributor is the one bearing the costs of establishing the business in the foreign market. These investments obviously also require a long-term commitment on the part of the exporting firm (see Table 4-1).

Table 4-1 *What is the Correct Entry Strategy?*

Match the description of these responsibilities to an agent, distributor, or marketing subsidiary.	
When the company expects a short product life cycle	
When the product is not a stock item, but a product specifically designed and made for a particular customer	
When the company is not pursuing a "top-of-the-line" strategy, and does not attempt to collect premium prices	
When the firm estimates that sales in the potential market are small, with moderate or no growth potential	
When the product is a rather moderately priced item	
When the company prefers to handle export sales with only one customer	
When the product requires frequent after-sales service and/or maintenance parts	
When the product is technology-driven, with substantial intellectual property content	
When the company expects to become one of the major players in the market	
When the company is exacting premium prices from customers	

The choice of a sales or marketing subsidiary is made when the company wants to retain control over its sales in that country, usually when the company is faced with one or more of the following situations:

1. When the firm estimates that the market potential is considerable (more than 25 percent of its domestic sales) or when it estimates that there is very substantial growth potential or very substantial profits to be made
2. When the product is technologically driven, with substantial intellectual property content
3. When the product is a rather complicated product to sell
4. When the company expects to be involved for the long run, with additional products introduced later on
5. When the product requires sophisticated after-sale service and/or maintenance parts
6. When the company expects to become one of the major players in the market
7. When the company is exacting premium prices from customers
8. When the company is uncomfortable relinquishing control of its products and prices.

4.3.5 Coordinating Direct Export Strategies

It should now seem self-evident that there are two types of factors included in the entry decision for an exporter: those factors that are market-driven and those that are company- or product-driven. Consequently, some firms elect to have a policy to always follow a strategy driven by their product line, and always use a sales subsidiary, or a distributor or an agent. However, some firms decide on a country-by-country basis which strategy is the most appropriate and juggle a combination of agents, distributors, and marketing subsidiaries. Each of these overall strategies have advantages and disadvantages.

When a company chooses to have the same entry strategy in all its export markets, it certainly simplifies the management of its exports and presents a unified front to its customers on all aspects of its marketing. In particular, if the firm uses agents or sales subsidiaries in all countries, its prices are bound to be well coordinated and its after-sale policies clearly controlled. If there are any discrepancies, they are known to the firm and can be clearly managed and understood. A firm choosing to use distributors in all of its markets can exercise the same level of control by using contracts that specify clearly which prices distributors are allowed to charge—a practice that is generally legal or, at least, tolerated—and which after-sale service they must provide. However, there are problems with this "fit-all" strategy, as inappropriate strategies may lead to a poor match with the market: A potentially very lucrative market may be given away to an agent, or a sales subsidiary may have to be established in a small market. Moreover, a firm may have to postpone entry in a lucrative market because of a lack of resources if it adheres to a strategy where it will only build subsidiaries.

When a firm chooses to have different entry strategies in different countries, or when it decides to sell through a series of independent distributors, the coordination of prices and after-sale service is more difficult to achieve, and the possibility of parallel imports (see Section 4.5) looms. However, the most appropriate strategy is chosen for each country, and, generally, the greatest profits can be extracted from the foreign markets.

For a firm, the decision to have a coordinated entry strategy is based on criteria that can be interpreted differently by different management teams. However, there is one significant issue to consider once a choice has been made: The costs of changing from one entry strategy where an exporter uses agents or distributors to a strategy based upon sales subsidiaries can exact a significant toll on all involved parties. The agents and distributors have generally invested a considerable amount of time, money, and talent into building a significant market for the exporter's products, for which they are rightfully compensated according to the terms of the original contract. If they are very successful, the exporter is often tempted to recover these "expenses" (the commissions paid to the agents or the profit opportunities given to the distributor) by establishing a sales subsidiary. This change of strategy should be avoided as much as possible, as it is traumatic for all involved parties and often results in reduced sales and profits for several years: The customers' loyalties usually lie more with the agent or the distributor than with the exporter, and regaining these customers' confidence can take considerable efforts. The slighted distributor can also be strongly tempted to counterattack, in court or otherwise: Some companies can suffer greatly from this change of heart in strategy if the courts are sympathetic to the plight of the local firm;[6] they often are.

4.3.6 Foreign Sales Corporation (FSC)

Foreign sales corporations (FSCs) were created in the United States as a tax break for exporters. It is not a method of entry at all, but rather a way for a United States-based corporation to lower its income tax. The only conditions are that the corporation must export products that have a 50 percent U.S. content and it must incorporate a subsidiary in one of several pre-approved foreign locations, such as the U.S. Virgin Islands, Barbados, or Jamaica. By channeling its export sales through the FSC, the corporation is eligible for a

reduction in its tax rate on profits earned on export sales of fifteen percentage points, from 45 percent 30 percent.[7] It is essentially a tax incentive available to exporters, regardless of the method used export, with the exception of sales though an ETC, because those sales are domestic in nature (s Section 4.2.1).

The European Union brought a complaint to the World Trade Organization (WTO) that the FSC conce was a subsidy to exports, a practice that was prohibited by the agreement, and the WTO ruled against t United States in August 1999. The United States had lost and exhausted all of its appeals by March 20(Nevertheless, the concept of a tax break to exporters is likely to stay, as the U.S. Congress has shown tha was loathe to eliminate it: In 1984, the Domestic International Sales Corporations (DISCs) were found to violating the General Agreement on Tariffs and Trade, and Congress created the FSCs in their pla Similarly, before the United States had exhausted its appeals to the WTO regarding FSCs, the U.S. Cc gress passed the American Job Creation Act of 2004, which created special tax deductions for manufact ing activities that take place in the United States for the purpose of export.[8] If that effort is found to against WTO rules—and it likely will be—the United States could "move to a territorial tax system, and n tax companies' foreign operations, which would be much more beneficial to export[er]s than the curre system of taxing worldwide operations."[9] Such a change in the Tax Code would meet WTO requirement

4.4 Production Abroad

Another alternative to exporting is for a company to start operations abroad; this strategy can be followe for example, when the manufacturing costs are lower abroad, or when the shipping costs are prohibitiv or when domestic manufacturing capacity is reached, or when the product has a significant intangib content, such as in services. Here again, the order in which the alternatives are introduced represents increasing level of involvement for the company interested in penetrating a foreign market.

4.4.1 Subcontracting/Contract Manufacturing

The first alternative is subcontracting—also called contract manufacturing—which occurs when a cor pany enters an agreement with a producer in the foreign market to manufacture its goods. For example, publishing firm may contract with a printing facility to publish its books rather than ship them from i home printing plant. Another example would be a cement manufacturer contracting with local produce to make and package cement under its brand. Yet another would be a supplier to an automobile manufa turer (often called an Original Equipment Manufacturer or an OEM) that contracts with a company provide subassemblies for that OEM's plant in a foreign country.

Contract manufacturing is not truly a method of entry: It is a way to get the product manufactured in foreign country, and the marketing and distribution of the product remains to be organized. This distrib tion can be achieved either through a distributor or a marketing subsidiary, or, very occasionally, throug the marketing channels used by the local contractor.

Contract manufacturing is often sought as a strategy to enter a market in which there are significa barriers to entry, such as high tariffs and quotas, but there is always great difficulty to find a suitab manufacturing facility in such a country: If it has a protectionist streak, it is unlikely to have domest firms that are operating at world standards.

4.4.2 Licensing

Licensing is the granting of rights to **intellectual property** owned by a company to another company for fee. The intellectual property is either a patent on a specific technology, process, design, or product;

trademark; a brand; a copyright; a trade secret; or other know-how, and it remains the property of the **licensor**—the firm granting the license. The company using the intellectual property—the **licensee**—only has the right to use the property, and for every use, it has to pay a fee called a **royalty**. Licensing is quite common in manufacturing, where companies license processes they have developed to other firms, or products such as chemical compounds or molecules.

In an international environment, the licensor is the "exporting" company and the licensee is the foreign company, and the range of intellectual property commonly licensed increases; several companies license their more visible intellectual property—trademarks, copyrights, or designs—to foreign firms. This strategy is followed when the access to the market is limited by high tariffs or nontariff barriers, when the shipping costs are prohibitive, or when the licensor is uninterested in actively pursuing the market.

Licensing, as a strategy, can be quite beneficial to a firm; it does not have to lay out any capital and can generate worldwide income from its intellectual property fairly rapidly. The down side is that intellectual property is not always well protected in some countries, that piracy is rampant in several, and that these risks can be perceived as major deterrents for the owners of intellectual property. However, this is a danger associated more with the ownership of intellectual property than with the strategy of licensing. Should an individual decide to violate a patent or infringe a copyright, s/he certainly does not need a licensing agreement to start: Patent information is available from all patent offices as a matter of course—the U.S. Patent Office has most of its six million patents available online—and copyrights are by definition protecting publicly available products, such as this book and software. To a certain extent, it is probably better to have a local firm enforce its license of a copyright than to attempt to enforce the copyright from abroad.

4.4.3 Franchising

Franchising is, in concept, quite similar to licensing, except that the **franchisor** is granting the rights to a large number of intellectual property items, all bundled in a business package, to a **franchisee** who pays royalties for using this business model. The business model is comprised of trademarks, copyrights, and patents, as well as know-how, training, and methods of operation. Most franchises tend to be retail establishments, because consumers tend to value a uniform product and service and like to find retail names with which they are familiar. Similarly, entrepreneurs abroad like to invest in a business concept with a proven track record, which most franchised businesses have. Finally, franchisors have the opportunity to gain market share without having to invest any capital. It has proven to be a fairly popular means of expansion both domestically and abroad.

Franchising is usually a very good option for a number of businesses seeking expansion abroad, but it certainly is inappropriate for most. The ones who can enter a market successfully are retail operations that involve a service requiring a fairly low level of employee skills, such as fast food restaurants, car repair shops, hotels, and car rental outlets. It is inappropriate for high-skill consulting or advertising services, and nearly impossible for manufactured goods.

One of the consequences of franchising is that this strategy generates a substantial amount of "piggybacking": As the franchisors demand that the franchisees use exactly the same equipment worldwide, the suppliers of those pieces of equipment end up selling worldwide as well. This is also true for items such as signage, furniture, and, in some cases, for consumables: In 1997, for every dollar earned by franchisors in foreign franchising fees, $15 were spent on U.S. products by the franchisees to set up and run their franchised operations.[10]

4.4.4 Joint Venture

With a joint venture (JV), the exporter invests in a facility abroad, but finds one or more partners with which to share the costs of the venture. A joint venture is characterized by the creation of a new corporation in the foreign country, jointly owned by the joint venture partners in any combination of ownership percentages; most joint ventures involving two partners are owned 50 percent–50 percent or 51 percent–49 percent, but they can be held 97 percent–3 percent. Some joint ventures include three or more partners, but they are less frequent.

Entry strategies using joint ventures are generally created for one of several reasons:

1. The firm feels compelled to minimize its exposure in a foreign investment (i.e., the amount of money it has at stake in a foreign country), and it achieves this objective by lowering the investment costs by half or by two-thirds.
2. The firm finds a partner with a complementary line of products to offer to the same market. Both partners feel that a joint effort, with a complete line, is the appropriate strategy, and neither of them is ready to enter the market alone.
3. The firm wants a minority local partner to teach it the local ways of business and help smooth out the many obstacles that a firm is bound to experience in a foreign venture.
4. The firm is legally required to find a local partner by the host government. This requirement was "popular" until the mid-1990s and it has become less of an issue recently. Generally, the local partner was a politically connected individual rather than a partner who brought in additional capital.

The strategy of joint venture was quite popular until the early 1990s for several reasons. First and foremost, this strategy lowered the exposure of firms to the political risk presented by some countries. As early as the 1950s, some developing countries' governments decided that a good way to obtain means of production and create investment capital would be to "nationalize" plants owned by foreign investors. This policy also looked attractive politically, because the local perception was that the natural resources of a country should be managed and owned by its people. Libya, Egypt, Venezuela, and numerous others decided to just seize, without compensation to their actual owners, all of the petroleum production facilities within their borders. Several other countries followed the same policy, nationalizing any type of foreign-owned facility, until the late 1970s; some did it with some form of compensation, most without. The end result of these expropriation policies was clear: Not only did the countries have difficulties in running plants without the expatriate technicians of the nationalized firm, but they also scared away new foreign investors for decades. A joint venture with another firm was therefore a strategy developed to minimize the impact of a possible nationalization. In addition, a joint venture with a politically well-connected local partner was a good strategy for those firms who sought to minimize the probability of nationalization.

Countries who still wanted to create local ownership of capital and had not practiced nationalization found another effective strategy: Their governments asked foreign enterprises who wanted to invest in their country to take on a local businessman as a joint venture partner. These local businessmen were always very well connected but often largely undercapitalized and therefore did not bring anything but their contacts to the venture. In effect, the requirement was a partial nationalization of sorts, as the 100 percent investment that the foreign corporation made was quickly diluted to a 50 percent ownership of the JV. Some of these partnerships ended up being extreme examples of nepotism, such as in Indonesia, where Suharto's relatives were the only possible JV partners.[11] Obviously, the change in government and the prosecution of Suharto could have substantial consequences for these joint ventures. In other cases, the political partners were more of a hindrance than a help, even in dealing with the government, because they had been chosen more for their contacts than their business acumen and some ended up being dishonest; such were the cases

for the respective partners in China of Kimberly-Clark, Borg-Warner, BASF, Potain, and countless others, unfortunately.[12]

However, the greatest problem with joint ventures, and the main reason a large majority of them are unsuccessful, is that they are akin to a marriage in which the spouses change over time. When the joint venture is first created, there is a good fit between all the partners' goals and strategies, and most JVs start well. However, as time goes on, the original management on both sides changes. Some managers might retire or change positions within the firm, one of the original partners may be purchased by a conglomerate, corporate strategies can change, and gradually, the perfect strategic match that created the JV in the first place is gone and partners squabble over the JV's objectives. Eventually, they accuse each other of all ills. The JV between Ford and Volkswagen in Argentina—named Autolatina—failed because the partners' objectives changed as the venture progressed.[13]

Because of all these problems, the strategy of creating joint ventures has become less and less attractive to foreign investors. Some countries have actually retreated and no longer require foreign investors to create a joint venture with a local partner, at least partly because the existence of these policies detracted some highly sought investors from entering their market; for example, Pepsico in India and 3M in China. These countries now routinely allow 100 percent ownership by a foreign entity.

4.4.5 Subsidiary

A subsidiary, also called a Wholly Owned Foreign Enterprise—or a Wholly Owned Foreign Enterprise (WOFE), pronounced "Woofie"—is an investment of 100 percent in a foreign venture by a firm. This strategy is followed by firms who want total control of an investment and are willing to take the risk of such a venture. A WOFE is either a green-field operation, where a foreign firm builds a brand new facility, or an acquisition of an existing firm, which is the preferred method of entry in most European markets, where it represents 56 percent of all foreign investments.[14] There is another alternative, which is still limited in scope but growing, particularly in the developing countries' markets: A firm will relocate an entire plant to a foreign location, usually to use cheaper labor and forgo the higher costs of a brand-new facility. The technology may not be the latest available, but the cost savings may be numerous, especially if the old plant no longer meets the environmental regulations of the exporting country. As the United States does not track export sales of used equipment—the Shipper's Export Declarations (see Section 9.3.3 in Chapter 9) do not distinguish between old and new equipment—the extent of this practice is not fully known, but anecdotal evidence abounds.[15]

The WOFE strategy allows the firm to retain complete control over its investment, which has become the main reason for a firm to choose this form of entry. The firm does not have to share its trade secrets, its know-how, and no one is privy to any of its strategies or policies. The firm does not have to share its profits with anyone else, does not have to rely on anyone else for information on its customers, is free to pull out from a given market if the prospective sales do not become concrete, and so forth.

The WOFE strategy is also often very beneficial to the host country—it creates jobs, for one—and many countries offer substantial incentives to foreign companies willing to establish a facility within their borders: free land, tax abatements of all sorts, training programs, infrastructure improvements, and, if the foreign firm considering the investment is willing to establish itself in a rural or economically depressed area, the incentives can make a WOFE extremely attractive. For example, Ireland put in place an extensive panoply of tax incentives in the 1980s and achieved unprecedented growth and employment in the following decade. Today, Ireland is no longer perceived as an essentially rural country, but as a booming, economically prosperous country with access to the entire European market; its incentive program convinced dozens of firms to invest there.

The drawbacks of a subsidiary strategy are that there is a high cost of setting a facility abroad, and al it is borne by a single firm. However, the firm can use this facility to manufacture goods to be shipped b to the home country or to other markets; for example, having a facility within the European Union give firm duty-free access to the entire Western European market and more favorable duty rates in East Europe than a facility in the United States. The costs can therefore be recovered fairly quickly. Similarly Japanese firm can get duty-free access to the United States and Canada by setting up a facility in Mexi which also enjoys low labor costs.

A wholly owned subsidiary subjects the firm to a high exposure to the risks of investments, althougl is evident that the risks that make a management team worry about its investments abroad are in decli Political risks are becoming less prominent, with yet a greater number of countries solidly in the democra camp, and the economic risks are in decline as well. Except for countries in which there is no real mark for many products, the prospects for a stable economy, a stable government, or, at least, a stable transiti to a new government are very good.

A WOFE also faces the relocation costs if a decision is made to move the production facility to anoth country. Cost may include significant compensation to employees who will be laid off during the locati process. The expenses vary by country and must be considered in the relocation analysis. In 2006, Kra Foods decided to move its subsidiary from Australia to China, and this decision resulted in sever substantial costs.

Finally, a WOFE presents the disadvantage of having to manage in a foreign country without a ver good understanding of local customs and regulations. As a firm invests in a foreign country, it oftentime chooses to have an expatriate manager at its helm; this manager often runs into difficulties that s/he ma have avoided, had the firm elected to have a local partner. For example, the European countries hav countless customs that sound peculiar or even counterproductive to any foreigner, but which local manag ers support heavily: thirty-five-hour workweeks in France, *Mitbestimmung* (co-determination) in Germany late-night work hours in Spain, and so on. These drawbacks can easily be overcome by hiring a competen local general manager.

All of these methods of producing products abroad are summarized in Table 4-2.

Table 4-2 *Production Abroad*

Methods of Production Abroad	
Licensing	Licensing is the granting of rights to intellectual property owned by a company to another company for a fee. Licensing is quite common in manufacturing, where companies license processes they have developed to other firms, or products such as chemical compounds or molecules.
Joint Venture	With a joint venture, the exporter invests in a facility abroad, but finds one or more partners with which to share the costs of the venture.
Contract Manufacturing	Contract manufacturing occurs when a company enters an agreement with a producer in the foreign market to manufacture its goods. For example, a publishing firm may contract with a printing facility to publish its books rather than ship them from its home printing plant.
Franchising	Franchising is, in concept, quite similar to licensing, except that the franchisor is granting the rights to a large number of intellectual property items, all bundled in a business package, to a franchisee who pays royalties for using this business model. Most franchises tend to be retail establishments, like restaurants or bookshops.
Subsidiary	A subsidiary is an investment of 100 percent in a foreign venture by a firm. This strategy is followed by firms who want total control of an investment and are willing to take the risk of such a venture.

4.5 PARALLEL IMPORTS

One of the greatest problems faced by a firm involved in several markets is the risk of parallel imports, which is particularly acute if the firm has relinquished some control over its goods' prices; for example, by using distributors.

Parallel imports—or **gray market** goods—are goods that are sold outside the regular distribution channels of a company, usually because there is a discrepancy between the price charged in one country and the price charged in another. Gray market goods are not counterfeit or shoddy goods: They are the legitimate items, but are sold outside the channel chosen by the company (see Figure 4-2). For example, an item such as shampoo may sell at different prices in Germany and in Spain: For whatever reason, the Spanish version of a brand is significantly cheaper. An entrepreneur buys some shampoo in Spain, ships it to Germany, and sells it through a discount store. The price paid by a consumer in Germany for the Spanish version of the product ends up being lower than the price of the German version; because the sale is "outside" of the regular channel of distribution, it is considered a parallel import. The legitimate retailer in Germany is not happy to be undersold and the shampoo manufacturer has lost some control over the marketing of its products.

Figure 4-2 *The Gray Market*

Parallel imports occur in all sorts of product lines, from shampoo to cars to spare parts; however, it is a particularly sensitive issue in luxury goods, such as watches, electronics, and high-end automobiles. While there are ways to combat parallel imports, which can be found in any good textbook in international marketing, the best strategy is to avoid having discrepancies in prices from one country to another, which usually means that the firm must have a coherent entry strategy.

On a final note, there is no legal recourse possible, as the product is a legitimate product, manufactured by an authorized plant. The Supreme Court of the United States affirmed this point recently: Once a firm has sold a product, it has no right to keep on controlling it. In Justice John Paul Stephens' words: "The whole point [. . .] is that once the copyright owner places a copyrighted material in the stream of commerce by selling it, it has exhausted its exclusive statutory right to control its distribution."[16] The U.S. Customs Service will not stop gray market goods unless they are different from the goods sold by the traditional distribution channel in the United States; for example, products with a different chemical composition under the same brand name to satisfy foreign requirements or consumer tastes abroad.[17] Other countries have taken similar stances.

4.6 Counterfeit Goods

One other significant issue when a firm starts to expand abroad is that it increases the probability that unscrupulous competitors—and sometimes partners—will manufacture and distribute counterfeit goods that mimic the original products. **Counterfeit goods** are copies of the original products, sold under the same (or a very similar) brand name, are generally of lower quality, and are sold at much lower prices than the original. Most of the time, the purchasers are well aware that they are not purchasing the genuine product, but do not feel that they are doing anything wrong: They are intent on saving money or are interested in obtaining the status that the brand conveys, but without paying for it.

Counterfeiting activities generally happen when there is a substantial discrepancy between the variable cost of manufacturing the product and the price at which it sells. Counterfeits are therefore abundant in the software and in the entertainment industries; a DVD of a movie or a CD of a software program can be reproduced for a few pennies, but sell for much more.[18] Counterfeit activities are also common in luxury goods (handbags, watches, clothing),[19] pharmaceutical drugs,[20] and cigarettes,[21] all of which exhibit the same characteristics: low manufacturing costs and high selling prices. The probability increases further if the product is physically small and light enough that it can be sold easily and "discreetly" on the streets: Sidewalk peddlers constitute the most common "distribution channel" for counterfeit goods.

The existence of such counterfeiting activity is not dependent on the method of entry chosen. Whether a firm enters a foreign market through licensing, contract manufacturing, or a wholly owned subsidiary does not matter. Counterfeit manufacturing is generally present in countries in which government authorities have other priorities than defending the intellectual property rights of (foreign) firms. The countries of China and India are often the countries that are most commonly accused of ignoring counterfeiting activities, but they are just the more visible targets. Counterfeiting happens in just about any country in the world.

Since about 2003, many countries have started to crack down seriously on counterfeiting; there are several reasons for that policy. The governments of those countries have realized that counterfeiting is not a crime that just affects the profits of foreign firms, it also affects the health of their citizens, such as when they purchase counterfeit and dangerous pharmaceutical products,[22] it hurts their legitimate entrepreneurs who have intellectual property to protect,[23] and it sometimes hurt the interests of the state itself. China, for example, is cracking down on manufacturers of goods that use a counterfeit 2008 Beijing Olympics logo.[24] However, the task remains daunting; counterfeiting is difficult to prosecute and most consumers—as well as local law enforcement officials who are also consumers—see counterfeiting as a crime that benefits them[25] and only hurts the large foreign corporations with which they do not empathize.

4.7 Other Issues in Methods of Entry

4.7.1 Foreign Trade Zones (FTZ)

Foreign Trade Zones (FTZs) are areas of a country that have acquired a special Customs status, with the specific purpose of encouraging foreign investments and exports. Effectively, a Foreign Trade Zone – sometimes also called a Free Trade Zone—is an area of a country that is, for Customs purposes, still "outside" of the country; goods can be shipped to the FTZ without being subject to duty and quotas. Once in the FTZ, the goods can be transformed, assembled, repackaged, and so on. If the goods are re-exported, they never pay duty in the host country in which the FTZ is located; if they are sold in the host country, it is only after leaving the FTZ that they have to pay duty.

FTZs exist in one form or another in just about every country. Some countries use them aggressively to encourage foreign investments by allowing just about any economic activity within the zone, including manufacturing; goods come in the trade zone duty-free; are transformed in the zone into a final product,

creating jobs in the host country; and the product is then re-exported abroad or in the host country. In China, for example, there were 11,900 foreign firms and 5,900 Chinese firms in FTZs in 1996, and they represented a substantial proportion of the total Chinese export activity.[26]

FTZs are particularly attractive to a manufacturer if the host country has a so-called "inverted tariff structure" (i.e., the tariffs charged on parts are higher than the tariffs charged on the final product).[27] FTZs can also be quite advantageous to hold a good in inventory until sold, or to wait for a numerical quota to open. However, in view of the progress made in the last few years by the WTO to lead countries to lower tariffs and increase trade, FTZs may have a limited future because their advantages are dwindling. Nevertheless, they remain attractive and should be considered as a possible alternative site for a foreign investment, whether a sales subsidiary, a joint venture, or a WOFE.

4.7.2 Maquiladoras

Maquiladoras are companies in the country of Mexico with a Customs status similar to the status of an FTZ located both in Mexico and in the United States. They can import goods from the United States duty-free, transform these goods by assembling them into products, and then re-export them to the United States, where the goods are only assessed duty on the value added in Mexico. Originally, maquiladora status could only be obtained in a geographic band located just south of Mexico's border with the United States, but it was expanded to the remainder of the country in the late 1980s. Today, with the completion of the North American Free Trade Agreement (NAFTA), maquiladoras have limited attractiveness to a foreign investor, but this alternative is still available.

4.7.3 Foreign Corrupt Practices Act

One of the last aspects of significant concern in the creation of a method of entry in a foreign country is the fact that business practices in some countries tend to include corruption and bribery. The Organization for Economic Cooperation and Development (OECD) has tried to ban such practices by developing its Anti-Bribery Convention (ABC), which thirty-six countries had ratified by June 2006. One aspect of the Convention is that it asks the developed countries' governments to cease the practice of letting firms deduct bribery as a business expense; as of July 2006, all but one OECD country prohibited the tax deduction of bribes to foreign officials. However, the United States is one of the few countries to have passed a punitive Foreign Corrupt Practices Act (FCPA), which heavily fines companies that are caught using bribery to gain access to some contracts. Several countries have incorporated in their legislation anti-bribery laws that extend beyond the prohibition of bribes directed at foreign government officials.[28]

The FCPA is far-reaching and prohibits "all officers and employees and anyone else acting on behalf of the firm and its subsidiaries [from] offer[ing] any payments, direct or indirect, or through a third party, to government officials in return for getting or keeping business."[29] This includes payments made by an agent to a foreign official, or "special incentives" given to a well-connected partner in exchange for having won a contract: Anything that is not contractual is suspect. The U.S. government prosecutes any firm in the United States that it thinks has violated the law, whether it knew of the practice or not, and fines can run in the millions of U.S. dollars.

The FCPA and the ABC are attempts by the developed countries' governments to "clean up" business practices abroad and prevent firms from being subject to extortion by corrupt foreign government officials. So far, there seems to be minimal evidence that these efforts have been effective, but they have taught foreign officials that it was useless to attempt to request bribes from developed countries' companies, and, in that respect, these efforts have worked. There is substantial grumbling, though, in the export community that the FCPA and the ABC have cost developed countries' exporters billions of dollars in lost business to foreign competitors that are unimpeded by these laws and can deduct bribes as a business expense.[30]

From a practical standpoint, for any exporter, the rules are fairly simple: Business abroad must be conducted above board and remain within the boundaries set in the original agency or distributorship contracts. The only things that the FCPA and the ABC will tolerate is "facilitating payments for routine government actions," such as obtaining permits, speeding up telephone installation, and clearing Customs.[31]

Review and Discussion Questions

1. What are the principal differences between an agent and a distributor?
2. What are the different methods of entry regrouped under the term "Indirect Export"?
3. Using a product of your choice and a country of your choice, determine what would be the best method of entry for an exporter interested in that market. Justify your decision using the guidelines provided in the chapter.
4. Why would a company decide to franchise abroad?
5. What advantages would a foreign trade zone represent for an importer/exporter?
6. What are the advantages and disadvantages of using a subsidiary rather than a joint venture for a firm interested in manufacturing abroad?